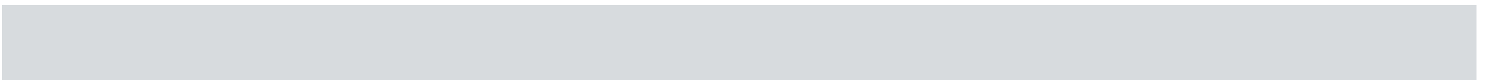
COMMERZBANK
Finance & Covered Bond S.A.

COMMERZBANK
Group

Annual Report 2017



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Management Report

1 Management Report

Economic conditions in 2017

In 2017, the global economy recorded the strongest growth it had seen since 2011. Emerging markets provided significant momentum. After a deep recession, Russia and Brazil returned to the growth track. The fact that the growth slowdown seen in China the year before was not sustained also helped. The Chinese economy actually grew even more strongly than in 2016, by 6.9%.

The industrialised countries also noticeably picked up speed in 2017. In the USA, growth was clearly higher than in 2016 at 2.3%. The unemployment rate is now lower than it was before the deep recession of 2007–09. Against this backdrop, the Federal Reserve decided in 2017 to raise the target range for key interest rates by a further 75 basis points to 1.25%–1.50%, and also started to slowly run down its holdings of securities.

The eurozone also noticeably picked up speed in 2017. Growth was even stronger than in the USA, at 2.5%. The expansive monetary policy of the European Central Bank (ECB) is having an increasingly powerful effect on the real economy. At the same time, the eurozone economy is profiting from lively global demand. Thanks to this growth, the situation on the labour market has continued to significantly improve, with the unemployment rate falling from 9.7% at the end of 2016 to 8.7% in December 2017. Despite the tighter supply of available labour, wages rose only very modestly in 2017. Accordingly, there was no change in the low underlying inflation.

The core inflation rate, i.e. the year-on-year rate of the consumer price index excluding highly volatile food and energy prices, continues to fluctuate around 1%. The subdued inflationary outlook led the ECB to extend its bond purchase programme until September 2018. However, since the start of the year it has only been buying €30bn, half as much as before. The ECB also decided to fully reinvest the proceeds of maturing securities even after the programme has ended.

The German economy grew slightly more strongly in 2017 (2.2%) than it did in 2016 (1.9%). Adjusting for the different number of working days, the increase was as much as 2.5%. Unemployment at year-begin was a seasonally adjusted 5.4%, the lowest level since German reunification. The economy was mainly bolstered by stronger investment and higher export growth.

Financial markets were once again dominated in 2017 by the extremely loose monetary policies pursued by the leading central banks. Investors continued to rush into riskier forms of investment such as equities, corporate bonds and the government bonds of periphery countries.

Future economic situation in 2018

The development of the global economy in 2018 will be determined by geopolitical risks as well as the economic development of emerging markets. The spotlight here remains on China, where growth will probably slow somewhat. Firstly, the important construction sector in China will expand less rapidly as real estate prices are hardly rising any more; secondly, heavily indebted companies (mainly state-owned ones) will boost their investments at a lower rate. The upturn in countries whose exports are dominated by raw materials, by contrast, will continue to gain in strength.

In the USA there is every chance that the expansion which has been under way for more than eight years will continue in 2018. Private consumption will again rise sharply, driven by rising employment and accelerating wage growth. The same applies to corporate investment, which is being buoyed by promising sales prospects. In addition, the stronger crude oil price will again provide impetus to capital expenditure in oil and gas production. US exports will probably rise as fast in 2018 as they did in 2017. To date, the fears of a trade war which emerged during the US presidential election campaign have not been realised. Further support is likely to come from the tax cuts which have been approved, benefiting both companies and employees.

The US economy is set to grow by 2.7% in 2018, again faster than production potential. The already low unemployment rate will decline further. This will confirm the Federal Reserve in its expectation that core inflation (inflation excluding food and energy) is heading up towards 2% again. We therefore assume that they will raise benchmark interest rates in 2018, by a total of 100 basis points.

Real gross domestic product – change from previous year	2017	2018	2019
USA	2.3%	2.7%	2.3%
Eurozone	2.5%	2.5%	2.3%
Germany	2.2%	2.5%	1.8%
Central and Eastern Europe	3.8%	3.4%	3.0%

The figures for 2018 and 2019 are all Commerzbank forecasts.

A very powerful recovery is underway in the eurozone, which only a change of direction by the ECB would put at risk. There is no sign of this on the horizon. The ECB halved its bond purchases at the start of the year, and will only buy €30bn of securities per month until September, gradually ceasing altogether after that. But that does not mean the end of loose monetary policy. The ECB deposit rate is likely to remain at –0.4% for a considerable time. Low interest rates are making the still high debt levels of many companies and households more sustainable.

The solid economic growth will drive unemployment down further, but this will probably have little impact on the weak trend in wages so underlying inflation will also remain weak.

The UK's vote in favour of leaving the EU will have no further impact on the eurozone economy. For one thing, it will probably be several years before the UK actually leaves the internal market. We also anticipate that it will ultimately reach an agreement with the EU that minimises the economic disruption.

The German economy looks set to grow about as fast in 2018 as it did last year, once adjusted for the different number of working days. On an unadjusted basis, the rise will be 2.5%, driven by vigorous investment activity. Consumption should post sound growth once again. Slightly higher wage increases and a continued strong rise in employment are still giving a powerful boost to employees' household income. Domestic demand is not the only source of support, though. The German economy will continue to benefit from lively global demand.

It is worthy of note, however, that unit labour costs at German companies have been rising faster than in the rest of the currency union for several years now. And in the property market, low interest rates are driving up prices, especially in the major cities.

The US interest rate reversal and the continuation of the ECB's highly expansive monetary policy will once again shape the financial markets in 2018. The end to ECB bond purchases will not have any major upward impact on the yield of ten-year German government bonds. The bull run on equity markets is not yet over, although volatility is likely to rise. The current financial year is set to be a good one for equity investors once again. The healthy economy is causing corporate earnings to rise. The persistently loose monetary policy is also supportive of equity valuations. The euro/dollar exchange rate looks set to weaken in 2018, as the Fed will probably hike its benchmark rates more than the markets currently expect.

Exchange rates	31.12.2017	31.12.2018	31.12.2019
Euro/US-dollar	1.20	1.18	1.26
Euro/Sterling	0.88	0.88	0.92
Euro/CHF	1.20	1.14	1.18

The figures for 2018 and 2019 are all Commerzbank forecasts.

Significant events in 2017

Mr Ansgar Herkert stepped down as a member of the Board of Directors with effect from 30 June 2017. The Board of Directors appointed Mr Arno Kratky to replace him as at 1 July 2017. Mr Kratky was officially appointed by the Extraordinary General Meeting on 25 September 2017.

As part of its regular review, Moody's updated Commerzbank Finance & Covered Bond S.A.'s issuer rating on 16 August 2017 (Baa1, outlook stable). This rating upgrade is based on the letter of support from Commerzbank AG and the strong organisational integration of Commerzbank Finance & Covered Bond S.A. in the Commerzbank Group.

In connection with the IFRS 9 conversion, in 2017 the Commerzbank Group decided to allocate the LOBO portfolio to the residual business model. Commerzbank Finance & Covered Bond S.A. will also implement this accounting decision in its separate financial statements. The initial application effect resulting from the reporting of the LOBO portfolio at fair value in accordance with IFRS 9 creates the need for write-downs of at least £1.0bn (around €1.1bn), which had a negative effect on the equity capital of Commerzbank Finance & Covered Bond S.A. as at 1 January 2018. In order to meet regulatory capital requirements (minimum requirements, SREP requirements and large exposure limits), the parent company had to implement a capital increase of €1.0bn. The decision to implement a capital increase was executed by the shareholder Commerzbank AG in the form of an immediate

payment into the capital reserve on 21 December 2017. This increased the CET 1 ratio of Commerzbank Finance & Covered Bond S.A. without creating new capital instruments in accordance with Art. 26, para. 1 a) of the Capital Requirements Regulation (CRR).

The payment into the capital reserve therefore fell under Other reserves pursuant to Art. 26, para.1 e) CRR. As the capital was immediately available to cover risks and losses, this satisfied the requirement pursuant to Art. 26, para. 1 (2) CRR and a separate regulatory review/ petition in accordance with Art. 26, para. 3 CRR was not necessary after also consulting the ECB.

In December 2017, securities lending was introduced as a new product at Commerzbank Finance & Covered Bond S.A. in order to manage the bank more flexibly with regard to regulatory requirements. In December 2017, repo transactions in the amount of €3.121m were replaced by securities lending. The investment of excess liquidity at Commerzbank AG in the amount of €2.190m, which had been generated in connection with the original repos concluded at Commerzbank Finance & Covered Bond S.A., was also discontinued ahead of schedule due to the termination of repo transactions, resulting in a reduction of the balance sheet, RWA savings and a decrease in the bank levy.

With the ECB's SREP resolution dated 19 December 2017, the Bank was informed that it would be allocated to the key Group subsidiaries in the Commerzbank Group which are subject to supervision on a consolidated basis in accordance with Ordinance (EU) No. 575/2013. The ECB resolutions dated 4 December 2015 concerning regulatory requirements at the level of individual institutions and dated 8 December 2016 on the separate capital adequacy requirement were thus nullified. Nevertheless, the Bank must comply at all times with the equity and liquidity requirements in accordance with the provisions of the ECB and the supplementary Luxembourg provisions.

The audit mandate for financial year 2018, which had to date been held by the audit firm PricewaterhouseCoopers Luxembourg, was publicly tendered and awarded in the second quarter of 2017 in accordance with Ordinance (EU) No. 537/2014 and pursuant to the rotation regulations stipulated in Art. 17. Consequently, the audit firm Ernst & Young will assume the mandate as the new auditor beginning with Group reporting in the first quarter of 2018.

Net assets and financial position

Liquidity was maintained throughout 2017. During the year, the Bank complied with its obligations to the Banque Centrale du Luxembourg (BCL) in respect of minimum reserves and the equity and liquidity requirements imposed by the banking supervisor (SREP requirements).

Commerzbank Finance & Covered Bond S.A. is not currently planning to issue any new Lettres de gage. Future funding requirements are being reduced by the sale of assets and covered by repo transactions and internal, unsecured refinancing transactions.

Capital

Including reserves and regulatory deductions, the Bank's Common Equity Tier 1 capital amounts to €2,049m (31 December 2016: €1,118m). Together with the eligible Tier 2 capital, the Bank has a total regulatory capital base of €2,062m (31 December 2016: €1,132m). As at 31 December 2017, the capital adequacy ratio under CRR/CRD IV (CoRep) was 67.09% (31 December 2016: 29.47%).

Areas of activity

As a financial institution with a special banking licence, Commerzbank Finance & Covered Bond S.A. is entitled to carry on all activities specified in Art. 12-2 of the Luxembourg Law on Lettres de Gage of 21 November 1997 as most recently amended, including agency business and fiduciary notes as accessory business. The Bank conducted no other types of business as defined by law during 2017. The Bank only does business with counterparties within the Group when it comes to any transactions affecting liquidity.

Public-sector loans

Total lending to customers was reduced by a nominal €2,161m over the course of the year from a nominal €11,408m as at the end of 2016 to €9,247m as at 31 December 2017. This amount includes €687.9m in scheduled maturities and around €665.4m (at year-end exchange rates) in sales and currency effects.

As at year-end Commerzbank Finance & Covered Bond S.A.'s exposure to GIIPS countries amounted to a nominal €2,042.4m (31 December 2016: nominal €2,674.4m).

The Bank is exposed to risks arising from the current level of public-sector debt, albeit to a lesser extent than in previous years. As at 31 December 2017 the Bank had an exposure of a nominal €2,042.4m (31 December 2016: €2,455.2m) to GIIPS countries excluding Ireland and Greece; this was comprised of exposure to the Republic of Italy (€1,140.5m), to the Kingdom of Spain (€463.3m) and to the Republic of Portugal (€438.6m). Further details may be found in the credit risk report.

Both this and other upheavals on the capital markets gave rise to the significantly negative revaluation reserve on available-for-sale (AfS) financial assets of €–169m and the high hidden liabilities of €1,575m arising from the difference between carrying amount and market value in loans and receivables (LaR).

The Bank applies the Commerzbank Group's internal certified rating procedure, which is subject to constant review, recalibration and validation. The internal rating system indicates that the proportion of assets with a rating of AA– or better fell from 39.6% of the total loan portfolio as at 31 December 2016 to 36.0% as at 31 December 2017. In contrast to the preceding year, the proportion of investment-grade exposures (as rated using the internal system) only changed slightly as at 31 December 2017 (89.6%). Over the past year the ongoing portfolio reduction once again resulted in a change to the debtor structure, and so had an effect on the breakdown of the credit portfolio by rating.

Lending policy

Following a resolution of the full Board of Managing Directors in November 2015, Commerzbank Finance & Covered Bond S.A. was spun off as a legal entity from Asset & Capital Recovery in 2016. Since then the Bank has been legally independent under the global functional leadership of Group Management Treasury, in whose strategy it is integrated and to which it reports.

At the Bank's request, the CSSF has approved the complete exemption of risks in respect of Group entities when calculating large exposures, in accordance with Part XVI paragraph 24 of Circular CSSF 06/273 as amended. This exemption is also valid under CRR/CRD IV.

Internal Governance: amended circular CSSF 12/552

Commerzbank Finance & Covered Bond S.A. has complied with all the requirements imposed on it by the current version of circular CSSF 12/552, within the bounds of the proportionality principle. The qualifications of the members of the Board of Directors and the management were examined and confirmed.

The Board of Directors and management have drawn up guidelines to make the work of their key functions transparent and prevent conflicts of interest.

The internal governance policy compiled by Commerzbank Finance & Covered Bond S.A. brings together the circulars of relevance to the Bank and prevents redundancies.

The internal control system

Commerzbank Finance & Covered Bond S.A.'s internal control system is based on the methodology of Commerzbank AG and hence derived from the international "COSO I" framework developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). It aims to ensure: a) the effectiveness and efficiency of business processes, b) compliance with laws and regulations currently in force and c) the reliability of financial reporting.

It includes the three lines of defence required for an effective control system, as defined by the latest version of CSSF Circular 12/552.

Internal Audit reviews the appropriateness and efficiency of central administration, management and risk management. It supports management in optimising business activities in order to minimise the associated risks.

It conducts regular audits as required by law and internal rules, examining

- Compliance with laws, regulations and CSSF requirements
- The effectiveness and efficiency of internal controls
- The organisation of the administration and accounting functions
- The separation of functions and the conduct of business

- The recording of transactions and the accuracy and meaningfulness of financial statements
- The maintenance of liquidity reserves and capital adequacy
- Appropriate risk management
- The efficiency of the compliance and risk control functions
- Key functions

Appointments to the key functions of Chief Risk Officer, Chief Compliance Officer and Chief Internal Auditor are permanent and for an unlimited period. Commerzbank Finance & Covered Bond S.A. has outsourced the function of Chief Internal Auditor, while the two other functions remain in-house. All three function holders possess the required competences and enjoy direct access to the Board of Directors, the CSSF and the auditors and regularly, at least once a year, submit summary reports to them on what they do and how they work.

Risk measurement

Commerzbank Finance & Covered Bond S.A.'s internal governance regulations, which cover in particular strategies and policies applicable to equity and liquidity reserves, must clearly reflect the whole range of its various risks. The Bank determines in particular its capacity for the risks it takes on.

Authority to determine the methods and parameters for the risk measurement programmes rests with Commerzbank AG. It is, however, ensured that Commerzbank Finance & Covered Bond S.A. has a full overview of all its risks.

Internal limits are set by Commerzbank AG. These are assigned internal "sub-limits" (e.g. product, currency, etc.) by Commerzbank Finance & Covered Bond S.A. and are monitored on a day-to-day basis. Levels and channels for escalation have been put in place.

Further information may be found in the separate and enclosed risk report (Section 6) which forms part of the Management Report.

Internal controls and risk management during compilation of financial data

The Bank has the processes and control systems required to compile financial information. Accounting is outsourced under service level agreements to Commerzbank AG, Luxembourg branch, whose Finance department performs the relevant functions.

Transactions are entered in the IT system on a daily basis. The required general ledgers and order books are maintained. The chart of accounts is designed to meet the Bank's requirements and enable accounts to be accurately allocated in accordance with the reporting templates for credit institutions. Internal and dormant accounts are reconciled regularly. Automated and standardised processes applied throughout the Group are used for most valuations.

In addition to daily closing balances, monthly balances are also generated, largely by automated processes but with manual adjustments in some areas. Weekly internal reports are

generated to keep management informed about the Bank's financial position and earnings performance. These reports are based on the transaction data stored in the IT system and prepared in line with information requirements.

Personnel report

As at the end of the 2017 financial year Commerzbank Finance & Covered Bond S.A. had 12 employees (31 December 2016: 14 employees), 5 of whom were female and 7 male (31 December 2016: 6 female and 8 male).

Commerzbank Finance & Covered Bond S.A. has implemented CSSF circular 2010/437 "Guidelines on remuneration policy in the financial sector". Allowing for the requirements of its organisational structure, the Bank has adopted in full the remuneration system of Commerzbank AG, which has been agreed with the German Federal Financial Supervisory Authority (BaFin) and the Financial Market Stabilisation Fund (SoFFin).

Organisation

The Board of Directors of Commerzbank Finance & Covered Bond S.A. oversees the accounting process and ensures it complies with current legislation, guidelines and regulations. As required by regulations, Group Audit produces summary reports during the year on audit work and the material findings emerging from it.

The allocation of responsibilities is set out clearly in Commerzbank Finance & Covered Bond S.A.'s business allocation plan. The Asset Liability Management, Credit Risk Management and Analytics & Regulatory Issues departments are permanent features of the Bank's structure. In the past, in the interests of ensuring operational stability, essential functionalities were outsourced to the Commerzbank Group under service level agreements. The work done is regularly reviewed and evaluated as part of outsourcing controlling. This process also considers any further outsourcings that might have occurred. Where necessary, all organisational changes are agreed with the ECB (via the local regulator, the CSSF).

Service level agreements have been under continual development and continue to be so.

The Bank has no subsidiaries or branches.

Commerzbank Finance & Covered Bond S.A., together with other Luxembourg companies belonging to the Commerzbank Group, has, since 2011, constituted a tax group for corporation and business tax purposes. The parent company is the Luxembourg branch of Commerzbank AG.

Commerzbank Finance & Covered Bond S.A. does not conduct any research or development.

No treasury shares were acquired during the financial year and Commerzbank Finance & Covered Bond S.A. held no treasury shares as at the reporting date.

Earnings performance

At the end of the reporting period, net interest and commission income was €–2.4m, after €32.4m the previous year. Adjusted for one-off effects, in particular from the net loss on the sale of loans and receivables in the amount of €–8.6m and the repurchase of own liabilities in the amount of €+1.4m, net interest income was €–1.3m (31 December 2016: €10.6m). In loan loss provisions, income of €0.6m (31 December 2016: €0.6m) was mainly attributable to reversals of general loan loss provisions on promissory note loans. Net commission income was €+6.0m, compared with €+4.0m the previous year. Net income from hedge accounting, which includes the net remeasurement gain or loss from using hedge accounting under IAS 39, was €–8.4m (31 December 2016: €+3.2m).

The Bank's net trading income in 2017 was €–70.6m (31 December 2016: €+45.0m). Income from financial investments was €–2.0m (31 December 2016: €11.4m). The Bank's operating expenses rose by 14.2% to €24.6m (31 December 2016: €21.5m).

Overall, negative net trading income in particular resulted in a negative result before taxes of €–105.2 (31 December 2016: €+72.8m).

There was a loss after taxes of €-83.6m (31 December 2016: €+58.8m).

Total assets

The Bank's total assets fell to €14.7bn, down €-2.9bn (–16.4%) from 31 December 2016.

Proposal for appropriation of profit

A proposal will be put to the Annual General Meeting on 24 April 2018 that the balance sheet as at 31 December 2017 and the statement of comprehensive income for 2017 be approved and that the loss for 2017 of €83,643,876.13 be offset as follows:

Withdrawal from retained earnings of €83,643,876.13.

Summary of business performance in 2017

The Board of Directors has taken note of the business performance of Commerzbank Finance & Covered Bond S.A. in view of the challenging market environment in 2017.

Report on events after the reporting period and outlook and opportunities report

Report on events after the reporting period

There have been no other events of particular significance since the end of 2017 with the exception of those already described in the section entitled "Significant events in 2017".

Outlook and opportunities report

The outlook and opportunities report covers expectations and forecasts for the future. These forward-looking statements are founded on planning assumptions and estimates derived from all the information available to the Bank as of the date on which the annual financial statements for 2017 were finalised.

Commerzbank Finance & Covered Bond S.A. accepts no obligation to revise these statements in the light of either new information or future events. Forward-looking statements are always subject to risks and uncertainties. For that reason, actual results and performance may differ substantially from those forecast now. Such differences may result above all from changes to the general economic situation and the competitive situation, as well as from developments on the international capital markets. The Bank's results may also be affected by defaults on the part of borrowers or counterparties to transactions, changes to legislation in Luxembourg and abroad, especially as regards tax rules, as well as other risks, some of which are set out in detail in the risk report.

As a general rule, the Bank only does business with counterparties within the Group. This rule also applies to secured and unsecured borrowings in euro and other currencies. Liquidity requirements for the short and long term are analysed, with changes resulting from asset sales or repurchases of Lettres de gage taken into account accordingly. Liquidity risks and adherence to limits are monitored daily by the Market Risk department.

Forecast

The targeted reduction in risk-weighted assets (RWA) will have a major influence on the trend in key management figures. However, lower ratings in the portfolio and the associated increase in impairments may have an adverse effect on capital ratios. Interest income will fall permanently as a consequence of the reduced portfolio volume. The agency business is expected to continue generating stable commission income in future and the repurchase of liabilities may have positive effects. Future sales may result in further charges, and this may be reflected in the income from financial investments. Commerzbank Finance & Covered Bond S.A. takes this into account where disposals appear sensible as part of managing the portfolio with an awareness of risk and in such a way as to preserve capital. Write-downs on lending cannot be completely ruled out. Measurement effects in net trading income may result in volatility. Operating expenses are expected to remain at the same level as last year. Risks arising from changed conditions and the sovereign debt crisis will continue to have an impact on the Bank's business operations into the future.

The requirements associated with the introduction of IFRS 9 (see Section 5.3 of the Notes) have been met. In particular, reference is made here to the initial application effect of IFRS 9 in 2018.

For 2018, the corporate structure of Commerzbank Finance & Covered Bond S.A. is expected to be converted from a one-tier system to a two-tier system.

Acknowledgements

The Bank wishes to thank all employees, managers and governing bodies of Commerzbank Finance & Covered Bond S.A., not forgetting of course all the employees at Commerzbank Group who work for it. Their constructive and loyal cooperation has helped Commerzbank Finance & Covered Bond S.A. to achieve the demanding objectives set over the past year.

Particularly under the extraordinary circumstances under which it finds itself, the Bank does not take this sort of great dedication for granted.

Luxembourg, 15 March 2018
The Board of Directors

Auditors' opinion

2 Auditors’ opinion

To the Board of Directors
Commerzbank Finance & Covered Bond S.A.

Report on the audit of the annual financial statements

Audit opinion

In our opinion based on the findings of our audit, the enclosed annual financial statements comply with the International Financial Reporting Standards (IFRS) as applied in the European Union and give a true and fair view of the net assets and financial position of Commerzbank Finance & Covered Bond S.A. as at 31 December 2017 as well as the earnings performance and cash flows for the financial year ended on that date.

The annual financial statements consist of:

- the balance sheet as at 31 December 2017;
- the statement of comprehensive income;
- the statement of changes in equity;
- the consolidated statement of cash flows for the financial year ended on that date;
- and the Notes including a summary of significant accounting policies.

Basis for the audit opinion

We carried out our audit of the annual financial statements in accordance with EU Regulation 537/2014, the Law on Audit Activities (law dated 23 July 2016) and the International Standards on Auditing (ISA) as adopted for Luxembourg by the Commission de Surveillance du Secteur Financier (CSSF). Our responsibility for the financial statements pursuant to this Regulation, law and Standards is described in detail in the section entitled “Responsibility of the auditor”.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Independence

We are independent from the Bank in accordance with the International Ethics Standards Board for Accountants’ Code of Ethics for Professional Accountants (IESBA Code) adopted for Luxembourg by the CSSF and the professional standards of conduct with which we must comply within the scope of the audit of the annual financial statements and we have fulfilled all other professional requirements in accordance with these standards of conduct.

We declare that, to the best of our knowledge, we have not rendered any prohibited non-audit services as defined by Art. 5 (1) of EU Regulation 537/2014.

The non-audit services we provided to the Bank within the period from 1 January 2017 to 31 December 2017 are listed in Note 7.10 of the annual financial statements.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance to the audit of the annual financial statements for the current period under review. These matters were addressed in the context of our audit of the annual financial statements as a whole, and in forming our audit opinion thereon, and we do not provide a separate audit opinion on these matters.

Key audit matter	Findings
Value of the public finance portfolio **We refer to Notes 5.5, 5.6 and 5.11 of the accounting and measurement principles, Notes 8.2 to 8.7 of the Notes to the balance sheet and Note 9.21 (Fair value of financial Instruments).**	
The Bank's public finance portfolio consists of receivables and securities most of which are assigned to the IFRS category "Loans and receivables" ("LaR"). The portfolio accounts for the majority of the asset side with approximately 86% of total assets.	As part of the audit of the annual financial statements, we carried out control-related audit procedures with the aim of determining whether the operational and organisational structure of the Bank is suited to assessing the value of loans and receivables.
The Bank's portfolio also comprises financing to borrower entities with a public-law background and publicly guaranteed financing to OECD countries. These receivables form the statutory cover for outstanding Lettres de gage (LdG).	We also carried out evidence-based audit procedures on the basis of risk-oriented random sampling with the aim of determining whether the Bank's key assumptions in the credit risk assessment are justifiable.
In order to measure value, the Bank has defined the following qualitative and quantitative criteria (trigger events): • Fair value at amortised cost above 20%; • Master scale rating below 3.0; • Interest and/or principal arrears. Insofar as the Bank needs to make an impairment, its amount is determined by a comparison of amortised costs and the net present value of expected future cash flows from the LaR instrument, where the latter is mainly influenced by estimates. Due to the above, the impairment test of LaR posed a risk of material misstatement and was therefore a key component of our audit.	

Key audit matter	Findings
NET INTEREST INCOME **We refer to Note 5.15 in the accounting and measurement methods and Note 7.1 in the Notes on the statement of comprehensive income.**	
Net interest income, with its components listed below, represents a key part of total net income in the annual financial statements of Commerzbank Finance & Covered Bond S.A.	As part of the audit of the annual financial statements, we carried out control-related audit procedures with the aim of determining whether the operational and organisational structure of the Bank is suited to ensuring that interest income and expenses are properly recognised. Moreover, we carried out evidence-based audit procedures to ensure that selected interest income and expenses are properly recognised.
The Bank's net interest income mainly comprises the following components: • Interest income from securities trading and public-sector loans (2017: €+382.7m; 2016: €+449.3m) • Interest expense for registered and public Pfandbriefe issued (2017: €143.2m; 2016: €150.1m) • Net interest income from swaps (2017: €–210.4m; 2016: €–245.6m) • Non-recurring effects from the sale and voluntary repayment of loans, the sale of securities and the repurchase of liabilities (2017: €+1.5m; 2016: €+11.5m) Due to the inherent risk related to the individual interest components, net interest income is a risk of material misstatement that we must assess and was therefore a significant part of our audit.	

Further Information

The Board of Managing Directors is responsible for the further information. Further information includes information contained in the management report, but not the annual financial statements or our auditors' opinion on them. Our audit opinion on the annual financial statements does not cover the further information and we give no assurance of any kind in respect thereof.

Our responsibility in relation to the auditing of the annual financial statements is to read the further information and on that basis assess whether there is any material inconsistency with the annual financial statements or the insights gained in the course of the audit or whether the further information appears otherwise to be materially misrepresented. Should we conclude from the work done by us that the further information contains material misstatements, we are obliged to make a report to that effect. We have nothing to report on this point.

Responsibility of the Board of Directors and those charged with governance for the annual financial statements

The Board of Directors is responsible for the preparation and proper presentation of the annual financial statements in accordance with the IFRS as applicable in the European Union and the internal controls it regards as necessary to facilitate the preparation of annual financial statements free from material misstatements, whether resulting from error or deliberate fault.

In preparing the annual financial statements, the Board of Directors is responsible for assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the Board of Directors intends to liquidate the company or suspend business operations or has no other realistic alternative but to do so.

Those charged with governance are responsible for overseeing the preparation of the annual financial statements.

Responsibility of the auditor for the annual financial statements

The objective of our audit is to obtain reasonable assurance about whether the annual financial statements as a whole are free from material misstatements, whether resulting from error or fraud, and to issue an auditors' opinion on this which contains our audit opinion. Reasonable assurance corresponds with a high level of assurance, but is not a guarantee that an audit conducted in accordance with EU Regulation 537/2014, the law dated 23 July 2016 and the ISAs adopted for Luxembourg by the CSSF will always detect a material misstatement, if one exists. Misstatements can arise from error or fraud and are considered material if, individually or in the aggregate, they could reasonably be expected to influence economic decisions of users taken on the basis of these annual financial statements.

We use our best judgement and take a critical approach within the scope of an audit of financial statements in accordance with EU Regulation 537/2014, the law dated 23 July 2016 and the ISAs adopted for Luxembourg by the CSSF. Furthermore:

- We identify and assess the risk of material misstatements in the annual financial statements resulting from error or fraud, plan and conduct audit procedures as a response to these risks and obtain audit evidence that is sufficient and appropriate to provide a basis for our audit opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control;
- We obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control;
- We evaluate the appropriateness of the accounting policies used by the Board of Directors, accounting estimates and the corresponding information in the Notes;
- We draw conclusions about the appropriateness of the Board of Directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' opinion to the related disclosures in the annual financial statements or, if such disclosures are inadequate, to modify our audit opinion. These conclusions are based on the audit evidence obtained up to the date of the auditors' opinion. However, future events or conditions may cause the Company to cease to continue as a going concern;
- We assess the overall presentation, structure and contents of the annual financial statements, including the information in the Notes, and we evaluate whether they accurately represent the underlying transactions and events.

We communicate with those charged with governance regarding multiple matters, including the planned scope and timing of the audit, significant audit findings and any significant deficiencies in the internal control system that we identify during our audit.

We have provided those charged with governance with a statement that we have complied with the relevant requirements regarding independence and communicated to them all relationships and other matters that may reasonably be thought to bear on our independence and, if relevant, the related safeguards.

With regard to the matters communicated to those charged with governance, we identify those matters that were of greatest significance to the audit of the consolidated financial statements of the current period under review as the key audit matters. We describe these matters in our report unless the law or other regulations preclude public disclosure of the matter.

Report on further legal and regulatory obligations

The Management Report, which is the responsibility of the Board of Directors, is consistent with the annual financial statements and has been drafted in accordance with the requirements of the law.

The Board of Directors first appointed us as the auditors on 2 March 2007 and the uninterrupted term of our mandate, including previous extensions and reappointments, is 11 years.

PricewaterhouseCoopers, Société coopérative
Luxembourg, 15 March 2018

Represented by
Björn Ebert

Annual financial statements of Commerzbank Finance & Covered Bond S.A.

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All details in this Annual Report are derived from information and business performance figures of Commerzbank Finance & Covered Bond S.A. (CFCB) as at 31 December 2017.

Unless otherwise indicated, all amounts are shown in thousands of euros (€ thousand). Due to rounding, slight deviations may occur in totals and calculations of percentages.

3 Annual financial statements of Commerzbank Finance & Covered Bond S.A.

Statement of comprehensive income

in €000	Notes	1.1.-31.12.2017	1.1.-31.12.2016	Change in €000	Change in %
Interest income	7.1	433,184	482,208	-49,024	-10.2
Interest expenses	7.1	441,597	453,795	-12,198	-2.7
Net interest income	**7.1**	**-8,414**	**28,412**	**-36,826**	**>100**
Loan loss provisions	7.2	-567	-617	50	8.2
Net interest income after loan loss provisions		**-7,847**	**29,029**	**-36,876**	**>100**
Commission income	7.3	6,751	4,899	1,853	37.8
Commission expenses	7.3	713	871	-157	-18.1
Net commission income	**7.3**	**6,038**	**4,028**	**2,010**	**49.9**
Net income from hedge accounting	7.4	-8,419	3,214	-11,633	>100
Net trading income	7.5	-70,578	45,049	-115,627	>100
Net investment income	7.6	-2,002	11,411	-13,412	>100
Operating expenses	7.7, 7.8, 7.10, 7.11	24,602	21,542	3,059	14.2
Other net income	7.12	2,201	1,573	628	39.9
Operating profit/loss		**-105,208**	**72,761**	**-177,969**	**>100**
Restructuring expenses		0	0	0	0
Taxes on income	7.13	-21,564	13,951	-35,515	>100
Surplus/shortfall for the year		**-83,644**	**58,810**	**-142,454**	**>100**
Change from remeasurement of defined benefit plans not recognised in the income statement		77	-794	871	>100
Items not recyclable through profit or loss		**77**	**-794**	**871**	**>100**
Change in revaluation reserve					
before taxes		56,004	-10,536	66,540	>100
Taxes		-14,567	-6,070	-8,497	>100
Items recyclable through profit or loss		**41,438**	**-16,606**	**58,044**	**>100**
Other comprehensive income		**41,514**	**-17,400**	**58,914**	**>100**
Total comprehensive income		**-42,129**	**41,410**	**-83,539**	**>100**

The Notes are an integral part of these financial statements.

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Balance sheet

Assets in €000	Notes	31.12.2017	31.12.2016	Change in €000	Change in %
Cash reserve	5.9, 8.1	105,326	6,731	98,595	>100
Claims on banks	5.10, 8.2	1,486,920	1,803,082	-316,162	-17.5
Claims on customers	5.10, 8.3	4,352,736	4,698,352	-345,616	-7.4
Loan loss provisions	5.11, 8.4	-3,394	-4,626	1,232	26.6
Positive fair values of derivative hedging instruments	5.14, 8.5	574,124	742,430	-168,306	-22.7
Trading assets	5.15, 8.6	403,744	463,969	-60,225	-13.0
Financial investments	5.16, 8.7	7,729,549	9,833,403	-2,103,854	-21.4
Intangible assets	5.17, 8.8	10,024	13,365	-3,341	-25.0
Fixed assets	5.17, 8.8, 8.9	32	32	0	0.0
Deferred tax assets	5.18, 8.10	20,422	19,485	937	4.8
Other assets	8.11	25,877	22,339	3,538	15.8
Total		**14,705,358**	**17,598,561**	**-2,893,203**	**-16.4**

Liabilities in €000	Notes	31.12.2017	31.12.2016	Change in €000	Change in %
Liabilities to banks	5.19, 9.1	5,649,119	7,548,780	-1,899,661	-25.2
Liabilities to customers	5.19, 9.2	1,365,949	1,673,364	-307,415	-18.4
Securitised liabilities	5.19, 9.3	2,034,398	2,958,564	-924,166	-31.2
Negative fair values of derivative hedging instruments	5.20, 9.4	3,337,367	3,843,903	-506,536	-13.2
Trading liabilities	5.21, 9.5	213,291	422,947	-209,656	-49.6
Provisions	5.22, 9.6	7,678	9,964	-2,286	-22.9
Current tax liabilities	5.18, 9.9	27,948	27,948	0	0.0
Other liabilities	9.10	4,459	5,090	-631	-12.4
Subordinated capital	5.23, 9.11	17,729	18,452	-724	-3.9
Equity	5.24, 9.12	2,047,419	1,089,549	957,870	87.9
Subscribed capital	5.24, 9.12	235,000	235,000	0	0.0
Capital reserve	5.24, 9.12	1,859,000	859,000	1,000,000	>100
Retained earnings	5.24, 9.12	206,503	147,616	58,887	39.9
Revaluation reserve	5.24, 9.12	-169,439	-210,877	41,438	19.7
Surplus/shortfall for the year	5.24, 9.12	-83,644	58,810	-142,454	>100
Total		**14,705,358**	**17,598,561**	**-2,893,204**	**-16.4**

The Notes are an integral part of these financial statements.

Statement of changes in equity

in €000	Notes	Sub-scribed capital	Capital reserve	Retained earnings	Revalu-ation reserve	IAS 19 reserve	Surplus/shortfall for the year	Total
Balance as at 31.12.2015		**235,000**	**568,038**	**70,486**	**-194,271**	**-1,461**	**79,386**	**757,178**
Balance as at 1.1.2016		**235,000**	**568,038**	**70,486**	**-194,271**	**-1,461**	**79,386**	**757,178**
Net income for the year	5.24, 9.12						58,810	58,810
Capital allocation	5.24, 9.12		290,962					290,962
Transfer to retained earnings	5.24, 9.12			79,386			-79,386	0
Change in revaluation reserve	5.24, 9.12				-16,606			-16,606
Change in IAS 19 reserve	5.24, 9.12					-794		-794
Balance as at 31.12.2016		**235,000**	**859,000**	**149,872**	**-210,877**	**-2,255**	**58,810**	**1,089,549**
Portfolio as at 1.1.2017		**235,000**	**859,000**	**149,872**	**-210,877**	**-2,255**	**58,810**	**1,089,549**
Net income for the year	5.24, 9.12						-83,644	-83,644
Capital allocation	5.24, 9.12		1,000,000					1,000,000
Transfer to retained earnings	5.24, 9.12			58,810			-58,810	0
Change in revaluation reserve	5.24, 9.12				41,438			41,438
Change in IAS 19 reserve	5.24, 9.12					77		77
Balance as at 31.12.2017		**235,000**	**1,859,000**	**208,681**	**-169,439**	**-2,179**	**-83,644**	**2,047,419**

The Notes are an integral part of these financial statements.

Cash flow statement

in €000	Notes	31.12.2017	31.12.2016
Surplus/shortfall for the year		**-83,644**	**58,810**
Non-cash positions in net income for the year and reconciliation with cash flow from operating activities:			
Write-downs, depreciation, write-ups on receivables, fixed and other assets, changes in provisions and net changes due to hedge accounting		-439,395	369,324
Change in other non-cash positions		-150,746	99,055
Net gain or loss on the sale of fixed and other assets	7.6	6,103	15,143
Other adjustments	7.1	-8,836	-3,779
Sub-total		**-676,518**	**538,553**
Changes to assets and liabilities from operating activities after adjustment for non-cash positions:			
Claims on banks – loans and receivables	8.2	254,198	123,618
Claims on customers – loans and receivables	8.3	345,616	6,769
Available-for-sale financial investments	8.7	73,195	0
Financial investments – loans and receivables and other assets from operating activities	8.7, 8.8, 8.10	253,448	43,883
Liabilities to banks – other liabilities	9.1	-1,899,661	-1,208,302
Liabilities to customers – other liabilities	9.2	-307,415	-133,479
Securitised liabilities – other liabilities	9.3	-1,079,389	-1,259,493
Other liabilities from operating activities	9.4, 9.5, 9.6, 9.9, 9.10	-1,520	3,444
Interest received	7.1	486,273	835,911
Interest paid	7.1	-477,437	-832,131
Cash flow from operating activities		**-3,029,210**	**-1,881,227**
Proceeds from disposals of			
Financial assets	8.2, 8.3, 8.5	2,127,805	1,611,941
Payments for investments in			
Intangible assets	8.8	0	-15,314
Cash flow from investing activities		**2,127,805**	**1,596,627**
Proceeds from capital increases	9.12	1,000,000	290,962
Cash flow from financing activities		**1,000,000**	**290,962**
Cash and cash equivalents at the end of the previous period	8.1	**6,731**	**370**
Cash flow from operating activities		-3,029,210	-1,881,227
Cash flow from investing activities		2,127,805	1,596,627
Cash flow from financing activities		1,000,000	290,962
Cash and cash equivalents at the end of the reported period	8.1	**105,326**	**6,731**

The Notes are an integral part of these financial statements.

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4 Notes on the separate financial statements for Commerzbank Finance & Covered Bond S.A.

4.1 Legal background

The company is entered in the Commercial Register of the Luxembourg District Court under B 30.469. The Bank was granted a special banking licence (no. 356/99) by the Luxembourg Ministry of Finance on 23 September 1999.

Commerzbank AG holds 100% of the shares in the Bank, which was established on 1 September 2014 – with retroactive effect in accounting terms to 1 January 2014 – by the merger of Erste Europäische Pfandbrief- und Kommunalkreditbank Aktiengesellschaft in Luxemburg S.A. with Hypothekenbank Frankfurt International S.A. As part of the reorientation of Commerzbank's operations Luxembourg, the Erste Europäische Pfandbrief- und Kommunalkreditbank Aktiengesellschaft in Luxemburg was renamed as Commerzbank Finance & Covered Bond S.A. with legal effect from 15 February 2016.

Its Board of Directors determines its business policy and measurement principles except where these are prescribed by Luxembourg directives and regulations, and ensures the Bank's compliance with all these.

4.2 Object of the Bank

The object of the company is to conduct all such business as is permitted to a Pfandbrief bank by the Law on the Financial Sector of April 5, 1993 as most recently amended. The Bank (then operating under the name of "Europäische Hypothekenbank S.A.") has, since 23 September 1999, been the holder of a special banking licence (no. 356/99) under the Luxembourg Law on Lettres de gage dated 21 November 1997, which was incorporated into the Law of 5 April 1993 as amended to date as Articles 12-1 to 12-9 thereof. The Bank is thus authorised to issue Lettres de gage (Pfandbriefe under Luxembourg law) and conduct related secondary and ancillary business.

4.3 Compliance Statement

Commerzbank Finance & Covered Bond S.A. is a credit institution with its registered office in Luxembourg, Grand Duchy of Luxembourg. The annual financial statements as at 31 December 2017 were prepared in conformity with Regulation (EC) No. 1606/2002 (the IAS Regulation) of the European Parliament and Council of 19 July 2002, with the Law on 17 June 1992 on annual financial statements and consolidated financial statements of banks subject to Luxembourg law and with other regulations on the adoption of certain international accounting standards based on the International Accounting Standards (IAS) adopted and published by the International Accounting Standards Board (IASB) and the International Financial Reporting Standards (IFRS) as interpreted by the International Financial Reporting Interpretations Committee (IFRIC). All standards and interpretations which are mandatory within the EU in 2017 have been applied.

4.4 Date of release for publication

The annual financial statements for the year ending on 31 December 2017 were released by the Board of Directors on 15 March 2018.

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5 Summary of accounting and measurement methods

5.1 Basis on which the financial statements have been prepared

The IFRS financial statements as at 31 December 2017 include the additional national details (Notes and Management Report) required by the Law of 17 June 1992 on the financial statements of banks subject to Luxembourg law (version as at May 2016). The financial statements comprise the statement of comprehensive income, the balance sheet, the cash flow statement, the statement of changes in equity and the Notes. The internal evaluations carried out by the Board of Directors and the Managing Directors do not consider individual segments, which is why there is no segment reporting in the separate financial statements. Commerzbank Finance & Covered Bond S.A. is an independent bank within the Commerzbank Group which is assigned to Group Treasury.

Financial assets and liabilities are generally measured at amortised cost, unless a different form of measurement is required by IFRS. This applies, for example, in the case of those financial instruments that, under IAS 39, are measured at fair value. The account treatment and measurement assume that the Bank is a going concern. Income and expenses are accounted for on an accrual basis; they are recorded and recognised for the period to which they are attributable in economic terms.

The Bank recognises commission income and expenses in net commission income based on the accounting treatment of the associated financial instruments and the nature of the activity. Commission income for services which are performed over a certain period is recognised over the period in which the service is performed. Fees which are associated with the completion of a particular service are recognised at the time the service is completed in full. Performance-related fees are recognised when the performance criteria are met. The Bank recognises commission from trading transactions under net trading income.

Assets and liabilities are generally reported on a gross basis in the balance sheet, i.e. without netting. In accordance with IAS 32.42, financial assets and liabilities relating to the same counterparty are offset and shown in the balance sheet on a net basis if there is a legally enforceable right to offset the amounts and the transactions are settled on a net basis or the asset is realised simultaneously with the settlement of the liability. The Bank avails itself of this option when netting positive and negative market values from derivatives and the margin payments relating to them.

Note 9.17 contains a breakdown by the Bank of all balance sheet items into short-term and long-term items. The Bank reports residual terms for all financial instruments with contractual due dates.

The financial statements also include values which are determined, as permitted, on the basis of estimates and assumptions. The estimates and judgements required in IFRS accounting are reached in accordance with the relevant standard, are regularly reviewed and are based on experience and on other factors, including expectations of future events that appear reasonable under the given circumstances. Where estimates had to be wider in scope, the material assumptions underlying them are set out. The estimates and judgements themselves and the underlying estimation methods and judgement factors are reviewed and compared with actual events. Commerzbank Finance & Covered Bond S.A. regards the parameters used as reasonable and appropriate. Areas in which estimates may be uncertain include the calculation of pension obligations, which are measured on the basis of the projected-unit-credit method for defined benefit pension plans. In measuring these obligations, a number of assumptions have to be made, notably as regards long-term salary and pension trends and average life expectancy. Changes in the underlying assumptions from year to year and divergences from the actual effects each year are reported under actuarial gains and losses (for the impact of changes in parameters, see Note 9.7).

Uncertainties remain in the estimation of loan loss provisions and the determination of fair value using measurement models, and also in the measurement of financial instruments.

Further information on risk provisions may be found in the Bank's risk report. The assumptions and parameters underlying the estimates we have made are based on the exercise of appropriate judgement by management. This applies in particular to the appropriate selection and use of parameters, assumptions and modelling techniques when valuing financial instruments for which there are no market prices and no comparative parameters observable on the market. Where differing valuation models lead to a range of different poten-

tial values, management uses its judgement to determine the choice of the model to be used. Changes to estimates are taken into consideration only where they relate to only one period, and then only in that period and, where the change relates to both the present period and those following it, correspondingly in this and subsequent periods. The main methods used are described in Note 9.21.

The reporting currency in the financial statements is the euro. Unless otherwise indicated, all amounts are shown in thousands of euro. The reporting year is the calendar year.

5.2 Changes to accounting and measurement methods

Commerzbank Finance & Covered Bond S.A. has essentially employed the same accounting and measurement methods as for the financial statements for the year ended 31 December 2016, with the exception of the new and revised standards described below.

5.3 IFRS applied and new IFRS

In the financial year, the Bank implemented all new and revised standards and interpretations that are relevant for the Group which required initial mandatory application as at 1 January 2017 and which had already been endorsed into European law. All amendments to the standards have been taken into account in accordance with the applicable transitional provisions. The application did not result in any material effects for the Bank. The relevant and significant new standards for the Group are presented in the following section.

The application of IAS 1 (Presentation of Financial Statements – Disclosure Initiative) focuses on the concept of materiality. The application had no effect on the Group's accounting and measurement practices, although items related objectively and substantively in these financial statements are now summarised together in the notes on the individual components of the income statement and balance sheet.

The amendments to the IAS 7 Statement of Cash Flows were published as part of the Disclosure Initiative. Their object is to improve the information on an entity's liabilities arising from financing activities. This change was implemented in Note 9.24.

The IASB published an extensively revised new version of IFRS 9 Financial Instruments in July 2014. This was transposed into European law in November 2016. The standard must be applied in the EU for financial years beginning on or after 1 January 2018. The previous standard for the accounting treatment of financial instruments (IAS 39) will largely be replaced.

IFRS 9 contains new rules for classifying and measuring financial instruments. It specifies that all financial assets must be measured at fair value, with the remeasurement effects taken through profit or loss. Different subsequent measurement is only permitted for a debt instrument on the asset side if it is included in a portfolio that operates under a "hold" or "hold-and-sell" business model. Moreover, the financial instrument in question may as a rule only have cash flows that are payments of principal and interest on the principal amount outstanding (SPPI criterion). Irrespective of the above, a financial instrument may still be measured at fair value if this ensures the reporting is more economically meaningful. It is no longer possible to report embedded derivatives separately within financial assets.

As before, a fair value option also exists for financial liabilities. However, gains or losses deriving from a change in own credit risk are no longer reported through profit or loss but instead directly to equity (the revaluation reserve), if this ensures the reporting is more economically meaningful.

IFRS 9 also changes the rules on the accounting treatment of expected default risk (provisions). Unlike under IAS 39, provisions are not recognised only when a specific loss event occurs. Instead, for every financial instrument measured at amortised cost or fair value through other comprehensive income, the credit loss expected over the next 12 months must be recognised as a provision on initial recognition. If the borrower's credit risk increases significantly, but the borrower is not yet in default, a provision must be recognised for the full lifetime expected credit losses. If an instrument is in default, the present value of the provision must be calculated on the basis of the estimated cash flows that can still be expected.

IFRS 9 also contains improvements for hedge accounting. These new rules aim to improve the harmonisation between the accounting treatment of hedging relationships and (economic) risk management. However, the new standard also includes an option under which the current provisions of IAS 39 may still be applied. Commerzbank will utilise this option for hedge accounting.

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The Bank is involved in the project on IFRS 9 that has been set up within the Commerzbank Group. The project has involved the analysis of the new requirements applicable to methodology, data procurement and processes, with support from experts from the Finance, Risk and IT divisions. The results of these analyses were described in detail in technical concepts and incorporated into the Group-wide accounting guidelines.

Reported equity declined by €0.9bn as compared with IAS 39. This decrease was the result of two factors: a change in the methodology for risk provisioning versus IAS 39, and the required reclassification of the respective financial instruments. A number of financial assets are now measured at fair value, which results in a reduction in equity capital. The effects are presented in Note 9.25.

Amendments to IAS 12 clarify the recognition of deferred tax assets for unrealised losses. There were no repercussions on the Bank's financial statements. As the Bank does not hold any shares in other companies, the changes in IFRS 12 are not relevant to the Bank.

The new standard IFRS 16 Leases, published in January 2016, will replace IAS 17 and the related interpretations IFRIC 4, SIC-15 and SIC-27. The change was transposed into EU law in the fourth quarter of 2017. Under IFRS 16 all leases with a term of over twelve months must be recognised on the lessee's balance sheet together with the associated contractual obligations. Leases involving low-value assets are an exception. The lessee will in future recognise a right-of-use asset and a lease liability, which represents the obligation to make the lease payments. IFRS 16 adopts the criteria of IAS 17 for the classification of finance and operating leases by the lessor. The standard also contains further provisions on recognition, on the information in the notes and on sale-and-lease-back transactions. IFRS 16 will become effective for financial years beginning on or after 1 January 2019. Based on our knowledge as of today, we anticipate that the application of IFRS 16 will result in minor reporting changes in the income statement and a slight increase in total assets.

IFRS 15 Revenue from Contracts with Customers introduces a principles-based five-step framework dealing with the nature, amount and timing of revenues and cash flows arising from a contract with a customer. It replaces IAS 11 and 18, IFRIC 13, 15 and 18 and SIC-31. The standard also requires extensive qualitative and quantitative disclosures on contracts, performance obligations and significant judgements and estimates. It was transposed into European law in October 2016. The standard must be applied in the EU for financial years beginning on or after 1 January 2018. We have concluded our assessment of the new standard and it will have no material impact on the Bank's financial statements.

The clarifications in IFRS 2 Share-based Payment provide guidance on a number of issues relating to accounting for share-based payments settled in cash. The main change is the addition of rules on determining the fair value of liabilities arising from share-based payments. It has not yet been transposed into European law.

The changes under IFRIC 22 affect foreign currency transactions and advance payments and are mandatory for financial years that begin on 1 January 2018. They have not yet been transposed into European law. We do not anticipate any impact on the Bank's financial statements. We also do not expect any impact on the Bank's financial statements from the changes under IFRIC 23 (first application on 1 January 2019), which describes the uncertainties associated with income tax treatment.

5.4 Currency translation

The reporting and functional currency of the financial statements is the euro.

Monetary assets and liabilities denominated in foreign currencies and pending spot foreign exchange transactions are translated at the spot mid-rate, and foreign exchange forward contracts at the forward exchange rate, on the reporting date. Realised expenses and income are generally translated using the spot rate applying on the date of realisation. Average exchange rates may also be used to translate expenses and income, provided these have not undergone major fluctuations. Hedged expenses and income are translated using the hedging rate. Expenses and income resulting from the translation of balance sheet items are recognised in profit or loss under net trading income.

Non-monetary items are generally translated at historic exchange rates if they are measured at amortised cost. However, the current rate is used for translation where the non-monetary items are measured at fair value. Gains and losses on the translation of profits or losses on non-monetary items are recognised either in equity or profit or loss depending on the way the net gain or loss is recognised.

5.5 Financial instruments

Under IAS 39 all financial investments and liabilities – including financial derivatives – must be recognised in the balance sheet and measured according to their assigned category. A financial instrument is a contract that simultaneously gives rise to a financial asset for one entity and a financial liability or equity instrument for another. When first recognised, financial instruments must be measured at fair value, which is defined by IFRS 13 as their realisable price. This is the price that would be received in an orderly transaction between market participants on the measurement date for the sale of an asset or paid for the transfer of a debt.

Fair value is determined by the price established for the financial instrument in an active market (mark to market principle; fair value hierarchy level I). Where no quoted prices are available, fair value is established with the aid of valuation models (mark to model) which use observable market parameters to the maximum extent possible (fair value hierarchy level II). If insufficient recent observable market data are available to establish fair value, parameters which are not observable on the market will be used in the valuation models. Input parameters may include data derived by approximation from historical data or similar methods (fair value hierarchy level III). For a detailed explanation of the fair value hierarchies, please refer to Note 9.21.2. Subsequently, financial instruments are recognised, depending on their category, in the balance sheet either at (amortised) cost or fair value.

5.5.1 Recognition and measurement of financial instruments

On initial recognition financial instruments are measured at fair value. Where financial instruments are not measured at fair value through profit or loss, individual attributable transaction costs are included in the fair values as acquisition-related costs, increasing the fair values of financial assets or reducing the fair values of financial liabilities. Under IFRS 13, fair value is defined as the realisable price. This is the price that would be received in an orderly transaction between market participants on the measurement date for the sale of an asset or paid for the transfer of a debt.

Depending on their respective category, financial instruments are recognised in the balance sheet subsequently either at (amortised) cost or fair value. Fair value is determined by the price established for the financial instrument in an active market (mark to market principle; fair value hierarchy level I). If no market prices are available, valuation is based on quoted prices for similar instruments in active markets. In cases where no quoted prices are available for identical or similar financial instruments, fair value is established with the aid of valuation models which use observable market parameters (mark to model) to the maximum extent possible (fair value hierarchy level II). If insufficient recent observable market data are available to establish fair value, parameters which are not observable on the market will be used in the valuation models. These input parameters may include data derived by approximation from historical data or similar methods (fair value hierarchy level III).

These valuations are inherently subject to management judgement to a greater extent. For a detailed explanation of the fair value hierarchies, please refer to Note 9.21.2 .

5.5.2 Recognition and derecognition of financial instruments

A financial asset or financial liability is generally recognised in the balance sheet when the Bank becomes a party to the contractual provisions of the financial instrument. For ordinary spot purchases or sales of financial assets in the cash market the trading and settlement dates normally differ. These ordinary spot purchases or sales may be recognised using either trade date or settlement date accounting. At Commerzbank Finance & Covered Bond S.A., settlement date accounting is used for the recognition and derecognition of loans and receivables and trade date accounting for financial assets available-for-sale and financial assets or liabilities at fair value through profit or loss.

The derecognition rules in IAS 39 are based on both the concept of risk and reward and on control of the asset or liability in question, although when examining derecognitions, the assessment of risk and reward takes precedence over transfer of control. If the risks and rewards are transferred only partially and control over the asset is retained, the continuing involvement approach is used. This means that the financial asset continues to be recognised to the extent of the Group's continuing involvement and special accounting policies apply.

The extent of the continuing involvement is the extent to which Commerzbank Finance & Covered Bond S.A. continues to be exposed to changes in the value of the transferred asset. A financial liability (or part of a financial liability) is derecognised when it is extinguished, i.e. when the obligations arising from the contract are discharged or cancelled or expire. The repurchase of own debt instruments is also a transfer of

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financial liabilities that qualifies for derecognition. Any differences between the carrying value of the liability (including discounts and premiums) and the purchase price are recognised through the income statement in net interest income for bearer securities and in other net income for other liabilities; in the event of resale at a later date, a new financial liability is recognised with a cost equal to the sale price. Differences between this cost and the repayment amount are allocated over the term of the debt instrument using the effective interest rate method.

5.6 Categorisation of financial assets and liabilities and their measurement

Loans and receivables

Non-derivative financial instruments with fixed or determinable payments that are not quoted in any active market are assigned to this category. This holds true whether or not they were originated by the Bank or acquired in the secondary market. An active market is one in which transactions in the asset or liability take place sufficiently regularly and with sufficient volume to ensure the continuous availability of pricing data. Measurement is at amortised cost, which must be adjusted through the income statement in the event of permanent impairment. Premiums and discounts are recognised through the income statement in net interest income over the life of the liability, using the effective interest rate method. Where loans and receivables contain securities that have been reclassified, the fair value at the date of reclassification is taken as the new carrying amount. Any revaluation reserve net of deferred taxes existing at this point remains in the other reserves within equity and is amortised over the remaining term of the reclassified securities. For financial investments classified as loans and receivables, impairments are recognised in the same way as for lending business (see Note 5.11). Impairment of these financial instruments is included in net investment income and deducted directly from the financial investments. If the indicators for impairment of particular securities cease to apply or no longer suggest an impairment, the impairment of the securities must be reversed through the income statement, but to no more than the level of amortised cost.

Financial assets or liabilities measured at fair value through profit or loss

This category essentially comprises financial assets or liabilities held for trading and financial instruments designated at fair value through profit or loss. No use was made of the fair value option during the financial year, nor were any assets assigned to the sub-category of designated at fair value through profit or loss. Trading assets at present include only those derivative financial instruments that have a positive fair value. No assets were assigned to the fair value option during the financial year.

Trading liabilities comprise financial derivatives with a negative fair value. Financial derivatives used for hedging are only shown under trading assets or trading liabilities if they do not meet the conditions for using hedge accounting. They are otherwise shown as fair values from derivative hedging instruments. Trading assets and trading liabilities are measured at their fair value on each reporting date. Interest rate and cross-currency interest rate derivatives are measured in accordance with market practice, taking account of the fixing frequency for variable payments. Counterparty default risk is accounted for by recognising credit valuation adjustments (CVA), with the Bank's own default risk accounted for by recognising debit valuation adjustments (DVA). CVAs and DVAs are based on observable market data (for example CDS spreads) where available. Measurement and realisation results are recorded under net trading income in the statement of comprehensive income. Interest income and expenses from trading transactions are reported in net interest income.

In the case of funding valuation adjustments (FVAs), the funding costs or benefits of uncollateralised derivatives and collateralised derivatives where there is only partial collateral or the collateral cannot be used for funding purposes, are recognised at fair value. As for CVAs and DVAs, FVAs are determined by the expected value of the future portfolio market values using observable market data (e.g. CDS spreads). The funding curve used to calculate the FVA approximates to the Commerzbank funding curve.

Available-for-sale financial assets

This category comprises all non-derivative financial assets not assigned to one of the above categories or which have been designated as available-for-sale. These are at present exclusively debt instruments in the form of interest-bearing securities listed on an active market, but where there is no intention to sell in the short term. They are measured at fair value. Measurement gains or losses are reported in equity through

the statement of comprehensive income in a separate equity item (the revaluation reserve) after allowance has been made for deferred taxes. Premiums and discounts on debt instruments are recognised in net interest income over the life of the asset using the effective interest rate method. When a financial asset is sold, the cumulative measurement gain or loss previously recognised in the revaluation reserve is derecognised and taken through the statement of comprehensive income. Under IAS 39.59, financial instruments in this category must be monitored for any objective indications of a loss (such as breach of contract, loss event, increased likelihood of restructuring proceedings or insolvency) after initial recognition that would lead to a reduction in the cash flow arising from them. An impairment is recognised when the net present value of the expected cash flows is lower than the amortised cost of the financial instrument concerned. In the event of an impairment, the revaluation reserve is adjusted by this amount and the amount included in the statement of comprehensive income.

Debt instruments are reviewed individually for impairment if any qualitative trigger events have occurred. To operationalise qualitative trigger events, additional indicators for a write down have been developed. For example, an impairment charge for debt instruments in this category must generally be recognised if the debtor's rating is CCC or lower (see Section 6.3.4), and the fair value is lower than amortised cost. If the reasons for an impairment of debt instruments cease to apply, the impairment is reversed through profit or loss, but to no more than the level of amortised cost. Any amount exceeding amortised cost is recognised in the revaluation reserve.

Once the reason for the impairment ceases to apply, write-ups on financial instruments are reported in profit and loss up to an amount no greater than their amortised original cost.

Held-to-maturity financial assets

Non-derivative financial assets with fixed or determinable payments and fixed maturity may be included in this category if the entity has the intention and ability to hold them to maturity. Measurement is at amortised cost. If there is impairment, this is recognised through profit or loss when determining the amortised cost. Premiums and discounts are recognised in net interest income over the life of the asset using the effective interest rate method. As before, the Bank made no use of the held-to-maturity financial assets category in 2017.

Net gains or losses

Net gains or losses include fair value measurements recognised in profit or loss, impairments, impairment reversals, gains realised on disposal, and subsequent recoveries on written-down financial instruments classified in the respective IAS 39 categories. The components are detailed for each IAS 39 category in the notes on net interest income, loan loss provisions, net trading income and net income from financial investments.

Other financial liabilities

This category includes liabilities to banks and customers, subordinated debt, and securitised liabilities. Measurement is at amortised cost. Premiums and discounts are recognised in net interest income over the life of the liability using the effective interest rate method.

Financial guarantee contracts

IAS 39 defines a financial guarantee contract as a contract that requires the issuer to make specified payments that reimburse the holder for a loss they incur because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. If Commerzbank Finance & Covered Bond S.A. is the guarantee holder, the financial guarantee is not recognised in the financial statements and only taken into consideration when determining an impairment of a guaranteed asset.

5.7 Embedded derivatives

IAS 39 also regulates the treatment of derivatives embedded in financial instruments (embedded derivatives). Within the Bank, these are interest rate options and termination rights in connection with receivables.

According to IAS 39, the embedded derivative must, under certain conditions, be shown separately from the host contract as a stand-alone derivative.

Such a separation must be made in the financial statements if the following three conditions are met:

- the economic characteristics and risks of the embedded derivative are not closely related to those of the original instrument;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative under IAS 39; and
- the original financial instrument is not measured at fair value through profit or loss.

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In this case, the embedded derivative to be separated is regarded as part of the trading portfolio and recognised at fair value. Changes on remeasurement are recognised in the statement of comprehensive income. However, the host contract is accounted for and measured applying the rules of the category to which the financial instrument is assigned. If the above three conditions are not met, the embedded derivative is not shown separately and the hybrid financial instrument (structured product) is measured as a whole in accordance with the general provisions of the category to which the financial instrument is assigned.

5.8 Hedge accounting

IAS 39 contains comprehensive rules on accounting for hedges, i.e. on the accounting treatment of hedging instruments (derivatives in particular) and the underlying transactions hedged by them. The general rule is that derivatives are classified as trading transactions (trading assets or liabilities) and measured at fair value, with the measurement result reported in net trading income.

Where derivatives are demonstrably used to hedge risks other than from trading, IAS 39 permits the use of hedge accounting, subject to certain conditions. Under IAS 39, hedges may be recognised in the form of fair value hedges or cash flow hedges. Only micro fair value hedge accounting is at present used within the Bank.

On executing a transaction, the Bank documents the hedge between instrument and underlying, the risk(s) it is intended to manage and the strategy on which the hedge is based. The full fair value of the derivatives designated as hedging instruments is reported as a non-current asset or liability if the residual term of the underlying transactions hedged is longer than twelve months, and a current asset or liability where it is shorter than twelve months.

Fair value hedge accounting

IAS 39 prescribes the use of hedge accounting for derivatives which serve to hedge the fair value of assets or liabilities recognised in the balance sheet. The Bank's issuing and lending business is particularly subject to such a market value risk where fixed-interest securities are involved. At present, only interest rate swaps are used to hedge these risks. In line with the regulations for fair value hedge accounting, financial derivatives used for hedging purposes are recognised at fair value as fair values of derivative hedging instruments. Changes in measurement are reported in the statement of comprehensive income as "net income from hedge accounting". Any changes in the fair value of the hedged asset or hedged liability resulting from an opposite move in the hedged risk are reported and likewise recognised as "net income from hedge accounting" in the statement of comprehensive income.

Fair value hedge accounting for interest rate risk can take the form either of a micro fair value hedge or a portfolio fair value hedge:

- In micro fair value hedge accounting an underlying transaction is linked with one or more hedging transactions in a hedge. If they change in value, the carrying amounts of individual hedged and hedging transactions are adjusted through profit or loss.

- In a fair value hedge portfolio, interest rate risk is hedged at the portfolio level. What is hedged is not individual transactions or groups of transactions with a similar risk structure, but rather an amount of underlying fixed-interest transactions in a portfolio grouped by maturity bands.

Only micro fair value hedge accounting is used within the Bank. Hedges are dissolved once the criteria for the use of hedge accounting are no longer met. In this event, any hedge adjustments from the moment of dissolution of the hedge are released over the remaining term of the underlying transaction.

Application of the hedge accounting rules contained in IAS 39 is subject to the condition that there must be evidence of an effective hedge throughout the period of the hedge. Effectiveness in this context means the relationship between the change in fair value or cash flow of the hedged underlying transaction and the change in fair value or cash flow of the hedging instrument. If these changes offset each other almost fully, a high degree of effectiveness exists. Proof of effectiveness requires, on the one hand, that a high degree of effectiveness can be expected from a hedge in the future (prospective effectiveness), and, on the other, that when a hedge exists, it must be regularly demonstrated that it was highly effective during the period under review (retrospective effectiveness). Both retrospective and prospective effectiveness must be within a range of 0.8 to 1.25. The Bank uses regression analysis to assess effectiveness in micro fair value hedge accounting. The changes in fair value of the hedged transaction and the hedging instrument are determined by means of historical simulations for the prospective effective-

ness test, while the actual changes in fair value are used for the retrospective effectiveness test.

5.9 Cash reserve

The Bank's cash reserve is made up of cash on hand and credit balances with central banks. These are reported at their nominal value.

5.10 Claims

Those of the Bank's claims on banks and customers that are not held for trading and are not quoted on an active market are reported at amortised cost. Premiums and discounts are recognised in profit or loss in net interest income over the life of the asset using the effective interest rate method. The carrying amounts of claims to which micro fair value hedge accounting is applied are adjusted for changes in fair value attributable to the hedged risk. Embedded derivatives are separated from their host debt instrument where this is required, measured at fair value and recognised in either trading assets or trading liabilities.

5.11 Loan loss provisions

Loan default risk is addressed by the recognition of specific loan loss provisions (SLLPs) and general loan loss provisions (GLLPs).

When determining provisioning levels, a fundamental distinction is drawn between those claims which are in default and those which are not. All claims which are in default under the Basel III regulations are identified as in default or non-performing. The following events can be indicative of a customer default:

- Imminent insolvency (over 90 days past due).
- The Bank is assisting the customer in its financial rescue/restructuring measures, with or without restructuring contributions.
- The Bank has demanded repayment of its claims.
- The customer is in insolvency proceedings.

For significant claims which are in default, the Bank recognises specific loan loss provisions in accordance with uniform standards across the Group. The net present value of the expected future cash flows is used to calculate both specific valuation allowances as well as specific loan loss provisions (SLLPs). In addition to the expected payments, the cash flows include the expected proceeds from realising collateral and other recoverable cash flows. The loan loss provision is therefore equal to the difference between the carrying value of the loan and the net present value of all the expected cash flows. Where loans are placed on non-accrual status, the increase in the net present value over time using the original effective interest rate (unwinding) is recognised as interest income.

In the case of non-defaulted claims, the Bank accounts for credit risk in the form of general loan loss provisions (GLLPs). The amount of the general loan loss provisions, both for on- and off-balance sheet transactions, is determined using parameters derived from Basel III methodology.

Where the loan loss provision relates to claims recognised on the balance sheet, it is deducted from claims on banks and customers. However, the provision for losses in off-balance sheet business (irrevocable lending commitments) is shown under provisions for loan losses.

Unrecoverable claims for which no specific impairment has been recognised are written off directly. Amounts recovered on claims written off are recognised in profit or loss. Impaired claims are (partially) written down, utilising any specific provisions, if such claims prove to be partially or entirely unrecoverable. Those portions of impaired claims that exceed existing loan loss provisions and prove unrecoverable are also directly written off.

If the indicators for impairment of particular loans cease to apply or no longer suggest an impairment, these are reversed through profit or loss, but to no more than the level of amortised cost.

5.12 Repo transactions

Repo transactions combine the spot purchase or sale of securities with their simultaneous forward sale or repurchase to or from the same counterparty. Securities sold under repurchase agreements (spot sale) continue to be recognised and measured in the balance sheet as part of the securities portfolio. The securities are not derecognised, as we retain all risks and rewards associated with the ownership of the security sold under the repurchase agreement. The inflow of liquidity from the repo transaction is shown in the balance sheet as a liability to either banks or customers, depending on the counterparty. Agreed interest payments are recognised as interest expense according to maturity.

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The outflows of liquidity arising from reverse repos are recognised as claims on customers or banks. Measurement is either at fair value or at amortised cost. Securities bought under repurchase agreements on which the financial transaction is based (spot purchase) are not recognised in the balance sheet and thus not measured. Agreed interest payments in reverse repos are recognised as interest income according to maturity.

5.13 Securities lending transactions

Commerzbank Finance & Covered Bond S.A. conducts securities transactions with banks in order to meet delivery commitments or to enable it to carry out securities transactions. We report these transactions in a similar manner to securities repurchase transactions. Securities lent remain in our securities portfolio (trading assets or financial investments) and are measured according to the rules of IAS 39. Borrowed securities do not appear in the balance sheet, nor are they valued. In securities lending transactions, the counterparty credit risk can be avoided by obtaining collateral, which may be provided in the form of cash, for example. Collateral furnished for a securities lending transaction is referred to as "cash collateral out" and collateral received as "cash collateral in". No collateral was pledged or received within the scope of borrowing transactions in financial year 2017. In addition, cash collaterals are deposited or received as collateral in connection with derivative transactions. We show cash collateral which we have furnished for securities lending transactions as a claim and collateral received as a liability. Interest and expenses from securities lending transactions are recognised in net interest income according to maturity.

5.14 Positive fair values of derivative hedging instruments

Derivative financial instruments used for hedging purposes which qualify for hedge accounting and have a positive fair value are reported under this item.

The hedging instruments are measured at fair value using internal measurement procedures (present value or option price models).

Measurement gains or losses on fair value hedges from hedge accounting are reported under net income from hedge accounting in the statement of comprehensive income.

5.15 Trading assets

Trading assets comprise all derivative financial instruments which are not used as hedging instruments in hedge accounting and have a positive fair value determined by means of internal measurement procedures (present value or option price models). All realised gains and losses, together with unrealised measurement gains or losses, form part of net trading income in the statement of comprehensive income.

5.16 Financial investments

The Bank reports bonds and other interest-bearing securities as financial investments, unless they are treated as available-for-sale as defined in IFRS 5. Financial instruments classed as loans and receivables listed under this item are measured at amortised cost.

Where holdings are reclassified, the fair value at the date of reclassification is taken as the new carrying amount. The revaluation reserve net of deferred taxes existing at this point remains in the relevant equity item and is amortised over the residual term of the reclassified securities.

Holdings classified as available-for-sale financial assets are recognised and measured at their fair value. Where the fair value cannot be ascertained from active market data, the measurement is generally carried out using comparative and indicative prices from pricing service providers or other banks (lead managers) or internal measurement procedures (net present value or option price models).

Measurement gains or losses on holdings of financial assets available-for-sale are added to the revaluation reserve in equity. They are not recognised in profit or loss until sold, and then, unless permanently impaired, in net income from financial investments.

Premiums and discounts are recognised in profit or loss in net interest income over the life of the asset using the effective interest rate method. Interest income from bonds is also reported under net interest income.

If, however, an effective hedge with a derivative financial instrument exists for financial instruments reported in this item, then that portion of the change in fair value attributable to the hedged risk is shown under net income from hedge accounting.

In accordance with IAS 39.59, financial instruments in this category must be monitored for any objective indications of a loss (such as breach of contract, loss event, increased likelihood of restructuring proceedings or insolvency) that would lead to a reduction in the cash flow arising from them. An impairment is recognised when the net present value of the expected cash flows is lower than the carrying value of the financial instrument concerned. In the event of an impairment, the remeasurement loss is no longer recognised in the revaluation reserve in equity but recorded as an impairment charge under net investment income in the statement of comprehensive income.

Debt instruments are reviewed individually for impairment if any qualitative trigger events have occurred. To operationalise qualitative trigger events, additional indicators for an impairment have been developed in the Commerzbank Group. For example, an impairment charge for debt instruments in this category must generally be recognised if the debtor's rating is CCC or lower (see the Commerzbank master scale in the Group Risk Report) and the fair value is lower than amortised cost.

If the reasons for the impairment of debt instruments classified as financial assets available-for-sale cease to apply, the impairment is reversed through profit or loss, but to no more than the level of amortised cost. Any amount exceeding amortised cost is recognised in the revaluation reserve.

Impairments for financial investments classified as loans and receivables are recognised in the same way as those for securities classified as financial assets available-for-sale. The impairments are reported under net investment income. If the indicators for impairment of particular securities cease to apply or no longer suggest an impairment, the impairment of the securities may be reversed through profit or loss, but to no more than the level of amortised cost.

The fixed-interest securities in the Bank's own holdings are intended to provide long-term support to the Bank's business operations; the Bank acquired them with the object of holding them in the portfolio until final maturity, and they are largely classed as cover assets.

5.17 Fixed and intangible assets

Fixed assets are shown at acquisition or production cost. Acquisition costs comprise expense directly attributable to the purchase. Where such assets are subject to wear and tear, they are depreciated on a straight-line basis over their expected useful life.

Fixed assets are depreciated over their expected useful life as follows:

	Impairment Rate	method
Office furniture and equipment	20%	linear
IT (hardware)	25%	linear

Fixed assets are tested for impairments if events or changed circumstances suggest that an impairment might have occurred. In such situations, the impairment test under IAS 36 is carried out.

Unscheduled write-downs are carried out where the impairment can be expected to be permanent. If the reasons for the write-down cease to apply, it is reversed up to no more than the amortised cost of acquisition or production.

For reasons of materiality, acquisition costs of low-value assets are recognised directly as administrative expense during the period. Interest on debt used to fund fixed assets is not capitalised. Maintenance work on fixed assets is recorded as administrative expense in the financial year in which it is carried out. Depreciation is reported as administrative expense. Gains and losses from the sale of fixed assets are reported under other net operating income.

The Bank recognises customer relationships as intangible assets, at amortised cost. Due to their finite useful economic lives, customer relationships are written off on a straight-line basis over their prospective useful lives. The assets are also reviewed at every reporting date to determine whether the carrying amounts exceed the amounts recoverable. If so, an impairment is recognised.

The acquired customer base is written down over 4.5 years.

5.18 Taxes

Current tax assets and liabilities are calculated using the currently applicable tax rates at which payment is made to, or reimbursement received from, the tax authority concerned.

Deferred tax assets and liabilities are recognised to reflect differences between the IFRS carrying amounts of assets or lia-

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bilities and their taxable value (liability method), where these are likely to result in increases or reductions in future taxes on income (temporary differences). In addition, deferred tax assets are recognised for both tax loss carryforwards and unused tax credits, subject to the applicable conditions being met.

Commerzbank Finance & Covered Bond S.A., together with other Luxembourg companies belonging to the Commerzbank Group, has, since 2011, constituted a tax group for corporation and business tax purposes. Its parent company is the Luxembourg branch of Commerzbank AG. To compensate for the tax effects resulting from this tax group, the companies participating in it have entered into an apportionment agreement, which is also the basis for the accounting treatment.

The measurement of deferred taxes is based on income tax rates already approved as at 31 December 2017 and applicable upon realisation of the temporary differences. Deferred tax assets are recognised only if it is probable that taxable profits will arise in the same tax unit or tax group in future. Tax assets and liabilities may not be discounted. Depending on the treatment on the underlying situation, deferred tax assets and liabilities are recognised and carried forward either under taxes on income in the income statement or directly in equity in the relevant equity item. The Bank classifies deferred tax items in the balance sheet as non-current.

Deferred income tax assets and liabilities are netted if there is a right to net current taxes on income and the deferred tax assets and liabilities relate to taxes on income levied by the same fiscal authority on the same taxable entity.

Tax income and expense are reported as taxes on income in the statement of comprehensive income and broken down in the Notes into current and deferred tax assets and liabilities in the financial year. Other taxes not dependent on income are shown under other net operating income. Current and deferred income tax assets and liabilities are reported in the balance sheet as asset and liability items respectively.

The distinctions between current and deferred tax assets and between current and deferred tax liabilities are explained in Notes 8.10 und 9.9.

5.19 Liabilities to banks and customers and securitised liabilities

Financial liabilities are recognised at amortised cost. As part of micro fair value hedge accounting, hedged liabilities have been adjusted for the changes in fair value attributable to the hedged risk.

5.20 Negative fair values of derivative hedging instruments

This item shows derivative financial instruments that are used for hedging purposes and qualify for micro fair value hedge accounting, where they have a negative fair value. The hedging instruments are measured at fair value using internal measurement procedures (present value or option price models). In fair value hedges, changes to the fair value of the hedging instruments are recognised in net income from hedge accounting in the statement of comprehensive income.

5.21 Trading liabilities

Derivative financial instruments which are not used as hedging instruments in hedge accounting are reported under trading liabilities. Internal measurement procedures (net present value or option price models) are used for this purpose. All realised gains and losses, together with unrealised measurement gains or losses, form part of net trading income in the statement of comprehensive income.

5.22 Provisions

A provision must be recognised if on the reporting date, as the result of an event in the past, a current legal or factual obligation has arisen, an outflow of resources to meet this obligation is likely and it is possible to make a reliable estimate of the amount of this obligation. For that reason, provisions are made for liabilities of an uncertain amount to third parties and anticipated losses arising from pending transactions in the amount of the claims expected.

The amount recognised as a provision represents the best possible estimate of the expense required to meet the current obligation as at the reporting date. This estimate takes account of risks and uncertainties. If the interest rate effect is material, provisions are recognised at net present value.

Allocations to the different types of provisions are made through various items in the statement of comprehensive

income. Provisions for lending business are charged to loan loss provisions. Other provisions are generally recognised as administrative expense.

5.22.1 Provisions for pensions and similar commitments

Occupational pension provision for active and former employees and their survivors is based on various schemes (defined benefit and defined contribution plans).

Under a defined contribution plan, employees acquire an entitlement to a pension from an external pension scheme on the basis of contributions made. The Bank helps to fund this by paying a fixed contribution to external pension providers (which include the Versicherungsverein des Bankgewerbes a.G. (BVV), Berlin and the Versorgungskasse des Bankgewerbes e.V., Berlin).

In this case, the amount of present and future pension benefits is determined by the contributions paid and the income generated by associated assets. The accounting rules set out in IAS 19 for defined contribution plans are applied to such indirect schemes, so the contributions to the external pension provider are recognised as personnel expenses. No provisions are created.

There are also obligations arising out of entitlements to pensions and current benefits under the defined benefit plans operated by the Bank, based on a direct pension commitment on its part, where the level of the pension payment is predefined and dependent on factors such as age, salary level and length of service. As IAS 19 accounting principles for defined benefit pension plans apply to these pension schemes, provisions are recognised.

The pension expenses recorded under personnel costs for direct pension commitments is made up of several components: First, from the service cost, which represents the entitlements earned by members during the financial year, and secondly from the interest cost on the net present value of the pension obligations, since the moment at which the pension obligations have to be met has moved closer by one period. Moreover, the amount of pension expense is influenced by the recognition of actuarial gains or losses not previously recognised in profit or loss. Where direct pension commitments have been changed, resulting in a change to the obligation to pay benefits, past service cost or income is reported.

With defined benefit plans, pension obligations and similar obligations (age-related short-time working, early retirement, long service awards) are calculated annually by an independent actuary using the projected unit credit method. In performing this calculation, the actuary draws not only on biometric assumptions (e.g. the Heubeck 2005 G mortality tables) but also and in particular on an up-to-date market interest rate on prime long-term corporate bonds, fluctuation and career trends and expected rates of increase in salaries and pensions. Actuarial gains and losses are reported immediately in equity and to their full amount.

At the same time, past service costs resulting from retrospective plan changes are reported immediately and in full through profit or loss. As a consequence of these changes, the netting of pension obligations and plan assets leads to the full net pension obligation being shown in the financial statements. In addition, where pension obligations are funded from plan assets, the amended IAS 19 requires net interest costs to be determined. This is the interest applied to the net liabilities or net assets (the defined benefit obligation less fair value of the plan assets) using a consistent interest rate.

5.22.2 Restructuring provisions

Restructuring provisions are recognised if the Bank has a detailed formal restructuring plan and has already begun implementing this plan or has announced the main details of the restructuring. The detailed plan sets out the costs associated with the restructuring and the period over which the restructuring is to be carried out. The detailed plan must be communicated in such a way that those affected can expect it to be put into effect. The restructuring expenses item in the income statement contains further direct restructuring expenses which are due immediately and not included in the restructuring provision. No restructuring expenses were incurred in 2017.

5.22.3 Employee remuneration plans

1. Description of the main remuneration plan:

Commerzbank Incentive Plan (CIP)

The Commerzbank Incentive Plan (CIP), which grants beneficiaries an equity-related component tied to the performance of the Commerzbank share in addition to a cash component, was established in 2011. Under the legal structure of the share-based payment plans Commerzbank has the right to settle in cash rather than shares. To avoid further dilution through capital increases, Commerzbank Finance & Covered Bond S.A. has exercised this option for all future payments to employees (with the exception of management) since 2013.

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The mechanism of the remuneration model for variable remuneration comprises both a short-term incentive (STI) and a long-term incentive (LTI) in various formats. The STI component is designed as compensation for the previous financial year. The LTI component is designed as compensation for a vesting period of four years.

The proportion of the variable remuneration granted in the form of shares or cash depends on what are termed risk-taker groups:

- Risk-taker I (executives, members of management),
- Risk-taker II (chairs of important committees, functions with a significant impact on the bank's overall risk profile).

Risk-taker groups I and II differ in the weighting of the STI and LTI. In both cases around half of the short-term and long-term components is paid out in shares or cash.

The different remuneration components are estimated and recognised in profit or loss in the financial year on the basis of plan calculations. The level of variable remuneration and therefore the proportion in shares per employee is finalised in the annual target attainment meeting (performance appraisal I), which is held in the first three months of the following year. This amount represents the upper limit for variable remuneration for the entire four-year vesting period, after which it can be reduced in the annual target attainment meetings only as a result of Group-specific quantitative and individual qualitative attainment metrics. The number of shares to be settled in cash is determined by dividing the shares portion of the variable remuneration by the average Xetra closing price of the Commerzbank share in January and February of the current year plus that for December of the previous year.

In the STI the shares, or the optional cash settlement, are subject to a six-month lockup period. In the LTI, the shares vest in the beneficiaries after performance appraisal II at the end of the vesting period of four years (including the financial year that has ended), i.e. three years after determining the underlying number of shares. There is another six-month lockup period from the date on which the shares vest in the beneficiaries. If Commerzbank has paid dividends or carried out a corporate action during the term of the CIP, an additional cash amount equal to the dividend, or a cash settlement for the corporate action, will be paid out when the CIP matures.

2. Accounting treatment and measurement

The staff compensation plans described here are accounted for under the rules of IFRS 2 – Share-based Payment and IAS 19 – Employee Benefits. IFRS 2 distinguishes between share-based payments settled with equity instruments and those settled in cash. For both forms, however, the grant of share-based payments has to be recognised at fair value in the annual financial statements.

a) Share-based payment transactions settled with equity instruments

The fair value of share-based payments settled with equity instruments is recognised as personnel expense and reflected in equity in retained earnings. Fair value is determined on the date on which the rights are granted. If, however, rights cannot be exercised because other conditions for exercise are not met (service and non-market conditions), the amounts already recognised in equity are adjusted through profit or loss.

b) Measurement

The provision for the Commerzbank Incentive Plan is measured by multiplying the number of shares earned by participants by the closing price of the Commerzbank share on 31 December of the reporting year. The expense for allocations to provisions may also be recognised over the vesting period, depending on the remuneration plan.

5.23 Subordinated capital

Non-securitised subordinated liabilities are reported as subordinated debt and at amortised cost.

Premiums and discounts are recognised through profit or loss over the life of the liability using the effective interest rate method.

5.24 Equity

According to IFRS, equity constitutes a residual interest in the assets of an undertaking after deduction of all its obligations or claims and is not capable of being cancelled by the provider of capital.

5.25 Irrevocable lending commitments

Irrevocable lending commitments are obligations potentially giving rise to a credit risk in future. These include obligations

to grant loans (e.g. lines externally notified to customers), to buy securities or provide guarantees or acceptances.

Provisions for risks in respect of irrevocable lending commitments are included in provisions for loan losses.

The Bank had no irrevocable lending commitments as at 31 December 2017.

5.26 Leases

Under IAS 17, a lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership to the lessee. Leases where the lessee bears substantially all the risks and rewards are classified as finance leases. The net present value of the lease payments is central to determining the risks and rewards of the lease. If the net present value is at least equal to the amount invested into the leased asset, the lease is classified as a finance lease. The most commonly leased assets are real estate and motor vehicles.

If the risks and rewards of ownership remain substantially with the lessor (an operating lease), the asset will continue to be recognised on its balance sheet. Leased assets are shown at acquisition or production cost, less depreciation over their useful economic lives and/or impairments. Unless a different distribution is appropriate in individual cases, proceeds from leases are recognised on a straight-line basis over the term of the lease and reported under other net income.

The Bank has no financial leases; its obligations on the basis of operating leases are explained in Note 9.13 .

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6 Risk Report

6.1 Central administration, internal governance and risk management

The duties imposed by the current version of circular CSSF 12/552 are an established fact of life and day-to-day business practice at Commerzbank Finance & Covered Bond S.A. The key functions are in place and guidelines on them have been published for internal use. The process is reviewed annually.

The Bank complies in full with its requirements within the bounds of the proportionality principle.

6.2 Risk strategy

Risk management at Commerzbank Finance & Covered Bond S.A. is methodologically and organisationally integrated within the Commerzbank Group. The various risks are managed using a framework of guidelines, structured limits and a holistic risk management system, all of which are standard throughout the company. For the purpose of the quantitative measurement, monitoring and control of specific risks, the Group uses established systems and control mechanisms, which are regularly reviewed and adapted to current business trends.

6.3 Risk-oriented overall bank management

6.3.1 Risk management organisation

The Bank defines risk as the danger of possible losses or profits foregone due to internal or external factors. In risk management, a fundamental distinction is drawn between those risks that are quantifiable – i.e. usually measurable in the annual financial statements or in regulatory capital requirements – and those that are not quantifiable, such as reputational risk.

Risk management operations are the direct responsibility of the relevant Managing Director, who is also a member of the Board of Directors. This manager is responsible for the application of the risk policy principles adopted by the Group to address quantifiable risks, and reports to the Board of Directors on the Bank's overall risk position at least twice a year.

Specific committees have been set up throughout the Group for the purpose of conducting risk management operations; these act on the basis of delegated competences and assist the Board of Directors in reaching decisions on risk-related issues.

6.3.2 Integration into the Group

In managing its risks, Commerzbank Finance & Covered Bond S.A. uses the methodologies and systems established in the Commerzbank Group. This is reflected in the close integration of the Bank's local risk functions with their Group counterparts.

6.3.3 Risk-bearing capacity

Risk-bearing capacity analysis is a key part of overall bank management and Commerzbank Finance & Covered Bond S.A.'s Internal Capital Adequacy Assessment Process (ICAAP). The objective is to determine a level of capital adequacy appropriate to the Bank's risk profile. To do this, Commerzbank Finance & Covered Bond S.A. uses Commerzbank AG's risk-bearing capacity concept. Risk-bearing capacity is monitored using a gone concern approach which seeks primarily to protect unsubordinated lenders. The intention is that this objective should be achieved even in the event of extraordinarily high losses from an unlikely extreme event. The gone concern approach is supplemented here by elements aimed at ensuring the institution's continuing existence (going concern perspective).

The quantification of the economic risk coverage potential is based on a differentiated view of the accounting values of assets and liabilities and involves economic valuations of certain balance sheet items.

Also, when determining the economically required capital, allowance is made in a stress test for potential unexpected fluctuations in value. Where such fluctuations exceed forecasts, they must be covered by the available economic capital to absorb unexpected losses (economic risk coverage potential).

The capital requirement for the risks taken is quantified using the internal economic capital model. The confidence level of 99.91% in the economic capital model is in line with the underlying gone concern assumptions and ensures the economic risk-bearing capacity concept is internally consistent. When assessing the economic capital required, allowance

is made for all the types of risk at Commerzbank Finance & Covered Bond S.A. that are classified as material and quantifiable in the annual risk inventory. The economic risk approach therefore also comprises risk types that are not included in the regulatory requirements for banks' capital adequacy. The quantifiable risks in the economic capital model can be divided into default risk, reserve risk, market risk, operational risk and (although not shown separately in the table below) business risk. Business risk is considered as a deductible amount in risk coverage potential.

Other quantifiable risks include property value change risk and investment portfolio risk. Investment portfolio risk indicates the risk of an unexpected fall in the value of unlisted investments, while property value change risk is the risk of an unexpected fall in the value of owned property (especially real estate). As Commerzbank Finance & Covered Bond S.A. owns neither holdings nor real estate, these risks do not feature in its risk-bearing capacity analysis.

The results of the risk-bearing capacity analysis are shown using the risk-bearing capacity ratio (RBC ratio), showing the economically required capital in relation to the risk coverage potential.

Risk-bearing capacity CFCB in €bn	31.12.2017	31.12.2016
Economic risk coverage potential[1]	0.53	-0.29
Economically required capital[2]	1.35	1.55
of which: for credit risk[3]	0.70	0.62
of which: for market risk	0.65	0.93
of which: for OpRisk	0.00	0.00
of which: diversification effects	0.00	0.00
RBC ratio[4]	**40%**	**-19%**

[1] Including deductible amounts for business risk.
[2] Without property value change risk or unlisted investments risk.
[3] Credit risk incl. reserve risk
[4] RBC ratio = economic risk coverage potential/economically required capital

The Bank's risk-bearing capacity is monitored on a monthly basis. The capital increase implemented in December 2017 and the simultaneously reduced economic capital requirements are reflected in a considerable improvement in the risk-bearing capacity ratio as at the end of 2017. The RBC ratio increased markedly from –19% in the prior year to 40% as at 31 December 2017.

The minimum risk-bearing capacity is deemed to be met as long as the RBC ratio is higher than 100%.

As the economic capital requirement cannot at present be covered by the economic risk coverage potential, the Bank is relying on its regulatory risk-bearing capacity, which is assured. The shortfall in economic capacity is also underwritten by the letter of comfort given by Commerzbank AG, Frankfurt in respect of Commerzbank Finance & Covered Bond S.A.'s liabilities.
The Bank's regulatory risk-bearing capacity is assured.

The Bank conducts specific stress tests to show the risk-bearing capacity required in relation to liquidity. In the stress test, the Bank must have sufficient liquidity to last for one month, a period termed the Survival Period. This was assured throughout the year under review.

The Bank has taken various steps to restore its compliance with risk capacity requirements on a stand-alone basis.

6.3.4 Credit risk

Default risk

Default risk refers to the risk of losses due to defaults by counterparties and to changes in this risk. Under the heading of default risk, Commerzbank Finance & Covered Bond S.A. lists not only credit default and third-party debtor risk but also counterparty, issuer, settlement and replacement risk, as well as country and transfer risk..

Rating systems

As part of the check to be carried out on the creditworthiness of every borrower, the Bank assigns an internal rating (a reconciliation of internal ratings to external ones is provided in the attached master scale). It also calculates a loss given default (LGD) using various parameters including collateral and market value, recovery ratio and realisation period. In view of the Bank's integration into the Group-wide limit and management system, rating, further development, validation and monitoring are carried out by Commerzbank AG.

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Commerzbank Master Scale

Commerz-bank AG Rating	PD / EL Mid-point [%]	PD / EL Range[1] [%]	S&P Scale[2]		Credit Quality Steps In Accordance With Article 136 CRR[3]	
1.0	0.0000	0.0000	AAA	AAA		Investment grade
1.2	0.0147	0.0001 - 0.0190	AA+		I	
1.4	0.0248	0.0191 - 0.0319	AA. AA-	AA		
1.6	0.0412	0.0320 - 0.0525	A+, A			
1.8	0.0671	0.0526 - 0.0847	A-	A	II	
2.0	0.1071	0.0848 - 0.1339				
2.2	0.1675	0.1340 - 0.2073				
2.4	0.2567	0.2074 - 0.3144	BBB+			
2.6	0.3851	0.3145 - 0.4665	BBB	BBB	III	
2.8	0.5654	0.4666 - 0.6775	BBB-			
3.0	0.8120	0.6776 - 0.9621	BB+			Sub-investment grade
3.2	1.1401	0.9622 - 1.3355	BB			
3.4	1.5644	1.3356 - 1.8110	BB-	BB	IV	
3.6	2.0965	1.8111 - 2.3979				
3.8	2.7426	2.3980 - 3.0982				
4.0	3.5000	3.0983 - 3.9039				Non-investment grade
4.2	4.3545	3.9040 - 4.8571	B+			
4.4	5.4177	4.8572 - 6.0430	B	B	V	
4.6	6.7405	6.0431 - 7.5184				
4.8	8.3862	7.5185 - 9.3541	B-			
5.0	10.4338	9.3542 - 11.6380				
5.2	12.9812	11.6381 - 14.4794	CCC+	CCC		
5.4	16.1507	14.4795 - 18.0147	CCC, CCC-		VI	
5.6	20.0940	18.0148 - 22.4131	CC, C	CC, C		
5.8	47.3425	22.4132 - 99.9999				
6.1	100	> 90 days past due	D			Default
6.2		Imminent insolvency				
6.3		Restructuring with recapitalisation / partial waiving of claims				
6.4		Cancellation without insolvency				
6.5		Insolvency				

Comments:
[1] after rounding to the nearest decimal number having 4 digits behind the decimal point.
[2] Mapping can only be indicative, since observed default rates may differ among portfolios and fluctuate over time.
[3] CRR = Capital Requirements Regulation (EU) No. 575/2013

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In Group Management Treasury's collaboration with Commerzbank AG, the latter's rating procedure for states (sovereigns), sub-sovereigns and banks is used.

Credit risk management

Commerzbank Finance & Covered Bond S.A. is directly integrated in the Commerzbank Group's overall bank management concept. To manage and limit default risk, the following risk parameters are used: exposure at default (EaD), loss at default (LaD), expected loss (EL), risk density (EL/EaD), credit value at risk (CVaR = economically required capital for credit risk with a confidence level of 99.91% and a holding period of one year), risk-weighted assets and "all-in" for bulk risk. Stress scenarios are modelled on the basis of the credit value at risk (CVaR) of the loan portfolio model, both regularly and as and when required.

Taking economic capital as a fundamental concept makes it possible to ensure that the concentration of risks in clusters, countries, target groups and produces is limited.

Country / Nominal in €m	31.12.2017 in €m	Proportion %	31.12.2016 in €m	Proportion %
United States of America	4,240	45.9	5,412	47.4
Great Britain	2,256	24.4	2,401	21.1
Italy	1,140	12.3	1,253	11.0
Spain[1]	463	5.0	758	6.6
Portugal	439	4.7	444	3.9
Canada	431	4.7	502	4.4
Supranational	184	2.0	209	1.8
Japan	93	1.0	93	0.8
Ireland	0	0.0	219	1.9
Switzerland	0	0.0	84	0.7
Netherlands	0	0.0	25	0.2
Iceland	0	0.0	8	0.1
Totals	**9,247**	**100.0**	**11,408**	**100.0**

[1] incl. EIF guaranteed exposure

As regards risk concentration, there is only one counterparty exposure (internal rating cb2.8) that exceeds the limit of 5% of the nominal portfolio volume; this has a nominal amount of €754.7m (around 8.1%). The collateral held by Commerzbank Finance & Covered Bond S.A. to minimise credit risk is mainly in the form of guarantees given by public bodies in respect of that part of the portfolio that does not directly constitute sovereign risk.

Public finance

The portfolio of Commerzbank Finance & Covered Bond S.A. includes international state financing and financing for financial institutions. The public finance business focuses on the governments of national governments, provinces, federal states, regions, cities and municipalities in EU member states and OECD countries, as well as supranational institutions and a small proportion of covered bonds. The product groups to which it is exposed are securities and loans/promissory note loans. Broken down by product group, bonds made up approximately 76.3% (around €7.1bn nominal) and loans/promissory note loans approximately 23.7% (around €2.2bn nominal) of the overall portfolio as at 31 December 2017. As at 31 December 2016, bonds made up approximately 78.9% (around €9.0bn nominal) and promissory note loans approximately 21.1% (around €2.4bn nominal).

Overall, the hidden liabilities within assets classed as loans and receivables – resulting from the difference between carrying amount and fair value – amounted to €1,574.8m.

Credit exposure on the reporting date amounted to approximately €9,247m nominal (31 December 2016: €11,408m) and, according internal ratings classification (cb1.0 – cb2.8), 89.6% (31 December 2016: 89.9%) was investment grade (external rating AAA to BBB–). A total of around 43.9% (31 December 2016: 45.8%) can be regarded as of very good quality (internal rating cb1.0 – cb1.8). The change in percentage shares was largely due to the portfolio reduction and not to the general deterioration in asset quality.

Ongoing portfolio reduction resulted in a change to the debtor structure, which was consequently reflected in the rating breakdown.

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Nominal exposure	31.12.2017 in €m	31.12.2017 in %	31.12.2016 in €m	31.12.2016 in %
cb1.0	83	0.9	128	1.1
cb1.2	2,456	26.6	3,578	31.4
cb1.4	791	8.6	807	7.1
cb1.6	427	4.6	491	4.3
cb1.8	299	3.2	224	2.0
cb2.0	2,351	25.4	2,700	23.7
cb2.2	104	1.1	149	1.3
cb2.4	90	1.0	301	2.6
cb2.6	351	3.8	1,465	12.8
cb2.8	1,334	14.4	417	3.7
>cb2.8	961	10.4	1,149	10.1
Total	**9,247**	**100.0**	**11,408**	**100.0**

The Bank's loans portfolio mainly comprises loans/promissory note loans and securities (bonds) issued by public borrowers (public finance). It also includes securities and loans in the regions of Europe, North America and Asia, and similar guaranteed by public bodies. Government bonds are used to secure a position of US$250m, which was taken over from Commerzbank International S.A., Luxembourg in 2016.

Consistent progress was made on active portfolio reduction during the year under review. The Bank's loan portfolio was reduced in 2017 by some €2,161m nominal; this reduction included not only ordinary maturities but also amounts relating to the active portfolio reduction.

Other

On 1 August 2012, the City of San Bernardino in the USA filed a petition for Chapter 9 bankruptcy protection in the County of Riverside, California. The petition was granted on 16 October 2013.

With regard to the loan exposure in San Bernardino, which was moved to GRM-IC (Intensive Care) in September 2015 and for which a specific valuation adjustment was made as at 31 December 2016 in the equivalent of €29.4m, the unit within Commerzbank AG tasked with conducting the negotiations on behalf of Commerzbank Finance & Covered Bond S.A. was able to reach a provisional agreement with the city of San Bernardino in January 2016 on the restructuring of the outstanding bonds. This agreement was approved by the bankruptcy judge hearing the case on 7 February 2017. Following the approval of the bankruptcy judge, the Bank entered into a final exchange agreement with the parties involved (City of San Bernardino and AMBAC).

With this agreement, which took effect on 15 June 2017, the Bank was able to come to an arrangement with all parties that it found acceptable in this case.

6.3.5 Market price risk

Commerzbank Finance & Covered Bond S.A. defines market risk as the possibility of losses of economic value in its portfolio potentially resulting from changes to market prices. The main sub-risk types are general market risk (interest rates, exchange rates, basis risk, volatility) and specific market risk (credit spreads).

The Bank measures its market risk on the basis of the value at risk (VaR) concept, using Commerzbank AG's systems and methodologies.

VaR quantifies the potential loss from financial instruments due to changed market conditions within a set time horizon and at a specific probability. For internal management purposes, a confidence level of 97.5% and a holding period of one day are assumed. The value at risk concept makes it possible to compare risks over a variety of portfolios and/or business areas. It enables many positions to be aggregated, taking account of correlations between different assets. This ensures a consistent view of market risk at all times.

The main drivers of market risk are credit spread risk and interest and basis risk in the banking book.

Credit spread sensitivities are as follows as at 31 December 2017:

Credit spread sensitivities Rating

Credit spread sensitivities Rating	CS01 limit (in €000)	CS01 (in €000)	Utilisation in %
AAA or lower	-14,500	-11,951	82
AA or lower	-13,500	-11,540	85
A or lower	-11,000	-9,578	87
Below A	-2,800	-2,027	72

The credit spread sensitivities of all securities fell from €14.7m as at the end of 2016 to €12.0m as at the end of 2017.

As required by the regulator for a bank with only a banking book, Commerzbank Finance & Covered Bond S.A. also quantifies the effects of interest rate change shocks on the economic value of its portfolio. The Bank uses a number of stress scenarios, including two for sudden and unexpected changes in interest rates (+/– 200 basis points as "standard shock"). The outcome of the +200 basis points scenario would be a potential change in value of €+29m as at 31 December 2017, while the –200 basis points scenario would result in a potential change in value of €–35m as at the same date (assuming a 0% floor).

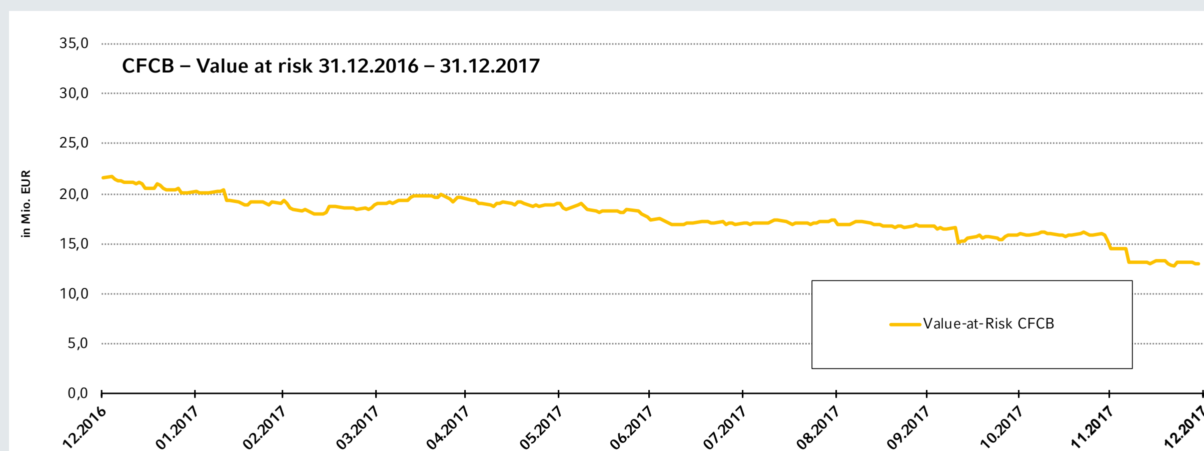
Key figures for value at risk (VaR)

Value at risk	Year-end 2017	Minimum 2017	Maximum 2017	Average 2017	Median 2017	Year-end 2016
VaR (97.5% / 1D) (in €m)	13.0	12.8	21.7	17.7	17.4	21.6

The table above shows Commerzbank Finance & Covered Bond S.A.'s limited VaR. In line with the methodology adopted at Group level, limited VaR comprises all interest rate risk (incl. credit spread risk) for the Bank's positions classified as financial assets available-for-sale, but not the credit spread risk on LaR positions.

The limited VaR of Commerzbank Finance & Covered Bond S.A. fell considerably during the year (see figure below). In addition to market conditions, in particular this was largely due to decreased volatilities in the one-year analysis of the market risk model (historical simulation).

CHANGE IN VALUE AT RISK IN 2017



Risks arising from extreme market conditions are simulated and limited using Group-wide market risk stress tests.

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6.3.6 Liquidity risk

The Bank defines liquidity risk in a narrower sense as the risk of being unable to meet its payment obligations on a day-to-day basis. In a broader sense, liquidity risk describes the risk that future payments cannot be funded for the full amount, in the required currency or at standard market conditions, as and when they are due.

The Bank uses Commerzbank AG's liquidity risk monitoring system to manage liquidity risk. This system is based on Commerzbank AG's liquidity gap profile concept. In addition, Commerzbank Finance & Covered Bond S.A. is fully involved in the management and monitoring of liquidity risks across the Group.

The liquidity gap profile is limited overall and for each significant currency. In 2017 the liquidity gap profile (overall) was within the set limit at all times.

The liquidity coverage ratio (LCR) is calculated as the ratio of liquid assets to net liquidity outflows under stressed conditions. It is used to measure whether a bank has a large enough liquidity buffer to independently withstand any potential imbalance between inflows and outflows of liquidity under stressed conditions over a period of 30 calendar days. Following an introductory period, a minimum ratio of 100% must be observed from 1 January 2018. Until then, the ratio is 60% from October 2015, 70% in 2016 and 80% in 2017. The Bank significantly exceeded the stipulated minimum ratio on every reporting date in 2017.

6.3.7 Operational risk

The risk of losses resulting from the inappropriateness or failure of internal procedures and systems, the human element or external events is defined as operational risk. The definition also covers legal risk, but not reputational or strategic risk.

Commerzbank Finance & Covered Bond S.A. is integrated into Commerzbank AG's operational risk management system for the purpose of complying with the requirements of the Group and the regulator. This means it is also integrated into Commerzbank AG's system for collecting loss data and the other main elements of its operational risk management approach. All quantitative and qualitative requirements for managing operational risks, including the associated steering mechanisms, have been met.

Commerzbank Finance & Covered Bond S.A. calculates its capital adequacy using Commerzbank AG's advanced measurement approach (AMA) and an allocation formula.

As at 31 December 2017, the capital allocated by the Bank to operational risk amounted to €0.6m (31 December 2016: €0.7m).

Outsourcing

Given its small size, the Bank does not have an in-house internal audit department. During the year under review, the functions of internal audit at the Bank were performed by the Group Audit department (GM-Audit) of Commerzbank AG under a service level agreement. The CSSF approved the outsourcing of the internal audit function in a letter dated 20 March 2003.

In order to meet the Minimum Requirements for Risk Management (MaRisk), the divisions responsible for central credit risk management at Commerzbank AG in Frankfurt process applications for loans, prepare loan documentation, use appropriate systems to compile ratings and perform the related functions, on behalf of Commerzbank Finance & Covered Bond S.A.

The departments outsourced by the Bank are GM-F Finance, Group GS-MO Banking Services, GM-CO Legal & Compliance and GRM-MR Market Risk. Service level agreements to this effect have been concluded and are subject to regular review as part of the monitoring of outsourcing. The departments remaining within the Bank are Asset Liability Management (ALM), Credit Risk Management (CRM) and Analytics & Regulatory Issues (ARI).

The monitoring and ongoing quantification of outsourcing risks as part of operational risk is accomplished by integrating the Bank in the Group-wide outsourcing policy of Commerzbank, the processes established for this purpose and the methods and procedures defined for it.

Other risks

To meet the requirements of pillar 2 of the Basel framework, an integrated approach to risk that also includes unquantifiable risk categories is necessary. All the risk types set out below are likewise subject to a Group-wide qualitative control and monitoring process.

Human resources risk
Within the Commerzbank Group, human resources risk is divided into four categories:

- **Adjustment risk**
  All employees must have the knowledge, experience and skills required to perform their task and duties and discharge their responsibilities. This is ensured on an ongoing basis by appropriate training and continuous professional development.

- **Motivation risk**
  Systems of remuneration and incentivisation must be constructed in such a way that they do not result in conflicts of interest and false incentives, especially among senior management.

- **Departure risk**
  The absence or departure of staff must not result in long-term disruption to the conduct of business. The criteria governing appointments, especially to senior positions, must be specified.

- **Supply risk**
  The quality and number of staff recruited must be appropriate to requirements, specifically in terms of its business operations, strategy and risk situation.

Business strategy risk
Business strategy risk is the risk of negative influences on the achievement of strategic goals as a result of changes in market and competitive, capital market requirements, banking regulation and policy or inadequate implementation of Group strategy and/or inconsistent performance by the business areas. Commerzbank Finance & Covered Bond S.A. aligns itself with Commerzbank AG's Group strategy. Material changes and developments are detected by means of ongoing observation and continuing analysis of the market and competitive environment in Germany and other countries and the requirements of regulators and the capital markets, with the measures to secure the company's long-term success being derived from these.

Reputational risk
Commerzbank Finance & Covered Bond S.A. manages reputational risk in accordance with the Group's guidelines. A company's reputation is becoming more and more crucial in today's competitive environment. This is attributable not least to the effects of the financial crisis and to the associated loss of confidence in banks, as well as to the influence of reports in the media and elsewhere. The Bank is aware of its responsibility in this regard. As the sum of its stakeholders' perceptions, Commerzbank Finance & Covered Bond S.A.'s reputation is of significant value and needs to be protected, as a good reputation is an indicator of, among other things, trustworthiness, a commitment to values and an awareness of corporate responsibility. Commerzbank Finance & Covered Bond S.A. avoids business policy measures and transaction with inherent tax or legal risks or that are in breach of business policy as expressed in its articles of association or other public statements.

Compliance risk
The monitoring of compliance with relevant laws, regulations and internal rules and adherence to standards and codes of conduct customary on the market in the course of business operations is carried out by the local Chief Compliance Officer, who works closely with Group Compliance at Commerzbank AG. The objective is to identify at an early stage compliance risks with potential to jeopardise the company's integrity and hence its success, prevent them if at all possible, manage them, or resolve them appropriately in the interests of all parties.

6.4 Summary

Risks of significance in terms of the overall assessment of Commerzbank Finance & Covered Bond S.A. have been reported. There is no indication of any other risk criteria or circumstances that might put the continued existence of the Bank at risk. The possibility of further impairments, notably within the US sub-portfolio, cannot be entirely ruled out, but there is at present no evidence of any need for them.

6.5 Disclaimer

The risk measurement methods and models used at Commerzbank Finance & Covered Bond S.A., which form the basis for the calculation of the figures shown in this report are state of the art and based on banking sector practice. The results produced by the risk models are suitable for managing the Bank. The measurement approaches are regularly reviewed by risk control and internal audit, external auditors and the supervisory authorities. Despite being carefully developed and regularly monitored, models cannot cover all the influencing factors that have an impact in reality or illustrate their complex behaviour and interactions. These limits to risk modelling apply particularly in extreme situations. Supplementary

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stress tests and scenario analyses can show only examples of the risks to which a portfolio may be exposed in extreme market situations; stress testing of all imaginable scenarios is not feasible. Stress tests cannot offer a final estimate of the maximum loss should an extreme event occur.

7 Notes on the comprehensive income statement

7.1 Net interest income

in €000	2017	2016
Interest income from	**433,184**	**482,208**
Public-sector loans	97,467	107,828
Other lending and money market transactions	38,233	8,291
Fixed-interest securities	285,231	341,504
of which LaR	*244,319*	*298,009*
of which AfS	*40,913*	*43,494*
Profit from the sale of loans and receivables	4,849	0
Profit/loss from repaid liabilities	1,450	0
Profit/loss from repurchased bearer paper	0	11,468
Other interest income	5,955	13,117
Interest expenses for	**441,597**	**453,795**
Securitised liabilities	73,745	89,618
Registered mortgage bonds	65,498	60,487
Loans received	805	715
Other lending and money market transactions	76,967	56,473
Loss on the sale of receivables	13,418	0
Current net income from swaps	210,358	245,621
Other interest expenses	807	881
Total	**-8,414**	**28,412**

Net interest income includes €433,184 thousand (31 December 2016: €482,208 thousand) in income from interest and €231,240 thousand (31 December 2016: €208,174 thousand) in interest expenses relating to financial assets and liabilities not measured at fair value through profit or loss and interest expenses of €210,358 thousand (31 December 2016: €245,621 thousand) for liabilities measured at fair value through profit or loss.

The result from repaid liabilities comes from the repurchase of the Bank's own securitised liabilities in the amount of €0.1bn.

No interest from unwinding effects was reported in the financial year.

7.2 Loan loss provisions

Risk provisions are made up of impairments in the lending business and are shown in the statement of comprehensive income as follows:

in €000	2017	2016
Allocation to loan loss provisions	-2	-178
Reversals of loan loss provisions	568	309
Write-ups on claims written-down	0	486
Total	**567**	**617**

The loan loss provisions (GLLP) released are made up of €1 thousand in claims on banks and €1 thousand in claims on customers. The loan loss provisions (GLLP) released are made up of €236 thousand in claims on banks and €332 thousand in claims on customers. The amounts recovered on claims written off in 2016 related to claims on banks.

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7.3 Net commission income

in €000	2017	2016
Commission income	**6,751**	**4,899**
Services transactions	6,609	4,899
Other income	143	0
Commission expenses	**713**	**871**
Securities business	537	713
Lending and guarantee transactions	146	47
Services transactions	31	111
Net commission income	**6,038**	**4,028**
Securities business	-537	-713
Lending and guarantee transactions	-146	-47
Services transactions	6,721	4,787
Total	**6,038**	**4,028**

The Bank reports income from agency business under commission income.

7.4 Net income from hedge accounting

in €000	2017	2016
from fair value hedges	-8,419	3,214
Total	**-8,419**	**3,214**

Net income from hedge accounting shows measurement gains or losses on effective hedges under hedge accounting. This result is subject to changes in market values.

Income from fair value hedges of €–8,419 thousand (31 December 2016: €+3,214 thousand) is made up of €+63,136 thousand (31 December 2016: €–105,873 thousand) from the measurement of derivatives used as hedging instruments and €–71,555 thousand (31 December 2016: €+109,088 thousand) from the measurement of hedged underlying transactions.

7.5 Net trading income

in €000	2017	2016
Net income from derivatives (no hedge accounting)	-68,074	44,918
Other net trading income – net income from currency transactions	-2,504	130
Total	**-70,578**	**45,049**

Financial instruments in the trading portfolio are measured at fair value. The measurement of transactions not listed on a stock exchange is based on recognised net present value and option price models. Net trading income is arrived at by netting trading income with the associated expenses. This includes gains and losses from the measurement of the holdings at fair value, so that unrealised gains and losses on prices are included in the results. As well as the results from realisations and measurements, this position includes results from CVAs/DVAs, namely €–32,641 thousand (31 December 2016: €+37,499 thousand) and FVAs of €–9,226 thousand (31 December 2016: €+10,521 thousand).

7.6 Net investment income

Net investment income covers gains or losses on the disposal and remeasurement of securities categorised as loans and receivables and available-for-sale.

in €000	2017	2016
Net gain or loss from interest-bearing business		
in the available-for-sale category	**-2,055**	**0**
Losses on disposals	-2,055	0
in the loans and receivables category	**54**	**11,411**
Gains on disposals	1,179	6,216
Losses on disposals	-3,225	-21,359
Net remeasurement gain or loss	2,100	26,554
Total	**-2,002**	**11,411**

AfS holdings are measured at fair value. The net remeasurement gain or loss includes not only net GLLP releases of €665 thousand on financial investments categorised as LaR (31 December 2016: €1,276 thousand) and net SLLP releases of €1,435 thousand (31 December 2016: €25,278 thousand).

In 2017, sales generated losses amounting to a total €4,101 thousand (31 December 2016: €15,143 thousand). In 2017 these relate to the AfS category with €2,055 thousand and the LaR category with €2,046 thousand. In the prior year, the losses only related to the LaR category.

7.7 Operating expenses

Operating expenses total €24,602 thousand, made up of €1,483 thousand in personnel expenses, €19,777 thousand in non-personnel expenses, and €3,341 thousand in amortisation of intangible assets. These expenses are broken down as follows:

7.8 Personnel expenses

in €000	2017	2016
Wages and salaries	1,397	1,405
Expenses for pensions and similar employee benefits	86	187
of which: Contributions to the BVV	31	29
Total	**1,483**	**1,592**

Personnel expenses include €73 thousand on social security contributions (31 December 2016: €84 thousand).

7.9 Staff numbers, directors' and officers' remuneration, share-based payment plans

7.9.1 Staff numbers and directors' and officers' remuneration

The average number of staff during the financial years stood at 13 employees, made up, as at 31 December 2017, as follows:

Employees (number)	2017
CEO	2
Senior executives	1
Salaried employees	10
Total	**13**

As at 31 December 2017, the Bank had 13 employees, 5 of whom were female and 8 male.

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in €000	2017	2016
Payments to active officers	335	368
of which CEO and senior staff	335	368
of which BoD	0	0
Pension obligations	19	14
of which CEO and senior staff	19	14
of which BoD	0	0
Advances, loans, contingent liabilities	0	0
of which CEO and senior staff	0	0
of which BoD	0	0

In 2017, managers and executive were paid a total of €335 thousand. Expenditure in 2017 on pension provision for the persons mentioned above amounted to €19 thousand. Pension obligations in respect of former members of management and their survivors as at 31 December 2017 amounted to €4,400 thousand. Members of the Board of Directors received no remuneration.

7.9.2 Share-based payment plans

Expenses relating to share-based payments were incurred in 2017, as in previous years, in connection with services already rendered by employees (including the general management).

Expenses for share-based payments were as follows:

in €000	2017	2016
Cash-settled plans:		
of which: Commerzbank Incentive Plan	157	213

Provisions for plans with cash settlements are as follows:

in €000	2017	2016
Provisions		
of which: Commerzbank Incentive Plan	159	236

7.10 Administrative expenses

in €000	2017	2016
Occupancy expenses	135	337
IT expenses	0	1
Expenditure on consultancy services, other operating expenses and expenses required to comply with company law	646	981
Expenditure on advertising, public relations and representation	27	16
Personnel-related operating expenses	37	60
Workplace and information expenses	191	222
European Bank Levy	3,474	2,910
Service charged within Group	15,161	13,337
Other non-personnel expenses	107	136
Total	**19,777**	**18,002**

Other non-personnel expenses mainly included expenses from service charges within the Group of €15,161 thousand (31 December 2016: €13,337 thousand) and the European Bank Levy in the amount of €3,474 thousand (31 December 2016: €2,910 thousand). We will continue to report other operating expenses here.

The fee paid to the auditor, PricewaterhouseCoopers, Société coopérative, Luxembourg, in the financial year is made up in detail (excl. VAT) as follows:

Auditors' fees in €000 (excl. VAT)	2017	2016
Audit of financial statements	162	162
Other audit services	81	81
Tax consulting services	0	10
Total	**243**	**253**

7.11 Amortisation of intangible assets

in €000	2017	2016
Intangible assets	3,341	1,949
Total	**3,341**	**1,949**

Amortisation of the acquired customer base in agency business is shown under this heading.

7.12 Other net operating income

in €000	2017	2016
Income from reversals of provisions	1,660	1,088
Sundry other operating income	986	592
Total other operating income	**2,646**	**1,680**
Other taxes	1	11
Other operating expenses	445	96
Total other operating expenses	**445**	**107**
Total other net operating income	**2,201**	**1,573**

Other operating income and expenses include items that cannot be assigned to other headings in the statement of comprehensive income.

7.13 Taxes on income

The breakdown of taxes on income was as follows:

in €000	2017	2016
Current taxes on income	6,034	-6,804
Tax expense or income for the current year	6,034	-6,804
Deferred taxes on income	15,531	-7,147
Tax expense or income due to change in temporary differences and loss carryforwards	15,531	-7,147
Total	**21,564**	**-13,951**

In consequence of the establishment of the income tax group with effect from 1 January 2011, the taxable income of Commerzbank Finance & Covered Bond S.A. is allocated to Commerzbank AG, Luxembourg branch, in its capacity as parent company of the group.

The actual tax expense of €6,034 thousand includes the contribution from the income tax group. The deferred tax results from a change to temporary differences.

The tax rate applicable as at 31 December 2017 was 27.08%. This is made up of a corporation tax rate including Labour Fund premium of 20.33% and an effective trade tax rate of 6.75%.

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The following reconciliation shows the relationship between net pre-tax profit according to IFRS and tax expense in the financial year.

Calculated income tax was ascertained by multiplying pre-tax profit by the local tax applicable in the financial year, which was 27.08%.

in €000	2017	2016
Pre-tax profit or loss under IFRS	**-105,208**	**72,761**
Expected tax rate	27,08 %	29,22 %
Calculated income tax expense in financial year	**28,490**	**-21,261**
Tax effects		
a.) from previous years' taxes recognised in the financial year	0	0
b.) from tax-free income	0	0
c.) from temporary differences between values recognised for tax purposes and those recognised for IFRS purposes	15,531	-7,147
d.) tax effect from tax group	-22,457	14,457
e.) from other differences	0	0
Taxes on income	**21,564**	**-13,951**

The effective tax rate is 20.50%.

The following deferred taxes have been recognised directly in equity under the relevant heading:

in €000	2017	2016
Deferred taxes on income	**60,330**	**74,923**
Revaluation reserve	59,564	74,130
Application of IAS 19	766	793
Total	**60,330**	**74,923**

7.14 Net income

Net gains consists of measurements at fair value, impairments, impairment reversals, realised gains on disposal, recoveries on written-down financial instruments. The interest components from Note 7.1 for each IAS 39 category are shown in net interest income.

in €000	2017	2016
Net profit or loss from		
Trading assets and liabilities and derivative hedging instruments	-7,442	-60,825
Available-for-sale financial assets	-2,055	0
Loans and receivables	-221,253	73,501
Other financial liabilities	155,223	50,408
Net interest income from		
Trading assets and liabilities and derivative hedging instruments	-210,358	-245,621
Available-for-sale financial assets	40,913	43,494
Loans and receivables	392,271	438,713
Other financial liabilities	-231,240	-208,174

8 Notes to the balance sheet (assets)

8.1 Cash reserve

in €000	31.12.2017	31.12.2016
Balances with central banks	105,326	6,731
Total	**105,326**	**6,731**

8.2 Claims on banks

in €000	31.12.2017	31.12.2016
Due on demand	970,481	1,289,434
Other receivables	516,439	513,648
Public-sector loans	0	86,630
Sundry receivables	516,439	427,017
Total	**1,486,920**	**1,803,082**
Luxembourg	313,400	198,787
Abroad	1,173,520	1,604,295
Total	**1,486,920**	**1,803,082**

Claims on banks are classed as loans and receivables (LaR).

8.3 Claims on customers

in €000	31.12.2017	31.12.2016
Public-sector loans	4,283,816	4,589,328
Sundry receivables	68,920	109,024
Total	**4,352,736**	**4,698,352**
Abroad	4,352,736	4,698,352
Total	**4,352,736**	**4,698,352**

Claims on customers are classed as loans and receivables (LaR).

8.4 Loan loss provisions

Provisions for loan losses are made in accordance with rules that apply within the Group and cover all identifiable credit risks. Portfolio valuation allowances have been recognised for losses that have occurred but have not yet been identified; this has been done using parameters derived from the Basel III system, which have been reported for on-balance sheet positions in the loan loss provisions.

The portfolio valuation allowance for claims on banks totals €311 thousand (31 December 2016: €546 thousand), those for claims on customers €477 thousand (31 December 2016: €808 thousand) and those for financial investments €2,607 thousand (31 December 2016: €3,272 thousand).

Allocations to and reversals of claims recognised in profit and loss result in loan loss provision income of €567 thousand (31 December 2016: €617 thousand). There were no unwinding effects.

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	Valuation allowances for specific risks		Valuation allowances for portfolio risks		Valuation allowances total	
in €000	**2017**	**2016**	**2017**	**2016**	**2017**	**2016**
As at 1.1.	**0**	**0**	**4,626**	**6,033**	**4,626**	**6,033**
Allocations	0	0	279	1,113	279	1,113
Disposals	0	0	1,511	2,520	1,511	2,520
of which reversals	0	0	1,511	2,520	1,511	2,520
Exchange rate changes/ reclassifications	0	0	0	0	0	0
As at 31.12.	**0**	**0**	**3,394**	**4,626**	**3,394**	**4,626**

8.5 Positive fair values of derivative hedging instruments

This item shows derivative financial instruments used for hedging purposes and qualifying for hedge accounting. The instruments are measured at fair value.

in €000	**31.12.2017**	**31.12.2016**
Positive fair values of effective fair value hedges	574,124	742,430

8.6 Trading assets

Trading assets include derivative financial instruments not used for hedging. All the items in the trading portfolio are reported at fair value.

in €000	**31.12.2017**	**31.12.2016**
Positive fair values of derivative financial instruments (without hedge accounting)	**403,744**	**463,969**
Interest-rate-related transactions	172,899	216,367
Currency-related transactions	230,845	247,603
Cross-currency swaps	221,198	244,182
Foreign exchange forward contracts	9,647	3,420
Total	**403,744**	**463,969**

Fair values from interest rate-based transactions include CVAs of €1,292 thousand. The FVAs are recognised under trading liabilities (Note 9.5).

8.7 Financial investments

Financial investments are made up of bonds and other interest rate-related securities.

in €000	**31.12.2017**	**31.12.2016**
Bonds, notes and other interest-rate-related securities	**7,729,549**	**9,833,403**
Bonds and notes		
issued by public-sector borrowers	5,405,671	6,529,723
issued by other borrowers	2,323,878	3,303,679
including: measured at fair value	864,155	967,227
including: measured at cost	6,865,394	8,866,175
Total	**7,729,549**	**9,833,403**

Of the financial investments, those classed as loans and receivables (LaR) total €6,865m (31 December 2016: €8,866m) and those classed as available-for-sale (AfS) €864m (31 December 2016: €967m).

In its press release of 13 October 2008, the IASB issued an amendment to IAS 39 on the reclassification of financial instruments. In accordance with the amendment, securities in the public finance portfolio were reclassified from the "AfS" category to the "LaR" category in 2008 and 2009. The Bank had the intention and ability at the reclassification date to hold the securities for the foreseeable future or to final maturity. The securities concerned are primarily issued by public-sector borrowers (including European and North American local authorities and publicly guaranteed asset-backed securities) and financial institutions.

The revaluation reserve after deferred taxes for the reclassified securities amounts to €–93m compared with €–116m as at 31 December 2016, and is derecognised over the residual term of the securities.

The SLLP contained in this position on 31 December 2016 of €29.4m, for which a specific valuation adjustment was made for the loan exposure in San Bernardino, was fully utilised within the scope of an exchange agreement in financial year 2017 (see Note 6.3.4).

The net release of the general loan loss provision (GLLP) resulted in income of €766 thousand (31 December 2016: €1,275 thousand) in the statement of comprehensive income for the financial year 2017; the cumulative total of GLLPs amounted to €2,067 thousand (31 December 2016: €3,272 thousand).

If the reclassifications in 2008 and 2009 had not been carried out, there would have been a revaluation reserve after deferred taxes for all securities classed as "LaR" of €–372,293 thousand as at 31 December 2017 (31 December 2016: €–615,355 thousand); on the balance sheet date, the carrying value of the reclassified securities before GLLP was €6,378,953 thousand, and their fair value €5,946,620 thousand.

Average effective interest rates on the transactions range between 0.0% and 10.6% (31 December 2016: 0.0% and 10.6%). The cash inflow generated from them is expected to be €7.7bn (31 December 2016: €10.0bn).

	listed		Not listed	
in €000	**31.12.2017**	**31.12.2016**	**31.12.2017**	**31.12.2016**
Bonds, notes and other interest-rate-related securities	4,979,734	6,164,960	2,281,789	2,875,179
Total	**4,979,734**	**6,164,960**	**2,281,789**	**2,875,179**

8.8 Fixed and intangible assets

in €000	**31.12.2017**	**31.12.2016**
Office furniture and equipment	32	32
Total	**32**	**32**

The figure of €32 thousand reported under office furniture and equipment refers to works of art which have not been subject to depreciation.

in €000	**31.12.2017**	**31.12.2016**
Intangible assets	10,024	13,365
Total	**10,024**	**13,365**

The carrying value of the agency business customer base acquired in 2016 is reported as intangible assets.

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8.9 Changes in fixed and intangible assets

Changes in fixed assets in 2017 were as follows:

in €000	2016
Acquisition and production costs	**184**
As at 1.1.2016	**184**
Additions	0
Disposals	0
As at 31.12.2016	184
Depreciation and amortisation	
As at 1.1.2016	152
Planned depreciation and amortisation in the financial year	0
Disposals	0
As at 31.12.2016	**152**
Carrying amount as at 31.12.2016	**32**

in €000	2017
Acquisition and production costs	**184**
As at 1.1.2017	**184**
Additions	0
Disposals	0
As at 31.12.2017	184
Depreciation and amortisation	
As at 1.1.2017	152
Planned depreciation and amortisation in the financial year	0
Disposals	0
As at 31.12.2017	**152**
Carrying amount as at 31.12.2017	**32**

Changes in intangible assets in 2017 were as follows:

in €000	2016
Acquisition and production costs	**15,314**
As at 1.1.2016	**0**
Additions	15,314
Disposals	0
As at 31.12.2016	15,314
Depreciation and amortisation	
As at 1.1.2016	0
Planned depreciation and amortisation in the financial year	1,949
Disposals	0
As at 31.12.2016	**1,949**
Carrying amount as at 31.12.2016	**13,365**

in €000	2017
Acquisition and production costs	**15,314**
As at 1.1.2017	**15,314**
Additions	0
Disposals	0
As at 31.12.2017	15,314
Depreciation and amortisation	
As at 1.1.2017	1,949
Planned depreciation and amortisation in the financial year	3,341
Disposals	0
As at 31.12.2017	**5,290**
Carrying amount as at 31.12.2017	**10,024**

8.10 Tax assets

Deferred income tax liabilities represent the potential income tax reliefs arising from temporary differences between the values assigned to assets and liabilities in the consolidated balance sheet in accordance with IFRS and their values for tax accounting purposes in accordance with the local tax regulations.

Deferred tax claims have been treated as assets only in so far as business performance figures and the business environment make it probable that taxable income at the level of the tax group will be sufficient within the planning period.
Deferred income tax assets and liabilities are netted if there is a right to net current taxes on income and the deferred tax assets and liabilities relate to taxes on income levied by the same fiscal authority on the same taxable entity.

No loss carryforwards for tax purposes result from participation in the tax group.

in €000	31.12.2017	31.12.2016
Current tax assets	**0**	**0**
Deferred tax assets	**20,422**	**19,485**
Tax assets recognised in income statement	-39,908	-55,438
Tax assets not recognised in income statement	60,330	74,923
Total	**20,422**	**19,485**

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We expended the presentation in the table above compared to the prior year, and now report tax assets that are recognised and not recognised in the income statement as well as the balance after netting.

Of the tax assets not recognised in income statement as at 31 December 2017, €8.0 thousand are payable within 12 months.

Deferred tax assets were recognised in connection with the following items:

in €000	2017	2016
Fair values of derivative hedging instruments	407,239	557,528
Trading assets and liabilities	26,947	33,323
Financial investments	59,564	74,130
Provisions	851	906
Liabilities to banks and customers	80,319	99,819
Securitised liabilities	53,688	76,559
Other balance sheet items	1,035	1,237
Total	**629,642**	**843,503**
Netting	609,220	824,018
Total after netting	**20,422**	**19,486**

8.11 Other assets

The breakdown of other assets was as follows:

in €000	31.12.2017	31.12.2016
Accrued and deferred items	77	3
Sundry other assets	25,800	22,336
Total	**25,877**	**22,339**

Of the other assets, €846 thousand are due within one year and €25,031 thousand after more than one year.

The sundry other assets item mainly comprises receivables from the tax group amounting to €24,518 thousand and VAT claims of €720 thousand.

8.12 Subordinated assets

The portfolio contained no subordinated assets either as at 31 December 2017 or as at 31 December 2016.

9 Notes to the balance sheet (liabilities)

9.1 Liabilities to banks

in €000	31.12.2017	31.12.2016
Due on demand	174,596	186,702
Liabilities with limited periods	5,474,524	7,362,078
Other liabilities	5,474,524	7,362,078
Total	**5,649,119**	**7,548,780**
Luxembourg	353,046	819,407
Abroad	5,296,073	6,729,373
Total	**5,649,119**	**7,548,780**

Liabilities to banks are classed as liabilities measured at amortised cost.

9.2 Liabilities to customers

in €000	31.12.2017	31.12.2016
Liabilities with limited periods	**1,365,949**	**1,673,364**
Registered Covered Bonds	1,364,876	1,666,837
Other liabilities	1,073	6,527
Total	**1,365,949**	**1,673,364**
Abroad	1,365,949	1,673,364
Total	**1,365,949**	**1,673,364**

Liabilities to customers are classed as liabilities measured at amortised cost.

9.3 Securitised liabilities

in €000	31.12.2017	31.12.2016
Bonds and notes issued	**2,034,398**	**2,958,564**
Public-sector Pfandbriefe	2,034,398	2,946,022
Other bonds and notes	0	12,542
Total	**2,034,398**	**2,958,564**

Securitised liabilities are classed as liabilities measured at amortised cost.

No new bonds were issued in 2017. In the same period, the volume of bonds maturing was €0.7bn.

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9.4 Negative fair values of derivative hedging instruments

Derivative instruments held for purposes other than trading, used for effective hedging and with a negative fair value are reported under this balance sheet item. The financial instruments are measured at fair value.

in €000	31.12.2017	31.12.2016
Negative fair values of effective fair value hedges	3,337,367	3,843,903
Total	**3,337,367**	**3,843,903**

9.5 Trading liabilities

in €000	31.12.2017	31.12.2016
Negative fair values of derivative financial instruments (without hedge accounting)		
Interest-rate-related derivative transactions	155,345	171,326
Currency-related derivative transactions	57,947	251,621
Cross-currency swaps	54,576	207,605
Foreign exchange forward contracts	3,371	44,016
Total	**213,291**	**422,947**

Trading liabilities comprise negative fair values of derivative financial instruments not used for hedging as part of hedge accounting.

Fair values from interest-rate-based transactions include DVAs of €20,641 thousand and FVAs of €9,399 thousand (including FBAs of €10,093 thousand and FCAs of €–694 thousand).

9.6 Provisions

in €000	31.12.2017	31.12.2016
Provisions for pensions and similar commitments	6,622	6,825
Other provisions	1,055	3,138
Total	**7,678**	**9,964**

9.7 Provisions for pensions and similar commitments

Pension obligations are calculated annually by independent actuaries using the projected unit credit method:

in %	2017	2016
Calculatory interest rate	1.9%	1.8%
Change in salaries	2.5%	2.5%
Adjustment to pensions	1.5%	1.5%

The changes in the pension obligations were as follows:

in €000	2017	2016
Pension obligations as at 1 January	**6,825**	**5,874**
Service cost	22	62
Interest cost	121	151
Pension payments	-242	-198
Change in actuarial gains/losses	0	0
Experience adjustments	-2	196
Adjustments in financial assumptions	-102	788
Other changes (changes to exchange rates, reclassifications, changes to the plan)	0	-48
Pension obligations as at 31 December	**6,622**	**6,825**

The expenses for pensions and other employee benefits consist of the following components:

in €000	2017	2016
Service cost	22	62
Interest cost	121	151
Amortisation of actuarial gains (–) or losses (+)	0	0
Expenses for defined benefit plans	**143**	**213**
Expenses for defined contribution plans	31	29
Other pension benefits (age-related short-time working, early retirement)	0	0
Other expenses for pensions and similar employee benefits	33	0
Expenses for pensions and similar employee benefits	**207**	**242**

The sensitivity analysis shown here reflects the changes in the assumption; the other assumptions remain unchanged from the original calculation, i.e. potential correlation effects between the individual assumptions are not taken into account. The effects of the assumption changes on the net present value of the pension obligations were determined using the same methods – in particular, the projected unit credit method – as used for the measurement of pension obligations in the financial statements.

A change in the corresponding assumptions as at 31 December 2017 would have the following effects:

in €000	2017	2016
Interest rate sensitivity		
Discount rate +50bps	-476	-509
Discount rate – 50bps	533	572
Salary change sensitivity		
Adjustment to pensions +50bps	10	11
Adjustment to pensions –50bps	-11	-11
Pension adjustment sensitivity		
Adjustment to pensions +50bps	436	482
Adjustment to pensions –50bps	-396	-436
Mortality rate (life expectancy) change sensitivity		
Reduction in mortality of 10% [1]	116	124

[1] Corresponds to the change in life expectancy of around one year.

The weighted average duration of pension obligations as at 31 December 2017 was 15.5 years (compared with 16.1 years as at 31 December 2016).

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9.8 Other provisions

in €000	Provisions for the personnel area	Restructuring provisions	Other provisions	Total
As at 1.1.2016	**452**	**1,659**	**2,080**	**4,191**
Allocation	281	0	3,000	3,281
Utilisation	260	251	2,735	3,246
Release	229	859	0	1,088
As at 31.12.2016	**244**	**549**	**2,345**	**3,138**
As at 1.1.2017	**244**	**549**	**2,345**	**3,138**
Allocation	190	0	0	190
Utilisation	169	0	594	763
Release	99	0	1,411	1,510
As at 31.12.2017	**166**	**549**	**340**	**1,055**

Provisions for special human resources payments have been recognised. Service anniversary payments, which have also been provisioned, are by their nature long-term and the provisions for them will progressively be used up over future periods.

The provisions recognised for the restructuring measures are associated with the task of winding up and cover future HR-related liabilities and liabilities arising out of rental agreements. There were no new allocations in 2017.

There was no discounting on the grounds that, apart from the provisions for service anniversaries/restructuring, the terms generally extend over no more than one year. The discounting effect on provisions for service anniversaries would not be significant. Restructuring provisions are reviewed annually and are therefore not discounted.

Of the utilisation of sundry other provisions, €345 thousand relate to provisions for legal proceedings. In the financial year, €947 thousand in provisions for legal proceedings were also derecognised.

9.9 Tax liabilities

in €000	31.12.2017	31.12.2016
Current tax liabilities	**27,948**	**27,948**
Provisions for income tax	27,948	27,948
realised after more than twelve months	27,948	27,948
Total	**27,948**	**27,948**

Provisions for taxes on income are potential tax liabilities which have not yet been formally assessed. Deferred tax liabilities represent the potential income tax charge arising from temporary differences between the values assigned to assets and liabilities in the consolidated balance sheet in accordance with IFRS and their values for tax accounting purposes in accordance with the local tax regulations. Further information on the term may be found at Note 5.17.

Deferred income tax assets and liabilities are netted if there is a right to net current taxes on income and the deferred tax assets and liabilities relate to taxes on income levied by the same fiscal authority on the same taxable entity.

Deferred tax liabilities were recognised in connection with the following items:

in €000	31.12.2017	31.12.2016
Trading assets and liabilities	24,367	37,554
Fair values of derivative hedging instruments	133,656	176,013
Financial investments	319,903	407,264
Claims on banks and customers	99,804	163,364
Other balance sheet items	31,491	39,823
Total	**609,220**	**824,018**
Netting	609,220	824,018
Total after netting	**0**	**0**

9.10 Other liabilities

in €000	31.12.2017	31.12.2016
Accrued and deferred items	11	3
Other liabilities	4,448	5,087
Total	**4,459**	**5,090**

Other liabilities mainly comprise taxes and social contributions payable in the amount of €1,284 thousand (31 December 2016: €1,708 thousand). Liabilities from deliveries and services amounting to €331 thousand (31 December 2016: €547 thousand) and liabilities from the tax group of €2,833 thousand (31 December 2016: €2,833 thousand) are also still reported under this item.

Of the other liabilities, €1,615 thousand are due within one year and €2,833 thousand after more than one year..

9.11 Subordinated capital

in €000	31.12.2017	31.12.2016
Subordinated liabilities	13,800	13,800
Accrued interest, including discounts	-49	-105
Remeasurement effects	3,978	4,757
Total	**17,729**	**18,452**

The breakdown of the subordinated debt was as follows:

	in €m	Interest rate	Issue price	Maturity
Subordinated funds	3	5.20%	100	2021
	2	5.50%	100	2022
	8.8	5.50%	100	2026
Total	**13.8**			

Remeasurement effects result from the application of hedge accounting.

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9.12 Notes on equity

in €000	31.12.2017	31.12.2016
Subscribed capital	235,000	235,000
Capital reserve	1,859,000	859,000
Retained earnings	206,503	147,616
Revaluation reserve	-169,439	-210,877
Surplus/shortfall for the year	-83,644	58,810
Equity	**2,047,419**	**1,089,549**

Retained earnings consist of the statutory reserves and other retained earnings. From the net income for 2016, €58,810 thousand was allocated to other retained earnings. As at 31 December 2017, reserves required by law amounted to €23,500 thousand (31 December 2016: €23,500 thousand) and are subject to a limit on distribution. The other retained earnings, of €183,003 thousand (31 December 2016: €124,116 thousand) comprise the Bank's reinvested profits and transitory items resulting from the application of the amended IAS 19 (€2.179 thousand (31 December 2016: €2,255 thousand) after deferred tax).

The capital reserve, amounting to €1,859,000 thousand, is made up of capital contributions from shareholders amounting to €1,000,000 thousand in 2017 and €322,863 thousand in earlier years and the absorption into the capital reserve, on the merger of formerly EEPK with formerly HFI in 2014, of the equity of formerly EEPK, which totalled €536,137 thousand.

As at 31 December 2017, the share capital, being subscribed and fully paid up, was divided into 235,000 (31 December 2016: 235,000) registered shares with a nominal value of €1,000 each.

The sole shareholder is Commerzbank AG, Frankfurt am Main.

9.12.1 Return on capital

The return on capital, calculated as net profit divided by total assets, is –0.57%.

9.13 Other financial commitments

Commerzbank Finance & Covered Bond S.A. is the lessee in a number of operating leases. As at 31 December 2017, various operating leases, none of which can be terminated, were in place for real estate and other fixed assets (motor vehicles, copiers) used for the Bank's business operations. The main leases incorporate extension options and exit clauses in line with market conditions for commercial real estate, which tie changes in the lease payment to the cost-of-living index. The minimum obligations arising out of leases not capable of being terminated for real estate and other fixed assets will generate expenses of €136 thousand in the 2018 financial year and of €443 thousand in financial years 2019 to 2022.

Leasing in €000	2017	2018	2019 up to 2022	> 2022	Total 2018 onwards
Office space	139	136	443	0	579
Other fixed assets	12	0	0	0	0

The operating leases give rise to no restrictions on future dividend payments or leveraging on the part of the Bank.

9.14 The Bank's foreign currency position

The following assets and liabilities in foreign currencies were recognised as at 31 December 2017:

in €000	USD	CHF	GBP	Other	Total 31.12.2017	Total 31.12.2016
Cash reserve	0	0	0	0	0	0
Claims on banks	211,910	408	68	46	212,432	371,007
Claims on customers	75,039	0	4,137,582	0	4,212,621	4,509,316
Positive fair values of hedging instruments	60,221	130,535	0	7,209	197,966	251,035
Trading assets	337,811	20,466	22,863	0	381,140	394,785
Financial investments	5,289,665	0	65,645	11,881	5,367,191	6,889,234
Other balance sheet items	0	0	0	0	0	1
Foreign currency assets	**5,974,645**	**151,410**	**4,226,158**	**19,136**	**10,371,349**	**12,415,379**
Liabilities to banks	2,702,292	0	1,726,289	9,990	4,438,571	4,440,752
Liabilities to customers	1,011	0	2	0	1,012	745
Securitised liabilities	303,151	826,921	0	58,299	1,188,370	1,958,213
Negative fair values of hedging instruments	559,382	0	2,118,413	1,974	2,679,769	3,025,619
Trading liabilities	171,957	55,454	1,978	7,209	236,599	497,920
Subordinated capital/ profit-sharing certificates	0	0	0	0	0	0
Other liabilities	0	0	0	0	0	0
Foreign currency liabilities	**3,737,792**	**882,375**	**3,846,682**	**77,472**	**8,544,321**	**9,923,249**

Payments were made and received in these currencies during 2017.

The open balance sheet positions are matched by corresponding forward foreign exchange contracts or currency swaps with matching maturities

9.15 Derivatives

The following tables show the Bank's transactions in derivatives as at the reporting date.

A derivative is a financial instrument with a value determined by an "underlying asset", which may, for example, be an interest rate, foreign exchange rate or bond price. The financial instrument requires either no initial net investment or an initial investment that is smaller than would be required for other types of contract expected to have a similar response to changes in market conditions. Settlement is at a future date.

The derivatives transactions involve OTC derivatives, where the nominal amount, maturity and price are agreed individually between the Bank and its counterparties.

The nominal amount shows the volume traded by the Bank. However, the positive and negative fair values listed in the table are the expenses which would be incurred by the Bank or the counterparty to replace the contracts originally executed with transactions of an equivalent financial value. From the Bank's point of view, a positive fair value thus indicates the maximum potential counterparty-specific default risk present from derivative transactions on the balance sheet date.

In order to minimise both the economic and regulatory credit risk arising from these instruments, the Bank enters into master agreements (bilateral netting agreements) with its counterparties (such as the ISDA Master Agreement).

By concluding such netting agreements, the positive and negative fair values of the derivatives contracts included under a master agreement can be offset against one another, and the future regulatory risk add-ons for these products can be reduced.

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This netting process reduces the credit risk to a single net claim on the party to the contract (close-out netting).

For both regulatory reports and the internal measurement and monitoring of credit commitments, such risk-mitigating techniques are used only where they are regarded as enforceable in the jurisdiction in question if the counterparty should become insolvent.

Similar to the master agreements are the collateral agreements (e.g. the Credit Support Annex), which Commerzbank Finance & Covered Bond S.A. enters into with its counterparties to secure the net claim or liability remaining after netting (receiving or providing security). As a rule, this collateral management reduces credit risk by means of prompt (usually daily or weekly) measurement and adjustment of the customer exposure.

9.16 Derivatives – further details

The following list shows the nominal amounts and fair values of derivative business broken down by interest rate-based contracts, currency-based contracts and contracts based on other price risks, and the maturity structure of these transactions. The fair values are the sum totals of the positive and negative amounts per contract and are shown without deducting collateral and without taking account of any netting agreements, since these work on a cross-product basis. The nominal amount represents the gross volume of all sales and purchases. The maturity dates listed for the transactions are based on the term to maturity of the contracts and not the maturity of the underlying.

9.16.1 Maturity breakdown of derivatives

	Nominal values / Residual terms							Fair values		Fair values	
in €000	Daily demand	up to 3 months	3 months up to 1 year	over 1 year up to 5 years	Over 5 years	Total 31.12.17	Total 31.12.16	Positive 31.12.17	Negative 31.12.17	Positive 31.12.16	Negative 31.12.16
Foreign-currency-based forward transactions											
OTC products											
Foreign exchange spot and forward contracts	0	1,228,546	0	0	0	1,228,546	1,777,830	9,647	3,371	3,420	44,016
Interest rate / currency swaps	0	15,767	25,042	1,218,454	258,309	1,517,571	2,729,523	221,198	54,576	244,182	207,605
Total	**0**	**1,244,313**	**25,042**	**1,218,454**	**258,309**	**2,746,117**	**4,507,352**	**230,845**	**57,947**	**247,603**	**251,621**
Interest-based forward transactions											
OTC products											
Interest rate swaps	0	42,749	846,400	1,758,051	7,222,057	9,869,258	11,657,195	747,023	3,492,712	958,796	4,015,229
Forward rate agreements	0	0	0	0	0	0	0	0	0	0	0
Total	**0**	**42,749**	**846,400**	**1,758,051**	**7,222,057**	**9,869,258**	**11,657,195**	**747,023**	**3,492,712**	**958,796**	**4,015,229**
Total pending forward transactions	**0**	**1,287,062**	**871,442**	**2,976,505**	**7,480,366**	**12,615,374**	**16,164,547**	**977,868**	**3,550,658**	**1,206,399**	**4,266,850**

9.16.2 Counterparty breakdown of derivatives

The table below shows the positive and negative fair values of the Bank's derivative business broken down by counterparty. The Bank conducts derivative transactions with credit and financial institutions with excellent credit ratings based in an OECD country.

	Fair values		Fair values	
in €000	positive 31.12.2017	negative 31.12.2017	positive 31.12.2016	negative 31.12.2016
OECD banks	977,868	3,289,406	1,206,399	3,990,996
OECD financial institutions	0	261,252	0	275,854
Total	**977,868**	**3,550,658**	**1,206,399**	**4,266,850**

9.16.3 Use of financial derivatives

The following table shows how financial derivatives are used. Derivatives are used for hedging purposes. The applicable criteria are described in the accounting and measurement methods.

	Fair values		Fair values	
in €000	positive 31.12.2017	negative 31.12.2017	positive 31.12.2016	negative 31.12.2016
Hedging instruments not capable of being used for hedge accounting	403,744	213,291	463,969	422,947
Derivatives used as hedging instruments	574,124	3,337,367	742,430	3,843,903
for micro fair value hedge accounting	574,124	3,337,367	742,430	3,843,903
Total	**977,868**	**3,550,658**	**1,206,399**	**4,266,850**

9.17 Maturity breakdown

The residual term is defined as the period of time between the reporting date and the date on which the claim or liability falls contractually due.

Maturities of assets and liabilities

The Bank divides all assets and liabilities into current and non-current as set out below. Please refer to Note 9.16.1 for the breakdown of the nominal value of derivatives. The Bank defines the residual term or date of anticipated performance or settlement as current if the period between the reporting date and the maturity date is less than one year. Financial instruments in trading assets and liabilities without contractual maturity dates, the cash reserve, assets and liabilities held for sale, and actual taxes on income, are generally classified as current. However, the Bank generally classifies fixed assets as non-current. When it comes to the breakdown of other assets and liabilities, an estimate of the main items is made.

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31.12.2017 in €000	due on demand	Residual term up to 3 months	Residual term 3 months to 1 year	Residual term 1 year to 5 years	Residual term over 5 years	Total
Claims on banks	970,481	617,846	0	0	0	**1,588,327**
Claims on customers	1,018	29,856	114,303	440,429	5,091,880	**5,677,486**
Financial investments	0	108,000	284,907	2,097,064	7,116,513	**9,606,484**
Positive fair values from derivatives	0	5,016	23,051	183,780	672,780	**884,627**
Liabilities to banks	-174,596	-2,115,013	-1,162,933	-2,636,342	-11,217	**-6,100,100**
Liabilities to customers	0	-45,521	-32,900	-368,145	-1,058,553	**-1,505,120**
Securitised liabilities	0	-12,884	-879,548	-1,078,100	-926,595	**-2,897,128**
Subordinated liabilities	0	0	-750	-7,786	-10,736	**-19,272**
Negative fair values from derivatives	0	-159	-476	-197,592	-3,294,790	**-3,493,017**

31.12.2016 in €000	due on demand	Residual term up to 3 months	Residual term 3 months to 1 year	Residual term 1 year to 5 years	Residual term over 5 years	Total
Claims on banks	1,289,434	505,673	31,055	0	0	**1,826,162**
Claims on customers	2,890	28,082	95,249	476,674	5,302,070	**5,904,965**
Financial investments	0	374,839	412,070	2,070,420	7,839,609	**10,696,938**
Positive fair values from derivatives	0	7,429	3,951	347,739	847,280	**1,206,399**
Liabilities to banks	-186,702	-3,113,106	-1,093,335	-2,927,469	-266,722	**-7,587,334**
Liabilities to customers	-6,527	-47,156	-103,832	-420,369	-1,362,492	**-1,940,376**
Securitised liabilities	0	-366,351	-501,184	-1,890,998	-993,474	**-3,752,007**
Subordinated liabilities	0	0	-749	-6,001	-13,271	**-20,021**
Negative fair values from derivatives	0	-46,701	-8,439	-441,330	-3,770,380	**-4,266,850**

9.18 Repo and reverse repo transactions, securities lending transactions and cash collaterals

In repo transactions, the Bank sells or purchases securities with the obligation to repurchase or return them. The money received from repo transactions where Commerzbank Finance & Covered Bond S.A. is the borrower (i.e. where it is under an obligation to take the securities back) is shown in the balance sheet as a liability to banks or customers.

In these transactions, counterparty credit risk can be avoided by providing collateral, which may be in cash or some other form. Collateral furnished for a securities lending transaction is referred to as "cash collateral out" and collateral received as "cash collateral in".

Securities lending transactions are conducted with other banks in order to cover our need to meet delivery commitments or to enable us to effect securities repurchase agreements in the money market. We show lent securities in our balance sheet under financial investments, whereas borrowed securities do not appear in the balance sheet. We report cash collateral which we have furnished for securities lending transactions (cash collaterals out) as a claim and collateral received as a liability (cash collaterals in).

The repo and securities lending transactions executed up to the reporting date and the cash collaterals received or paid broke down as follows:

in €000	31.12.2017	31.12.2016
Repurchase agreements as borrower included		
in liabilities to banks	953,983	2,112,655
Cash collaterals received included		
in liabilities to banks	164,025	117,536
Total	**1,118,009**	**2,230,191**
Cash collaterals paid included		
in claims on banks	954,642	1,258,752
Total	**954,642**	**1,258,752**

Assets were transferred as collateral for the following liabilities:

in €000	31.12.2017	31.12.2016
Liabilities to banks	953,983	2,112,655

The following assets were transferred as collateral for the above liabilities:

in €000	31.12.2017	31.12.2016
Financial investments	1,091,497	2,332,354

Securities lent in securities lending transactions:

in €000	31.12.2017	31.12.2016
Carrying amount of securities transferred	3,531,620	0

The collateral was provided to borrow under securities repurchase agreements (repos). The transactions were carried out on standard market terms for securities lending and repo transactions.

9.19 Maximum credit risk

The maximum credit risk exposure under IFRS 7 – excluding collateral or other credit enhancements – is equal to the carrying amounts after impairments of the relevant assets in each class, or the nominal values of irrevocable lending commitments. The table below shows the carrying amounts or nominal values of financial instruments with a potential default risk:

in €000	31.12.2017	31.12.2016
Bonds, notes and other fixed-income securities held in financial investments	7,726,942	9,830,131
Claims on banks	1,486,609	1,802,536
Claims on customers	4,352,259	4,697,544
Receivables from derivative financial instruments including	977,868	1,206,399
Trading assets	403,744	463,969
Hedging instruments under IAS 39	574,124	742,430
Contingent liabilities	519	519
Total	**14,544,197**	**17,537,129**

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The maximum credit risk exposures listed above are not part of internal credit risk management, as credit risk management also takes account of collateral, probabilities of default and other economic factors. These amounts are therefore not representative of the Bank's assessment of its actual credit risk.

9.20 Basel III

By Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 646/2012, the European Banking Authority (EBA) transposed the Capital Requirements Regulation (CRR/CRD IV) into European law.

The Bank uses the standard approach for credit and market risk to determine its capital adequacy; authorisation to do so has been confirmed by the regulator, the CSSF. Operational risk is determined using the advanced approach.

The Bank's regulatory capital as at 31 December 2017 was €2,062m (31 December 2016: €1,132m), and its overall ratio 67.09% (31 December 2016: 29.47%). Capital adequacy is determined by application of Regulation (EU) 575/2013. After the initial application of IFRS 9 as at 1 January 2018, the equity coefficient is 36.48%.

Regulatory capital in €000	31.12.2017	Change	31.12.2016
Tier 1 capital			
Subscribed capital	235,000	0	235,000
Reserves	2,065,503	975,954	1,089,549
Result carried forward	0	0	0
Shortfall for the year	0	0	0
Deductions from tier 1 capital	-251,123	-44,665	-206,458
Total tier 1 capital	**2,049,380**	**931,289**	**1,118,091**
Tier 2 (supplementary) capital			
Subordinated loans	12,346	-1,349	13,695
Positive revaluation reserve	0	0	0
Deductions from tier 2 capital	0	0	0
Total tier 2 capital	**12,346**	**-1,349**	**13,695**
Total equity	**2,061,726**	**929,940**	**1,131,786**
Own funds requirements			
from credit risk	233,381	-57,773	291,154
from market risk	0	0	0
from CVA RCC	11,912	-3,551	15,463
from operational risks	568	-102	670
from currency risks	0	0	0
Total own funds requirements	**245,861**	**-61,426**	**307,287**
Equity coefficient	**67,09**	**37,62**	**29,47**

Own funds requirements in €000	31.12.2017	Change	31.12.2016
Credit risk positions			
Exposure class			
Claims on central government and central banks	169,918	-39,379	209,297
Claims on institutions	14,048	-4,794	18,842
Claims on companies	3,185	-2,049	5,234
Securitisation positions	43,548	-12,627	56,175
Other assets (other loan obligations)	2,682	1,076	1,606
Currency risk	0	0	0
Market risk	0	0	0
CVAs	11,912	-3,551	15,463
Operational risk	568	-102	670
Own funds requirements (total)	**245,861**	**-61,426**	**307,287**

9.21 Fair value of financial instruments

9.21.1 Determination of fair value

This note provides more information on the determination of fair values of financial instruments which are not recognised at fair value in the balance sheet, but for which a fair value has to be stated under IFRS 7.

The methods used to determine the fair values of financial instruments reported in the balance sheet at their fair values are set out in the accounting and measurement methods, "Measurement of Financial Instruments" (Note 5.5.1) and in the section "Fair Value Hierarchy" (Note 9.21.2) below.

The nominal value of financial instruments that fall due on demand is taken as their fair value. These instruments include the cash reserve and claims on and liabilities to banks and customers due on demand.

Market prices are not available for loans or for financial investments reclassified as loans and receivables as there are no organised markets on which such financial instruments are traded. The fair value of these instruments is calculated using mathematically accepted measurement procedures and up-to-date parameters derived from observation of the market.

Loans and financial investments reclassified as loans and receivables are measured using a discounted cash flow model with parameters based on a risk-free yield curve, credit spreads, and a fixed premium to cover liquidity spreads and administration and equity costs. The fair value of liabilities is also determined using a risk-free yield curve, with Commerzbank AG's own credit spread and a premium for administration costs applied separately. Market credit spreads for public and registered Lettres de gage and loans received are also used.

The fair value of securitised and subordinated liabilities is generally determined by reference to listed market prices. A number of different factors, including current market interest rates and the credit rating of the Commerzbank Group, are taken into account in determining fair value. If no quoted prices are available, fair values are calculated using mathematical measured models (discounted cash flows, option price models) that are themselves based on yield curves, volatilities, own credit spreads, etc.

The table below compares the fair values of the balance sheet items with their carrying amounts, taking into account recognised loan loss provisions:

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	Fair value		Carrying amount	
Assets in €000	31.12.2017	31.12.2016	31.12.2017	31.12.2016
Cash reserve	**105,326**	**6,731**	**105,326**	**6,731**
Claims on banks	**1,486,609**	**1,802,458**	**1,486,609**	**1,802,536**
due on demand	970,481	1,289,434	970,481	1,289,434
Public-sector loans	0	86,553	0	86,630
Sundry receivables	516,128	426,471	516,128	426,471
Claims on customers	**3,242,838**	**4,007,478**	**4,352,258**	**4,697,543**
Public-sector loans	3,175,503	3,902,300	4,283,340	4,588,520
Sundry receivables	67,337	105,179	68,920	109,024
Positive fair values of derivative hedging instruments	**574,124**	**742,430**	**574,124**	**742,430**
Trading assets	**403,744**	**463,969**	**403,744**	**463,969**
Financial investments	**7,261,523**	**9,040,139**	**7,726,942**	**9,830,131**

	Fair value		Carrying amount	
Liabilities in €000	31.12.2017	31.12.2016	31.12.2017	31.12.2016
Liabilities to banks	**5,648,280**	**7,547,701**	**5,649,119**	**7,548,780**
due on demand	174,596	186,702	174,596	186,702
Other liabilities	5,473,685	7,360,999	5,474,524	7,362,078
Liabilities to customers	**1,290,898**	**1,590,779**	**1,365,949**	**1,673,364**
Registered mortgage bonds	1,289,825	1,584,252	1,364,876	1,666,837
Other liabilities	1,073	6,527	1,073	6,527
Securitised liabilities	**1,972,049**	**2,784,237**	**2,034,398**	**2,958,564**
Negative fair values of derivative hedging instruments	**3,337,367**	**3,843,903**	**3,337,367**	**3,843,903**
Trading liabilities	**213,291**	**422,947**	**213,291**	**422,947**
Subordinated capital	**18,271**	**18,485**	**17,729**	**18,452**

When netted, the difference between carrying amount and fair value across all items as at 31 December 2017 is €–1,437.1m (31 December 2016: €–1,222.2m).

9.21.2 Fair value hierarchy

Under IAS 39, all financial instruments are initially recognised at fair value; financial instruments that are not classified as at fair value through profit or loss are recognised at fair value including certain transaction costs. Those financial instruments that are classified as at fair value through profit or loss and financial assets available-for-sale at any time are subsequently measured at fair value on an ongoing basis. For this purpose, financial instruments measured at fair value through profit or loss include derivatives, instruments held for trading and instruments designated as measured at fair value.

Under IFRS 13, the fair value of an asset is the amount for which it could be sold between knowledgeable, willing, independent parties in an arm's length transaction. The fair value therefore represents a realisable price. The fair value of a liability is defined as the price at which the debt could be transferred to a third party as part of an orderly transaction. The fair value of a liability also reflects own credit risk. If third parties provide security (e.g. guarantees) for the liabilities of the Bank, such security is not taken into account in the measurement of the liability, as the Bank's repayment obligation remains the same.

The most suitable measure of fair value is the quoted market price for an identical instrument in an active market (Level I in the fair value hierarchy).

Where no quoted prices are available, valuation is based on quoted prices for similar instruments in active markets. To reflect the price at which an asset could be exchanged or a liability settled, asset positions are valued at the bid price and liability positions are valued at the ask price. Where quoted prices are not available for identical or similar financial instruments, fair value is derived using an appropriate valuation model where the data inputs are, as far as possible, obtained from verifiable market sources (Level II in the fair value hierarchy).

In accordance with IFRS 13, valuation methods are chosen that are commensurate with the situation and for which the

required information is available. For the selected methods, observable input parameters are used to the maximum extent possible and unobservable input parameters to the minimum extent possible.

While most methods of measurement rely on data from observable market sources, certain financial instruments are measured using models incorporating other input values for which there insufficient recent observable market data are available. IFRS 13 recognises the market approach, income approach and cost approach as potential methods of measurement. The market approach relies on measurement methods that draw on information about identical or comparable assets and liabilities. The income approach reflects current expectations about future cash flows, expenses and income. The income approach may also include option price models. The cost approach (which may only be applied to non-financial instruments) defines fair value as the current replacement cost of the asset, taking into account the asset's current condition. These valuations are inherently subject to management judgement to a greater extent. These unobservable inputs may include data that is extrapolated or interpolated, or may be derived by approximation to correlated or historical data. However, such inputs maximise market or third-party inputs and rely as little as possible on company-specific inputs (fair value hierarchy Level III).

Valuation models must be consistent with accepted business methodologies for pricing financial instruments and must incorporate all factors that market participants would consider appropriate in setting a price. All fair values are subject to the Commerzbank Group's internal controls and procedures, which set out the standards for independently verifying or validating fair values. These controls and procedures are carried out and coordinated by the Independent Price Verification (IPV) Group within the finance function. The models, input data and resulting fair values are reviewed regularly by management and the risk function.

Under IFRS 13, financial instruments reported at fair value are assigned to the three levels of the fair value hierarchy as follows: Level I: Financial instruments where fair value is based on quoted prices for identical financial instruments in an active market; Level II: Financial instruments where no quoted prices are available for identical instruments in an active market and fair value is established using valuation techniques which rely on observable market parameters; Level III: Financial instruments valued using methods with input values where insufficient observable market data are available and where these inputs have a more than insignificant impact on the fair value. The allocation of particular financial instruments to the relevant level requires systematic judgement by management, particularly if the valuation is based both on observable and unobservable market data. An instrument's classification may also change over time due to changes in market liquidity and consequently in price transparency.

There were no financial instruments valued according to Level III in the portfolio as at either 31 December 2017 or 31 December 2016.

In the tables below, the financial instruments reported in the balance sheet at fair value are grouped by category and valuation method. They are broken down according to whether fair value is based on quoted market prices (Level I), observable market data (Level II) or unobservable market data (Level III).

in €000	Level I	Level II	Total 31.12.2017	Total 31.12.2016
Financial assets				
Positive fair values of derivative hedging instruments	0	574.124	574.124	742.430
Trading assets	0	403.744	403.744	463.969
of which: Positive fair values of derivatives	0	403.744	403.744	463.969
Financial investments available-for-sale	864.155	0	864.155	967.227
Total	**864.155**	**977.868**	**1.842.023**	**2.173.626**
Financial liabilities				
Negative fair values of derivative hedging instruments	0	3.337.367	3.337.367	3.843.903
Trading liabilities	0	213.291	213.291	422.947
of which: negative fair values from derivatives	0	213.291	213.291	422.947
Total	**0**	**3.550.658**	**3.550.658**	**4.266.850**

The Bank has not reclassified any financial instrument from Level I to Level II or vice versa during the current financial year, nor did it do so in the previous financial year.

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9.22 Off-balance sheet liabilities

Contingent liabilities and irrevocable lending commitments

in €000	31.12.2017	31.12.2016
Contingent liabilities	5	5
from guarantees and indemnity agreements	5	5
Irrevocable lending commitments	**514**	**514**
Other warranties	514	514
Total	**519**	**519**

Residual terms of contingent liabilities and irrevocable lending commitments

in €000	31.12.2017	31.12.2016
due on demand	5	5
up to three months	0	0
three months to one year	0	0
one year to five years	0	0
over five years	514	514
Total	**519**	**519**

9.23 Details of material transactions with related parties and persons

IAS 24 defines related parties as persons and companies capable of being influenced by Commerzbank Finance & Covered Bond S.A., capable of exercising influence over it, or under the influence of another of the Bank's related parties.

In the course of its ordinary activities, Commerzbank Finance & Covered Bond S.A. enters into business relationships with related parties, both persons and companies. Persons in key positions are defined as members of the Board of Managing Directors and the Supervisory Board of Commerzbank AG, the Board of Directors of Commerzbank Finance & Covered Bond S.A., members of their families, and companies controlled by these persons.

Related parties are the parent company, its parent and affiliated companies and their subsidiaries. The transactions were executed on normal market terms.

The table below shows claims on and liabilities to related parties and persons in key positions

2016 in €000	related parties	related persons
Claims on banks	318,360	-
Receivables from bonds and notes	-	-
Positive fair values of derivative hedging instruments	376,991	-
Trading assets	276,730	-
Other assets	18,484	-
Assets in relation to related parties and persons	**990,565**	**-**
Liabilities to banks	7,354,480	-
Negative fair values of derivative hedging instruments	2,266,691	-
Trading liabilities	338,464	-
Other liabilities	2,833	-
Liabilities to related parties and persons	**9,962,468**	**-**

2017 in €000	**related parties**	**related persons**
Claims on banks	315,418	-
Receivables from bonds and notes	-	-
Positive fair values of derivative hedging instruments	287,751	-
Trading assets	243,710	-
Other assets	24,518	-
Assets in relation to related parties and persons	**871,397**	**-**
Liabilities to banks	5,489,132	-
Negative fair values of derivative hedging instruments	2,033,068	-
Trading liabilities	120,012	-
Other liabilities	2,833	-
Liabilities to related parties and persons	**7,645,046**	**-**

Transactions with related parties in the financial year under review resulted in interest income of €11,275 thousand (31 December 2016: €4,757 thousand) and interest expense of €71,000 thousand (31 December 2016: €51,503 thousand). Further information on expenses relating to the remuneration of board members may be found in Note 7.9.

9.24 Cash flow statement

The cash flow statement is compiled in accordance with IAS 7. It shows the structure of and changes in cash and cash equivalents during the financial year. It is broken down into operating activities, investing activities and financing activities.

Net cash from operating activities includes payments (inflows and outflows) relating to claims on banks and customers and also other assets. Increases and decreases in liabilities to banks and customers, securitised liabilities and other liabilities also come under operating activities. The interest and dividend payments resulting from operating activities are similarly reflected in net cash from operating activities.

Net cash from investing activities is made up of cash flows relating to financial investments and fixed assets. Net cash from financing activities consists of the proceeds of capital increases as well as payments made or received on subordinated debt.

Cash and cash equivalents consists of items that can be rapidly converted into liquid funds and are subject to a negligible risk of changes in value. This includes the “cash reserve” item, which is made up of cash on hand and credit balances with central banks (see Note 8.1). Claims on banks which are due on demand are not included.

The cash flow statement is not very informative with regard to Commerzbank Finance & Covered Bond S.A. For the Bank, the cash flow statement replaces neither liquidity planning nor financial planning, nor is it employed as a management tool.

Changes in liabilities from financing activities were as follows:

in €000	Notes	31.12.2016	Cash items	Exchange rate change	Other non-Cash items	31.12.2017
Subordinated capital	9,11	18,452			-724	**17,729**
Total		**18,452**	**0**	**0**	**-724**	**17,729**

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9.25 Application of IFRS 9

The Bank has been applying IFRS 9 since 1 January 2018 in the version adopted by the European Union. The Group has not restated the prior-year figures because this is not required when applying the new standard for the first time.

General classification and measurement

The application of IFRS 9 requires the reporting entity to classify all assets and liabilities defined as financial instruments under IAS 32. This classification aims to enable the user of the financial statements to make a better assessment of the amount, timing and uncertainty of future cash flows. Fundamentally, all financial instruments must be recognised at their fair value on the date of acquisition. This acquisition principle applies regardless of the financial instrument's classification.

IFRS 9 sets out four types of subsequent measurement, which depend on the respective business model and the fulfilment of the SPPI criterion (solely payment of principal and interest):

- measurement at amortised cost (AC)
- fair value through other comprehensive income with recycling (FVOCImR)
- fair value through other comprehensive income without recycling (FVOCIoR)
- fair value through profit or loss (FVPL)

Financial assets are allocated to one of the following business models based on the respective strategic aim of profit realisation:

- “hold” business model: receipt of contractual cash flows with only seldom or immaterial sales activities.
- "hold-and-sell" business model: receipt of cash flows through holding and also through sales.
- residual business model: all portfolios that are not allocated to the “hold” or “hold-and-sell” business model. These include primarily trading portfolios and portfolios managed on a fair-value basis. The receipt of contractually agreed cash flows is of minor importance; the main objective is instead to maximise cash flows through purchases and sales.

The second criterion for classifying financial assets is the characteristics of their cash flows. When assessing these cash flows, the crucial consideration is whether they are solely unleveraged interest and principal payments on the outstanding capital, i.e. the SPPI criterion. In principle, a financial instrument is SPPI-compliant only if its contractual cash flows are equivalent to those of a simple loan, i.e. a basic lending arrangement.

The allocation to the business model can be made on a portfolio basis, whereas the SPPI criterion must always be assessed for each individual financial instrument that was allocated to the “hold” or “hold-and-sell” business model.

Measurement at amortised cost (AC) requires that the financial asset has cash flows which correspond to the SPPI criterion and that it has been allocated to a portfolio with the “hold” business model. The associated bookings correspond in principle to the previous IAS 39 fair value category of loans and receivables (LaR).

A financial asset is measured at fair value through other comprehensive income with recycling (FVOCImR) if its cash flows also correspond to the SPPI criterion and it has been allocated to a portfolio with the “hold-and-sell” business model. The associated accounting therefore corresponds fundamentally to the previous IAS 39 fair value category of available-for-sale (AfS).

The subsequent measurement at fair value with recognition of the value fluctuation in the income statement (FVPL) is required if either the financial asset has not been allocated to a portfolio with one of the aforementioned business models or its cash flows are not SPPI-compliant. This measurement category is therefore subsidiary in nature, i.e. if the asset cannot be clearly allocated to one of the two other measurement categories, it must be measured according to this category. A reporting distinction is made in this measurement category between financial instruments held for trading purposes (HfT) and other financial instruments requiring recognition at fair value with the resulting value fluctuation being recorded in the income statement (mFVPL). Besides the fair value option (FVO), there is also the possibility of voluntarily designating financial assets on acquisition into the mFVPL category if accounting mismatches can be avoided.

The methodology for measuring financial assets is based on the allocation of the asset to one of the following three groups

- **Derivatives:**
  Financial instruments for which the allocation criteria have not changed as compared with IAS 39. As derivatives do not have fixed redemption amounts, subsequent

measurement at amortised cost is not possible. They must always be measured at fair value, with the fluctuation in value being recorded in the income statement. If derivatives are not used for hedge accounting, they must always be allocated to the trading portfolio (HfT).

- **Equity instruments:**
  Financial instruments which correspond to the definition of equity under IAS 32 for the issuing entity. As they represent only a proportional right, and not a right to receive a fixed redemption amount, the SPPI criterion is not fulfilled and measurement at amortised cost is therefore precluded. However, an irrevocable decision can be made when the equity instrument is acquired to instead measure the instrument based on the FVOCI-without-recycling method. All value fluctuations are recognised in other comprehensive income and are not reported in the income statement upon the disposal of the financial instrument (without recycling). This option is not available for financial instruments that have been acquired for trading purposes or as conditional payment for the acquisition of a company. In these cases, similar to all other equity instruments, they must be measured at FVPL.

- **Debt instruments**:
  All financial instruments not considered to be derivatives as defined in IFRS 9 or equity as defined under IAS 32 are subsequently measured based on the business model of the portfolio to which the financial instrument was allocated upon acquisition, the contractual cash flows of the financial instrument (SPPI criterion) and the possibility of voluntarily applying the fair value option.

Debt instruments on the asset side of the balance sheet may thus be accounted for in one of the following ways:

- Subsequent measurement at amortised cost is required if the financial instrument is held only to realise the contractually agreed cash flows (“hold” business model) and, in addition, the contractually agreed cash flows are exclusively interest and principal payments as defined under IFRS 9 (SPPI compliance).
- Subsequent measurement at fair value with recognition of the change in value in other comprehensive income with recycling (FVOCImR) is required if the financial instrument is allocated to a portfolio with the “hold-and-sell” business model and, in addition, the contractually agreed cash flows are only interest and principal payments, and are thus SPPI-compliant.
- Upon disposal of the financial instrument, the cumulative valuation fluctuations that have been recognised in other comprehensive income are then recognised in the income statement (recycling).
- The subsequent measurement at fair value with recognition of the value fluctuation in the income statement (FVPL) is required if the financial asset has been allocated to a portfolio with the residual business model.

As a rule, financial liabilities must be measured at amortised cost. In addition, the possibility exists of applying the fair value option. Financial liabilities held for trading and all derivatives must be reported in the balance sheet in a separate line item and measured at fair value through profit or loss.

Impairment

IFRS 9 changes the rules on the accounting treatment of expected default risk (provisions). Unlike in IAS 39, provisions are not recognised only when a specific loss event occurs. Instead, for every financial instrument measured at AC or FVOCImR, the credit loss expected over the next 12 months must be recognised as a provision on initial recognition. If the credit risk increases significantly, but the borrower is not yet in default, a provision must be recognised for the full lifetime expected credit losses. If an instrument is in default, a provision must be recognised for the lifetime expected loss on the basis of the estimated cash flows that can still be expected. In this case, interest income is calculated based on the net carrying amount.

Hedge accounting

The improvements for hedge accounting contained in IFRS 9 aim to achieve further harmonisation between the accounting treatment of hedging relationships and (economic) risk management. We have utilised the option provided in the standard and have continued to apply the previous IAS 39 regulations.

The significant effects from the application of IFRS 9 Financial Instruments as at 1 January 2018 are presented below.

The Bank has made significant progress with the project to change its financial accounting in accordance with IFRS 9. The Bank is involved in the project on IFRS 9 that has been set up within the Commerzbank Group. The project has involved the analysis of the new requirements applicable to methodology, data procurement and processes, with support from experts from the Finance, Risk and IT divisions. The results of

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these analyses were described in detail in technical concepts and incorporated into the Group-wide accounting guidelines.

The Board of Directors has allocated the financial assets to a business model based on how the financial assets are managed to generate cash flows:

The object of the Bank is to conduct all such business as is permitted to a Pfandbrief bank by the Law on the Financial Sector of 5 April 1993 as most recently amended. The Bank focuses on the public finance and public sector lending business with loans and promissory note loans to public borrowers in countries in the EEA and OECD. As a rule, subjecting its assets to a buy-and-hold strategy is intrinsic to the business model of a Pfandbrief bank.

In view of this, the Bank allocated a significant portion of the assets (€8.5bn nominal) to the "hold" business model and thus measured them at amortised cost. A smaller portion of the portfolio (€2.1bn nominal) was allocated to the residual business model and is therefore measured at mFVPL. This relates to loans to British authorities, which are referred to as LOBO loans (lender's option – borrower's option). One of the key features of these loans is the lender's option to change the interest rate at the end of a specific term. Another feature is that the borrower subsequently has the right to reject the new interest rate, linked with the early repayment of the loan without the calculation of break funding costs. If derivatives are not used for hedge accounting, they must always be allocated to the trading portfolio (HfT).

Based on the current implementation status, the Bank expects a negative initial application effect on equity capital of €0.9bn, which consists of reclassification and revaluation effects. The significant individual effect of €–1.1bn comes from the classification of the loans to British authorities (LOBO loans), which were allocated to the residual business model and consequently measured at mFVPL.

In addition, the classification of the public finance business, which was allocated to the hold business model, has a positive effect on equity capital of almost €0.2bn.

IFRS 9 changes the rules on the accounting treatment of expected default risk (provisions). Unlike under IAS 39, provisions are not recognised only when a specific loss event occurs. Instead, for every financial instrument measured at amortised cost or at fair value through other comprehensive income, the credit loss expected for one year (12-month expected loss) must be recognised as a provision on initial recognition. The change in the provision methodology had a negative effect of almost €50m.

9.26 Events after the reporting date

No events of particular significance in relation to the Bank's equity capital, financial position or results occurred during the period from 31 December 2017 to 15 March 2018, with the exception of those presented in the section entitled "Significant events 2017" and in Note 9.25.

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10 Other disclosures

10.1 Cover holdings and public mortgage bonds

The cover holdings required by Articles 12-1 to 12-9 of the Law of 5 April 1993 on the financial sector, as currently amended, consist solely of securities subject to monitoring by a trustee.

The cover holdings are broken down by balance sheet item as follows:

31.12.2017	in €000	as % of Cover assets
Public Lettres de gage/ordinary cover		
Claim on banks	**–**	**0.00**
Claim on customers		
Public-sector loans	2,223,333	65.27
Bonds and notes		
issued by public-sector borrowers	1,148,489	33.71
other (secured by public bodies)	34,730	1.02
Total cover assets	**3,406,552**	**100.00**
Substitute cover	**0**	**0.00**
	3,406,552	**100.00**
Public Lettres de gage for which cover is required	**3,052,783**	**89.62**
Cover surplus	**353,769**	**10.38**

Using internal ratings on a prescribed scale between 1.0 and 6.5, cover holdings broke down at the end of the financial year as follows:

Ratings as at 31.12.2017	in €000	in % of cover assets
1.0 - 1.2	140,648	4.13
1.4 - 1.6	350,135	10.28
1.8 - 2.0	2,167,559	63.63
2.2 - 2.8	591,444	17.36
3.0 - 3.6	97,513	2.86
3.8 - 5.0	48,707	1.43
5.2 - 5.8	10,546	0.31
6.1 - 6.2	0	0.00
Total portfolio	**3,406,552**	**100.00**

Cover holdings broke down by size as follows:

31.12.2017	Number	in €000	in % of cover assets
up to 5m	160	342,551	10.06
up to 10m	102	661,660	19.42
up to 25m	91	1,334,970	39.19
over 25m	24	1,067,370	31.33
Total	**377**	**3,406,552**	**100.00**

Cover holdings broken down by country as follows:

Countries 31.12.2017	in €000	in % of cover assets
Canada	57,349	1.68
Great Britain	2,047,975	60.12
Italy	203,116	5.96
Japan	93,100	2.73
Portugal	43,600	1.28
Spain	89,091	2.62
United States	872,321	25.61
Total countries	**3,406,552**	**100.00**

10.2 Group Financial Statements

The Bank's annual financial statements are included in the Group financial statements of Commerzbank AG, Frankfurt am Main.

These may be obtained from the following address:

Commerzbank AG
60261 Frankfurt am Main
Germany

10.3 Deposit guarantee scheme

The Luxembourg law on the resolution, recovery and dissolution measures of banks and securities firms and on deposit guarantee and investor compensation schemes ("the Law") was adopted on 18 December 2015; this transposes into Luxembourg law EU directives 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms and 2014/49/EU on deposit guarantee and investor compensation schemes. The deposit guarantee and investor compensation scheme that had been in place until then and which was introduced by the AGDL, was replaced by a new deposit guarantee and investor compensation scheme based on contributions.

The new system guarantees all recoverable deposits from the same depositor up to €100,000 ("Fonds de garantie des dépôts Luxembourg" (FGDL / Luxembourg deposit guarantee fund)) and investment transactions up to €20,000 per investor ("Système d'indemnisation des investisseurs Luxembourg" (SIIL / Luxembourg investor compensation scheme)).

Provisions recognised in the past in banks' annual financial statements for the purposes of the AGDL will be progressively used up in line with the contributions to be paid by banks to the Luxembourg deposit guarantee fund ("Fonds de garantie des dépôts Luxembourg" (FGDL)) and/or the Luxembourg resolution fund ("Fonds de résolution" (FDR)).

Since the Bank neither accepts deposits from private individuals nor conducts securities transactions for its customers, it is under no obligation in the event of the failure of another bank. No provision for this purpose has therefore been recognised.

10.4 Registered office

Commerzbank Finance & Covered Bond S.A.
P.O. Box 321, L-2013 Luxembourg
25 rue Edward Steichen, L-2540 Luxembourg

Tel.: + 352 477 911 - 1
Fax: + 352 477 911 - 5348
Email: info@commerzbank-fcb.com
Website: www.commerzbank-fcb.com

Commercial Registry:
R.C.S. Luxembourg B 30.469
VAT ID No. LU14147251

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Responsibility statement by the Board of Managing Directors

To the best of our knowledge, and in accordance with the applicable reporting principles, the financial statements give a true and fair view of the net assets, financial position and results of operations of Commerzbank Finance & Covered Bond S.A., and the management report includes a fair review of the development and performance of the business and the position of the Bank, together with a description of the principal opportunities and risks associated with the expected development of the Bank.

Luxembourg, 15 March 2018

Commerzbank Finance & Covered Bond S.A.
The Managing Directors

Gerard-Jan Bais Markus Blaes

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Bank Committees

Board of Directors

Thorsten KANZLER
Wiesbaden, Germany
Chairman
Head of Group Treasury, Divisional Board Member, Commerzbank AG, Frankfurt am Main

Hermann RAVE
Bad Soden am Taunus, Germany
Deputy Chairman
Head of Group Accounting, Commerzbank AG, Frankfurt am Main

Gerard-Jan BAIS
Steinsel, Luxembourg
Member of the Board of Directors and Managing Director, Commerzbank Finance & Covered Bond S.A., Luxembourg

Markus BLAES
Freudenburg, Germany
Member of the Board of Directors and Managing Director, Commerzbank Finance & Covered Bond S.A., Luxembourg and Head of Treasury, Commerzbank AG, Luxembourg branch

Manfred BIER
Goergeshausen, Germany
Head of Group Treasury Investment Office (IO), Commerzbank AG, Frankfurt am Main

Ansgar HERKERT
Friedrichsdorf, Germany
Head of Public Sector & Country Risk Management, Commerzbank AG, Frankfurt am Main
(until 30 June 2017)

Arno KRATKY
Hofheim, Germany
Principal Project Manager, Group Market Risk Management, Commerzbank AG, Frankfurt am Main
(from 1 July 2017)

General Management

Gerard-Jan BAIS
Steinsel, Luxembourg
Member of the Board of Directors and Managing Director

Markus BLAES
Freudenburg, Germany
Member of the Board of Directors and Managing Director

Heads of Department

Markus BLAES
Asset Liability Management

Robert THÖMMES
Analytics & Regulatory Issues

Auditors

PricewaterhouseCoopers,
Société coopérative, Luxembourg

Trustees (Cover Pool Auditors)

KPMG Luxembourg,
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