2018

Annual Report · Short Version

Aargauische Kantonalbank

CONTENTS

This unaudited short version of the annual report is not a complete annual report. It is a translation of select segments of the original German annual and the pillar 3 report for information purposes only.

In the event of variances, the German version shall take precedence over the English translation. You can find the full German annual and pillar 3 report at www.akb.ch for additional information.

AT A GLANCE

in CHF million	2017	**2018**	Change in %
Income statement			
Net result from interest operations [1]	255.3	**293.4**	14.9
Result from commission business and services	62.3	**65.5**	5.1
Result from trading activities and the fair value option [1]	61.9	**23.8**	– 61.5
Other result from ordinary activities	6.7	**8.3**	23.2
Operating income	**386.2**	**391.0**	**1.2**
Personnel expenses	– 112.4	**– 114.7**	2.0
General and administrative expenses	– 74.6	**– 83.2**	11.6
of which compensation for the state guarantee	– 11.1	**– 11.5**	3.5
Operating expenses	**– 187.0**	**– 197.9**	**5.8**
Value adjustments on participations and depreciation and amortisation of tangible fixed assets and intangible assets	– 10.0	**– 11.2**	12.3
Changes to provisions and other value adjustments, and losses	0.7	**– 4.1**	– 659.6
Operating result	**189.9**	**177.7**	**– 6.4**
Extraordinary income	6.2	**6.3**	2.1
Extraordinary expenses	–	**–**	n. a.
Changes in reserves for general banking risks	– 38.1	**– 31.8**	– 16.5
Taxes	– 12.3	**– 8.0**	– 35.0
Profit	**145.6**	**144.2**	**– 1.0**
Appropriation of profit			
Allocation to statutory retained earnings reserve	49.6	**45.2**	– 8.9
Allocation to voluntary retained earnings reserves [2]	–	**39.0**	n. a.
Distribution to the canton	96.0	**60.0**	– 37.5

[1] For combinations of money market transactions and currency swaps as well as for currency swaps hedging FX positions, as of 1st January 2018, interest earned from currency swaps will not be booked under “results from trading activities and the fair value option” any longer but under “results from interest operations”.
[2] In consultation with the governing council of the Canton Aargau, voluntary retained earnings reserves shall be built up anticipatory in view of increasing requirements of the regulator and the capital requirements related to final Basel III.

in CHF million	31.12.2017	**31.12.2018**	Change in %
Balance sheet			
Total assets	**26 961.3**	**28 351.4**	**5.2**
Loans to customers	**21 826.2**	**22 795.8**	**4.4**
Amounts due from customers	1 017.5	**1 181.1**	16.1
Mortgage loans	20 808.7	**21 614.6**	3.9
Funds due to customers	**17 312.6**	**18 254.7**	**5.4**
Amounts due in respect of customer deposits	17 270.0	**18 221.4**	5.5
Cash bonds	42.6	**33.3**	– 21.8
Net equity before distribution of net profit	**2 272.4**	**2 352.4**	**3.5**
Client Volumes			
Client Assets [1]	24 217.3	**25 359.0**	4.7
Net new money	1 516.3	**1 771.5**	16.8
Business Volume [2]	49 174.2	**51 117.8**	4.0
Personnel [3]	**Jobs**	**Jobs**	
FTE (full-time equivalent)	693.2	**707.9**	2.1
of which apprentices/trainees	38.5	**39.5**	2.6

in %	2016	2017	**2018**	strategic targets
Key figures				
Return on Equity (ROE) [4]	9.5	8.9	**8.0**	7–8
Total Capital Ratio excl. voluntary retained earnings reserves, incl. national countercyclical buffer [5]	16.2	16.1	**16.1**	15,8–16,2
Total Capital Ratio incl. voluntary retained earnings reserves, incl. national countercyclical buffer			**16.4**	
National countercyclical buffer ratio	1.0	1.0	**1.0**	
Total Capital Ratio according to Pillar 3 [6]	17.2	17.1	**17.4**	
Leverage Ratio [7]	8.1	7.9	**7.9**	
Cost-income Ratio [8]	46.1	48.4	**50.6**	50–55

in CHF 1000			
Assets per employee	37 329	38 894	**40 050**
Operating income per employee	568	557	**552**
Operating expenses per employee	262	270	**280**
Operating result per employee	288	274	**251**

[1] Basis: deposits and assets under management (exclusive corporate assets).
[2] Basis: client assets, corporate assets and loans to customers.
[3] FTE (full-time equivalent) is shown as part-time adjusted, apprentices, trainees and employees in the trainee pool are counted as 50%.
[4] Calculation Return on Equity: Operating result/Average net equity.
[5] Eligible capital to risk-weighted assets ratio according to Art. 42 para. 2 CAO.
[6] See Pillar 3 Report at akb.ch/geschaeftsberichte.
[7] Ratio of core capital (Tier 1) to total engagement for the leverage ratio (assets, derivate engagements, securities financing transactions engagements and other off-balance-sheet positions).
[8] Calculation of cost-income Ratio: Operating expenses (incl. compensation for the state guarantee)/Operating income (incl. changes in value adjustments for default risks and losses from interest operations).

BUSINESS PERFORMANCE

Aargauische Kantonalbank can look back on a successful 2018. Operating income rose year on year by CHF 4.8 million and reached a record high at CHF 391.0 million. Annual profit of CHF 144.2 million is virtually unchanged compared to the previous year (CHF 145.6 million). Operational business performed very well in all divisions and the business volume rose CHF 1.9 billion to CHF 51.1 billion. The Board of Directors proposes in consultation with the Executive Council profit distribution to the canton of Aargau of CHF 60.0 million.

High Degree of Confidence in AKB
The balance sheet item “Amounts due in respect of customer deposits” increased by the net amount of CHF 1.0 billion or 5.5% to CHF 18.2 billion during the reporting year. Amounts due in respect of customer deposits made up 64.3% of total assets as at the end of 2018. The high net new money of CHF 1.8 billion (previous year: CHF 1.5 billion) is a strong vote of confidence in the quality of our services and consultancy.

Risk-conscious Growth in Loans to Clients
There was an increase in loans to customer of CHF 1.0 billion or 4.4%. With a total volume of CHF 22.8 billion of customer loans, the cantonal bank made a sustainable contribution to the economy in its business area.

Mortgage loans, the most important area of lending with a share of 76.2% of total assets, posted a net gain of CHF 0.8 billion or 3.9% to a total of CHF 21.6 billion. With this growth, AKB has further consolidated its leading position in mortgage lending to individuals.

Besides the mortgage business, AKB’s core business areas are loans to SMEs and issuing construction loans. The balance sheet item “Amounts due in respect of customer deposits” rose by the net amount of CHF 163.7 million or 16.1% to CHF 1.2 billion during the reporting year. Most of this increase is due to increased use of approved credit lines beyond the end of the year.

The quality of the loan portfolio continues to be very robust. This is also reflected in the income statement with the net reversals of unused impairments of CHF 8.6 million.

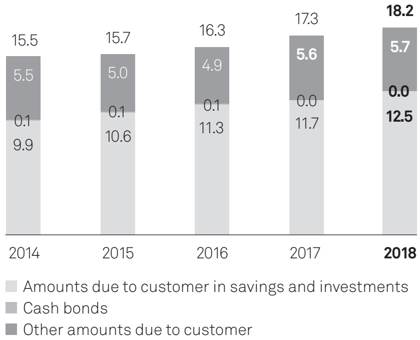
Business Volume exceeds CHF 50 billion Mark
At the end of 2018, total assets stood at CHF 28.4 billion, up CHF 1.4 billion or 5.2% on the previous year. The business volume, which consists of client assets (custody account assets and deposits) and customer loans, increased by CHF 1.9 billion or 4.0% during the reporting year and reached a new record high of CHF 51.1 billion.

Operating income at record Level
The operating income generated in 2018 increased by CHF 4.8 million or 1.2% to a new record high of CHF 391 million despite difficult market conditions.

Net result from interest operations stood at CHF 293.4 million, CHF 38.2 million or 14.9% higher than in the previous year. The change is mainly due to a change in the accounting method: The income from foreign currency hedges in the balance sheet will no longer be shown in net trading income but in net interest income as from 2018. Allowing for this change in practice and despite CHF 4.9 million

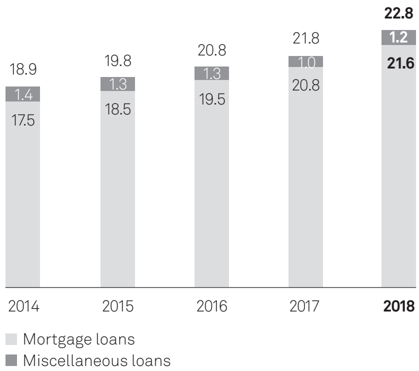
18.2 bn

Customer Funds
in CHF bn



22.8 bn

Customer Loans
in CHF bn



lower reversals of impairments than in the previous year, the increase in net result from interest operations stood at CHF 0.3 million.

Strong commission Business and Trading
Commission income from securities trading and investment activities noticeably increased in 2018. This is reflected in the performance of the result from commission business and services, which increased by 5.1% to CHF 65.5 million. The direct asset management business achieved the most significant growth. It posted growth of 15%.

Income from the trading activities and the faire value option amounted to CHF 23.8 million and underperformed the previous year by CHF 38.1 million. This decline is also due to the change in the accounting method mentioned in connection with the net interest income. Allowing for this change in practice compared to the previous year, the result from the trading activities, mainly based on client trading, is at the previous year's level (–CHF 0.2 million).

Other result from ordinary activities increased to CHF 8.3 million (+ 23.2%). These gains are mainly due to increased income from participations.

Investments Result in higher operating Expenses
AKB invested heavily in digital development and in the expansion and modernisation of its branch network during the reporting year. With the creation of a new business division "Digitalisation and Infrastructure", the bank created the structural and organisational prerequisites for client-focused further development. Among other things, it adapted its personnel resources to the increased requirements.

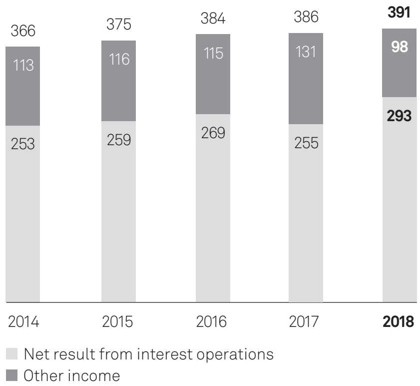
Operating expenses rose in 2018 by 5.8% to CHF 197.9 million. Personnel expenses rose by 2.0% to CHF 114.7 million. FTEs (full-time equivalents) increased by 15 performance units or 2.1% to 707.9 performance units. General and administrative expenses rose by 11.6% to CHF 83.2 million. The increases in operating expenses are within the planned framework for the implementation of the 2020 corporate strategy.

The payment of the state guarantee to the canton of Aargau is also an integral part of the operating expenses. This levy is governed under § 5 (2) of the Aargauische Kantonalbank Act. It amounts to 1.0% of the required capital according to the banking and stock exchange regulations, which for the reporting year results in a payment of CHF 11.5 million (previous year: CHF 11.1 million).

Cost-Income-Ratio
The cost-income-ratio is 50.6% and therefore still well below the maximum of 55.0% set in the long-term ownership strategy.

Operating Result below the previous Year's Level
The value adjustments on participations and depreciation and amortisation of tangible fixed assets of CHF 11.2 million are 12.3% below the previous year's level. This, too, is a consequence of investing in the future. Changes to provisions and other value adjustments and losses independent of interest operations amounted to CHF 4.1 million in 2018 (previous year: net reversal CHF 0.7 million).

391 m
Operating Income
in CHF m



The operating result, which shows the result from operating activities, amounted to CHF 177.7 million, CHF 12.2 million or 6.4% below the previous year's level. The decrease is due to an increase in operating expenses, but is also affected by 36.2% lower changes in value adjustments for default risks and losses from interest operations. Return on equity based on the operating result was 8.0% (previous year: 8.9%) and was thus at the upper limit of the strategy target of 7.0–8.0%.

"Extraordinary income" amounted to CHF 6.3 million and mainly includes the third earn-out payment in the reporting year from the sale of the holding in Swisscanto Holding AG to Zürcher Kantonalbank in 2015.

Profit at the same Level as the previous Year
To further increase risk-bearing own funds, the amount of CHF 31.8 million (previous year: CHF 38.1 million) was transferred from the income statement to the reserves for general banking risks. The tax expenses of CHF 8.0 million includes CHF 6.4 million (previous year: CHF 10.5 million) of income taxes in favour of the local communities of AKB in the canton of Aargau.

AKB reported a profit for the year of CHF 144.2 million, only a slight fall of CHF 1.4 million or 1.0% on the previous year (CHF 145.6 million). The smaller allocation to reserves for general banking risks and the lower tax expense largely offset the lower operating result.

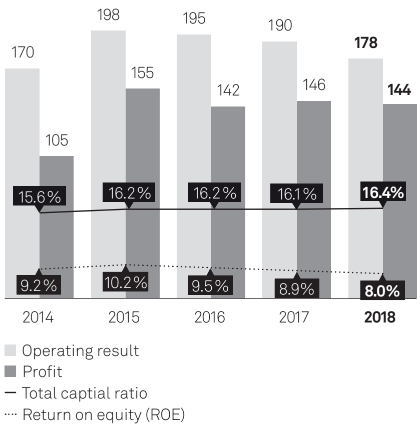
The company's profit before a change in the reserves for general banking risks was CHF 176.0 million compared to CHF 183.7 million in the previous year, which is CHF 7.7 million or 4.2% less.

Appropriation of Profit
The Board of Directors proposed in consultation with the Executive Council a profit distribution to the canton of Aargau of CHF 60.0 million and an allocation to the statutory retained earnings reserve of CHF 45.2 million as well as an allocation to the voluntary retained earnings reserves of CHF 39.0 million. The voluntary retained earnings reserves are to be definitively and proactively formed in view of the increasing requirements of the regulator and the own funds requirements in connection with Basel III. This will enable AKB to further expand its very solid equity capitalisation and ensure that it can continue its operating activities successfully as usual even under more acute conditions in the future.

The additional capital is built up by allocating it to a voluntary retained earnings reserve. These reserves will be increased over the coming years and transparently reported every year. Consequently, restated profit distribution to the canton of Aargau will be proposed to the Grand Council. AKB thus safeguards its earning power in the long term and acts proactively and from a strong starting position.

Along with the allocation to reserves for general banking risks of CHF 31.8 million, there is an increase in equity of CHF 116.0 million, resulting in an increase in the total capital ratio from 16.1 to 16.4%. Excluding the voluntary retained earnings reserves, the total capital ratio was 16.1% as in the previous year and thus within the target ratio of the ownership strategy of 15.8 to 16.2%.

Operating Result, Annual Profit, Total Capital Ratio and Return on Equity (ROE)
in CHF m



BALANCE SHEET

before appropriation of profit

in CHF 1000	31.12.2017	**31.12.2018**	Change in %
Assets			
Liquid assets	3 102 410	**3 357 901**	8.2
Amounts due from banks	470 001	**434 907**	– 7.5
Amounts due from customers	1 017 482	**1 181 143**	16.1
Mortgage loans	20 808 730	**21 614 634**	3.9
Trading portfolio assets	116 366	**91 351**	– 21.5
Positive replacement values of derivative financial instruments	121 255	**83 707**	– 31.0
Financial investments	1 199 734	**1 456 144**	21.4
Accrued income and prepaid expenses	20 198	**21 334**	5.6
Participations	15 712	**15 705**	– 0.0
Tangible fixed assets	61 527	**61 544**	0.0
Other assets	27 903	**33 046**	18.4
Total assets	**26 961 318**	**28 351 416**	**5.2**
Total subordinated claims	3 713	**9 377**	152.5
of which subject to mandatory conversion and/or debt waiver	–	**–**	n. a.
Liabilities			
Amounts due to banks	2 858 045	**2 767 078**	– 3.2
Amounts due in respect of customer deposits	17 270 041	**18 221 406**	5.5
Negative replacement values of derivative financial instruments	102 709	**99 153**	– 3.5
Liabilities from other financial instruments at fair value	112 604	**83 112**	– 26.2
Cash bonds	42 596	**33 324**	– 21.8
Bond issues and central mortgage institution loans	4 173 110	**4 664 763**	11.8
Accrued expenses and deferred income	83 518	**81 917**	– 1.9
Other liabilities	7 774	**9 721**	25.0
Provisions	38 473	**38 498**	0.1
Reserves for general banking risks	1 270 600	**1 302 400**	2.5
Bank's capital	200 000	**200 000**	–
Statutory retained earnings reserve	655 980	**705 580**	7.6
Profit carried forward	239	**268**	12.1
Profit	145 629	**144 196**	– 1.0
Total liabilities	**26 961 318**	**28 351 416**	**5.2**
Total subordinated liabilities	–	**–**	n. a.
of which subject to mandatory conversion and/or debt waiver	–	**–**	n. a.
Off-balance-sheet transactions			
Contingent liabilities	266 102	**263 386**	– 1.0
Irrevocable commitments	810 540	**974 848**	20.3
Obligations to pay up shares and make further contributions	48 458	**48 458**	–
Credit commitments	–	**–**	n. a.

INCOME STATEMENT

in CHF 1000	2017	**2018**	Change in %
Result from interest operations			
Interest and discount income	286 327	**284 117**	– 0.8
Interest and dividend income from financial investments	8 737	**8 032**	– 8.1
Interest expense	– 53 211	**– 7 272**	– 86.3
Gross result from interest operations	**241 853**	**284 877**	**17.8**
Changes in value adjustments for default risks and losses from interest operations	13 422	**8 561**	– 36.2
Subtotal net result from interest operations	**255 275**	**293 438**	**14.9**
Result from commission business and services			
Commission income from securities trading and investment activities	46 437	**49 420**	6.4
Commission income from lending activities	3 829	**3 997**	4.4
Commission income from other services	16 432	**17 125**	4.2
Commission expense	– 4 376	**– 5 069**	15.8
Subtotal result from commission business and services	**62 322**	**65 473**	**5.1**
Result from trading activities and the fair value option	**61 861**	**23 805**	**– 61.5**
Other result from ordinary activities			
Result from the disposal of financial investments	2 251	**1 189**	– 47.2
Income from participations	1 862	**4 521**	142.8
Result from real estate	1 990	**2 223**	11.7
Other ordinary income	755	**808**	7.0
Other ordinary expenses	– 160	**– 488**	205.0
Subtotal other result from ordinary activities	**6 698**	**8 253**	**23.2**
Operating income	**386 156**	**390 969**	**1.2**
Operating expenses			
Personnel expenses	– 112 404	**– 114 663**	2.0
General and administrative expenses	– 74 606	**– 83 240**	11.6
of which compensation for the state guarantee	– 11 139	**– 11 531**	3.5
Subtotal operating expenses	**– 187 010**	**– 197 903**	**5.8**
Value adjustments on participations and depreciation and amortisation of tangible fixed assets and intangible assets	– 9 999	**– 11 227**	12.3
Changes to provisions and other value adjustments, and losses	737	**– 4 124**	– 659.6
Operating result	**189 884**	**177 715**	**– 6.4**
Extraordinary income	6 164	**6 294**	2.1
Extraordinary expenses	–	**–**	n. a.
Changes in reserves for general banking risks	– 38 100	**– 31 800**	– 16.5
Taxes	– 12 319	**– 8 013**	– 35.0
Profit	**145 629**	**144 196**	**– 1.0**

APPROPRIATION OF PROFIT

in CHF 1000	2017	**2018**	Change in %
Appropriation of profit			
Profit	145 629	**144 196**	– 1.0
Profit carried forward	239	**268**	12.1
Distributable profit	**145 868**	**144 464**	**– 1.0**
Allocation to statutory retained earnings reserve	49 600	**45 200**	– 8.9
Allocation to voluntary retained earnings reserves	–	**39 000**	n. a.
Distribution to the canton	96 000	**60 000**	– 37.5
Profit carried forward	**268**	**264**	**– 1.5**

RISK MANAGEMENT

In connection with its business model and its strategic orientation, AKB is largely exposed to credit risks, market risks, liquidity risks, operational risks (including IT risks) as well as compliance risks. For AKB, risk management is a process in which all relevant risks with a potential negative impact on the Bank are systematically identified, analysed, assessed, managed and monitored. This process is supported by appropriate organisational structures as well as methods, tools, and guidelines.

I. Risk Governance Structure
The Bank's risk governance is based on the concept of the Three Lines of Defence.

Ultimate responsibility for risk management rests with the Board of Directors. It is responsible for the regulation, establishment and monitoring of effective risk management and overall risk management. To this end, it establishes the framework for institution-wide risk management.

The Audit and Risk Committee of the Board of Directors assists the Board of Directors in assessing and monitoring the functionality and appropriateness of internal control and/or the internal control system, bank-wide risk management and compliance.

The Executive Management is required to implement the operational business in accordance with the framework concept for bank-wide risk management. It must specify, set up and implement appropriate processes for identifying, assessing, managing, monitoring and controlling the risks taken by the Bank.

The overall company's risk management builds on three independent lines of defence below corporate governance:

1. Line of Defence of Risk Responsibility, Risk Assumption and Control:
The specific risk assumption is delegated by the Executive Management to the operational units by means of guidelines and instructions subject to clearly defined specifications and risk limits. In some significant types of risk, risk assumption is also delegated to defined internal committees. As Risk Officers, these operational bodies or committees are responsible for the assessment, management, control and reduction of risks.

2. Line of Defence of Risk Monitoring and Control:
The independent and centralised Risk/CRO sector, under the direction of the Chief Risk Officer (CRO), is responsible for the comprehensive and systematic monitoring and reporting of both individual and aggregated exposures to all material types of risk. The Risk/CRO sector is part of the Finance & Risk division and has direct access to the operational management, the Audit and Risk Committee and the Board of Directors. The Risk/CRO sector encompasses the functions of risk control and IT security and, together with the Compliance department, forms the Bank's "second line of defence".

The Risk/CRO sector issues various specific reports on the exposures and development of the risk situation for each major type of risk. In addition, it prepares a quarterly comprehensive and consolidated risk report covering all material risk categories for the attention of the Executive Management, the Audit and Risk Committee and the Board of Directors. In addition, the CRO immediately triggers the defined escalation and emergency procedures for significant risk-relevant developments. In any case, this includes violations of prescribed risk tolerances, risk limits and/or thresholds.

3. Line of Defence of independent "Assurance":
The independent internal auditing department, which is independent of the Executive management, assists the Board of Directors in the performance of its senior management function. In this role, it assesses the Bank's risk management, control and governance processes.

II. Framework for bank-wide Risk Management
The Bank has a framework for bank-wide risk management specified by the Board of Directors. This consists of the internal regulations on risk policy, the risk tolerance guidelines and the risk limits as well as the specific internal regulations and guidelines issued for the main types of risk.

The risk policy is limited to the definition of principles for the individual risk types, the delegation of authority, methodological and organisational standards as well as reporting and financial reporting.

The main risk types are limited by the Board of Directors by way of the risk tolerance guidelines. Based on the risk profile and risk-bearing capacity of the Bank, these limits define the risk tolerance of the Bank as a whole and the main types of risk to be complied with. The risk tolerance guidelines are reviewed annually and are continuously monitored. The defined risk tolerances are set up so that even in the case of a cumulative exhaustion they do not compromise the continued existence of the bank.

The specific implementation rules regarding the tasks, competencies and responsibilities as well as the principles of identification and evaluation, limitation and control, monitoring and reporting are ultimately contained in the specific internal regulations on the main types of risk.

The annual reassessment of the risk policy as well as the final assessment and approval of the systematic risk analysis took place most recently at the meeting of the Board of Directors on 25 October 2018.

In addition, the Board of Directors approved the new "Risk Appetite Framework", comprising the risk tolerance of the Board of Directors and risk limits of the management, at its meeting on 15 November 2018. The new framework will become effective as at 1 January 2019.

A. Credit Risks

An integral part of the framework for bank-wide risk management are the credit regulations, which establish the regulatory framework for all banking transactions that generate credit risks for the Bank. At the implementation level, the credit regulations are supplemented by credit guidelines as well as by various directives and process descriptions. The credit guidelines specify the regulatory principles and guidelines in lending, depending on the current risk assessment of the market and economic environments.

Credit risks are restricted by limits, quality requirements (e.g. minimum rating), fixed cover margins (reductions on eligible collateral) and guidelines for risk diversification. When granting loans and other exposures with default risks, creditworthiness and solvency are assessed using uniform criteria. There is a multi-level, risk-based allocation of responsibilities, which regulates both ordinary credit competencies and special and tolerance competencies.

The units responsible for acquiring and servicing customers are completely separate from the loan processing and credit administration. The credit risk monitoring at the portfolio level is carried out by the Risk/CRO sector, which is independent of the sales organisation and monitors the development of the credit portfolio in various ways. Appropriate methods and models are used to assess credit risks periodically and/or on an ad hoc basis.

The objective of credit monitoring at the portfolio level is to identify at an early stage existing and/or potential credit risks due to concentrations, interdependencies or influences of significant market developments and to assess and demonstrate their impact on the overall risk tolerance, risk limits and/or thresholds.

Monthly reports are sent to the senior credit approval department regarding the development of the credit portfolio. The Executive Management, the Audit and Risk Committee and the Board of Directors are each informed about the specific credit risk analyses. In addition, the risk assessment of the entire loan portfolio is reported in detail quarterly.

To measure and manage default risk, the Bank classifies its loans according to a rating system. The system is used to ensure the uniform assessment of default risks and to determine the expected losses which the Bank will incur in lending. This component is used for the risk-based definition of credit conditions and thereby directly influences the conclusion of credit transactions.

Methods used to identify Default Risks and to determine Impairment Requirements:

Additionally to the IT-based rating system, credit monitoring is based on defined early warning indicators (maturing resubmissions, overruns, interest arrears, impairments, etc.), which point to a deterioration in credit quality as early as possible and ensure the timely introduction of corrective measures.

The Bank attaches great importance to the consistent management of problem exposures and loss positions. The Special Financing sector monitors in particular the "watch list" positions and provides support for positions that are impaired or non-performing, either on its own or together with the client partner of the sales organisation. The sector is also responsible for the management and the rapid re-sale of properties foreclosed on by the Bank.

Receivables for which the Bank considers it unlikely that the borrower will be able to fully comply with its future obligations are considered at risk. Client commitments are classified as at risk at the latest when the contractual payments (principal, interest and/or commission) are 90 days or more overdue and when there is evidence that the borrower (taking account of coverage income) cannot comply at all or in full with its future obligations.

Loans at risk are valued individually and the impairment is covered by specific valuation allowances. The impairment is the difference between the receivable's carrying amount and the estimated recoverable amount, taking into account the counterparty risk and the net proceeds from the sale of any collateral. In determining the net proceeds of collateral, all holding costs such as interest, maintenance and sales costs, etc. up until the estimated time of sale, as well as any applicable taxes and fees, are deducted.

As it uses a well-developed range of tools for the early detection of receivables at risk, AKB does not create additional impairments to cover existing latent default risks in the client portfolio on the date of valuation. However, it estimates future unexpected losses at overall portfolio level. This serves as the basis for the calculation of capital allocation to reserves for general banking risks in the lending business in accordance with the concept of "risk provisioning".

The concept of "risk provisioning" is used for risk prevention and anticipation of future unexpected losses from the trade receivables and was revised during the reporting year. Depending on the provision situation, the aim of "risk provisioning" is to create additional, voluntary reserves for future loan defaults or to use these reserves to cover losses in the case of special events.

The calculation is based on an internal stress scenario, which assumes a severe general economic recession. The allocation to the account "Risk provisioning" accounted for separately under the balance sheet heading "reserves for general banking risks" is performed according to the "high water-mark method", i.e. an allocation is performed only if the CVaR (Credit Value at Risk) calculated in the stress scenario is greater than the amount of risk provisions. The addition or release is made via the income statement item "Changes in reserves for general banking risks". There was no allocation to risk provisions during the reporting year. The holdings at the end of the year amounted to CHF 222 million as before.

As part of the annual capital planning, stress losses were calculated in the loan portfolio according to defined default scenarios. The aim of the scenarios is to show the effects of a real estate price collapse or a macroeconomic recession on the loan portfolio.

In capital planning, the effects of the losses based on the stress scenarios on the capital situation are shown. The results show that when entering a series of very high credit losses which affect the entire banking industry equally, the bank itself would still have an intact equity ceiling, so the ordinary course of business could be guaranteed in compliance with the capital adequacy requirements.

1. Client Loans

The core business of AKB is the granting of mortgages and other mortgage-backed loans.

To determine the maximum amount of property financing, the following factors are decisive: collateral values internally defined by the Bank for each property type and the financial viability of the borrower and the observance of amortisation principles. The criteria to be applied in each case are set out in the credit guidelines and also take into account the assessment of the property market.

For loans with securities as collateral, the credit guidelines contain guidelines on the assets accepted as securities and their collateral values. The guidelines are further restricted using risk-based criteria by currency, issuer domicile, stock exchange, tradability and diversification and are reviewed periodically.

Alongside the mortgage business and securities collateral-secured loans for private clients, the Bank's operations include commercial lending, primarily to companies based in the market territory.

Valuation of Collateral:

To value property, AKB employs experts to support the client partners and the approval entities in technical matters, decisions and judgements. The guidelines for valuing all kinds of property are subject to binding regulations. A client partner can determine "standard transactions" under their own authority using a set of estimation tools. Properties which do not meet the defined parameters for standard transactions are assessed exclusively by real estate experts. The real estate experts are based in a central unit independent from the front office.

For the great majority of standard transactions, either a hedonic model for owner-occupied homes and single-family homes, or a capitalisation rate model for simple residential and commercial buildings is used. Both estimation tools are integrated into the lending process, which guarantee an efficient and consistent evaluation. In the case of poor creditworthiness an additional liquidation value is calculated.

The value of securities collateral is monitored daily. If the collateral values fall below the loan exposure amount, the outstanding amount needs to be reduced or additional collateral put up. In exceptional market conditions or in the case of increasing cover deficit, the collateral is realised and the loan closed out.

For commercial loans, the relevant evaluation criteria are mainly future earnings outlook, market position, the assessment by management and financial ability to repay the loan on schedule. Unsecured major exposures are restricted by limits at individual and total exposure level. Additionally, guidelines and benchmarks exist at the overall portfolio level.

2. Credit Risks from Trading

Responsibilities and technical tasks related to credit risks from trading, including the internal standards for the application of risk mitigation techniques, are set out in the loan regulations, in the credit guidelines and at the instruction level. The counterparty risks in the interbank business as well as in positions towards central counterparties are limited by a limit system. Limits must be approved by the competent approval entities at the request of the operational units in the trading department in accordance with the allocation of authority. The approval entities are completely separate from the units making the request. The adequacy of the limits is checked at least once per year or if particular events occur. To reduce wrong-way risks, care is taken to ensure appropriate diversification.

Compliance with limits is monitored daily by the Risk/CRO sector and is reported on a monthly basis. Furthermore, each quarter the Audit and Risk Committee and the Board of Directors are informed about limit compliance, risk assessment and particular findings.

AKB conducts interbank business primarily for liquidity management and handling of client orders (international payments). This involves short-term money market deposits and transfers from domestic and foreign banks.

3. Country Risk

Country risks are limited by the Board of Directors through predetermined thresholds based on rating category. Within these thresholds, the competent credit committee places additional limits in the form of individual limits per country. The Risk/CRO sector monitors compliance with country limits. Exposures in risk countries are assessed at least twice a year for traceability and impairments made if necessary.

B. Market Risk

Market risks describe the risk of losses arising due to changes in market prices (equities, exchange rates, interest, commodities and property) and factors influenced by market prices (e.g. volatility and correlations). We differentiate between three sub-risk categories:

- Market risk in the trading book
- Interest rate risk in the banking book
- Other market risks in the banking book

1. Market Risk in the Trading Book

Financial instruments that are held for the Bank's own account for resale in order to exploit short-term price and interest rate fluctuations are assigned to the trading book and measured on a fair value basis using daily market prices. These positions are actively managed within the defined risk tolerance and risk limits exclusively by the trading desks “Currency”, “Securities” and “Interest”. The Bank also acts as issuer of certificates. The underlying assets or securities of the certificates are held in the trading portfolio as a hedged item.

The concrete tasks, competencies and responsibilities as well as the principles of identification and evaluation, limitation and control, monitoring and reporting of the Bank's trading activities are regulated in the internal trading regulations. Entering into risks from proprietary trading is specified in detail in and regulated by the internal trading guidelines and dealer-specific instructions. With the exception of self-issued certificates, AKB does not engage in any market-making activities.

Derivative financial instruments may be used in currency, interest and securities trading for the Bank's own or a third-party account. Both standardised and OTC instruments are used.

Risk is limited by Value at Risk limits (VaR), position and daily loss limits.

The risk tolerance for the entire trading book (currency, securities and interest) is determined as VaR limits by the Board of Directors and its adequacy is verified at least annually. At Executive Management level, the risk tolerance is allocated to the individual trading desks “Forex”, “Equity” and “Interest” as VaR limits. Daily monitoring of the VaR limit is carried out by the Risk/CRO sector, which is an independent unit of the trading department. Daily reports on the utilisation of the VaR limit are sent to the competent department manager and managers of each trading desk, on a monthly basis to the Executive Management and on a quarterly basis to the Audit and Risk Committee and the Board of Directors.

For the monitoring and reporting of market risks in the trading book, the Risk/CRO sector has a dedicated IT system that derives the trading book positions directly from the core system of the Bank, evaluates them independently and calculates the limit utilisation.

The position and daily loss limits are allocated by the relevant department managers per trading desk or per trader and monitored by the respective manager of the corresponding trading desk. The position limits restrict the exposure for each dealer and are designed to protect to the Bank from excessive exposure. The daily loss limits are intended to restrict short-term losses due to large market fluctuations and prevent the Bank from exceeding its risk tolerance and/or VaR risk limits through an accumulation of realised and unrealised losses.

2. Interest Rate Risk in the Banking Book
It is the aim of interest rate risk management to reduce any margin pressure from changes in market prices and client behaviour, strengthen the solvency of the Bank and thus safeguard the stability of the equity through optimal asset and liability management. Asset and liability management is based on the internal regulations for liquidity and the asset and liability management. The regulations define principles, responsibilities and competencies.

The "Liquidity & ALM Board" (LAB) is the strategic decision-making committee for monitoring and managing interest rate risks, within the framework of the competencies and limits set by the Board of Directors. The LAB meets monthly and delegates certain well-defined tasks, competencies and responsibilities to the "Liquidity & ALM Committee" (LAC). The LAB comprises the members of the Executive Management and the advisory members of the LAC. The operational unit "Treasury" implements the strategic decisions of the LAB. Risk/CRO conducts the supervision/monitoring of the implementation of strategic decisions by the LAB and its compliance with the limits, independently from the operational units. It is also responsible for the monthly risk reporting to the LAC and LAB and quarterly reporting to the Audit and Risk Committee and the Board of Directors.

The management of interest rate risks is based on the present value method and focuses on limiting the negative impact in the net present value of equity and the income effect.

To calculate the present value of equity, fixed interest rate products are divided according to their maturity and variable interest rate products are replicated on the basis of their remaining lifetime. Replication is based on the need to reproduce, as accurately as possible, changes in client interest rates using changes in market interest rates, i.e. to achieve an optimum ratio between risk (interest rate risk) and income (margin). The optimum ratio is calculated with the aid of the efficient frontier method, which originates from portfolio theory. The entire equity complex is treated as non-interest sensitive and is not replicated. Replication is reviewed annually for its effectiveness.

Interest rate risks are monitored on the basis of static (sensitivity, market value of equity, VaR) and dynamic calculations (simulations of possible market scenarios). The Bank manages the interest rate risks through on-balance sheet measures. The LAB conducts hedging depending on the assessment of interest rate risk.

Interest rate risks are limited by the risk tolerance specified by the Board of Directors by limiting the maximum present value change in the equity and using a VaR limit. Simulations are carried out periodically to determine future trends in the Bank's earnings from interest operations. Both the value effect and income effect are measured here.

The market value of equity is stressed monthly by means of five different changes in the yield curve. The LAB is informed monthly of the scenarios used and the resulting changes in value.

Future potential changes in the interest balance (income effect) are stressed at regular intervals using various scenarios. These include both different changes in the yield curve and client behaviour, which can, depending on the interest rate environment, lead to massive shifts in capital. The interest balance calculated is based on a dynamic change in interest-bearing positions and the market environment. The results are discussed in the LAB and brought to the attention of the Audit and Risk Committee as part of the quarterly reporting.

For the monitoring and reporting of interest rate risks as well as for the calculation of key figures and the implementation of stress scenarios, the Risk/CRO sector has a dedicated IT system that derives the balance sheet data directly from the bank's core system.

Business Policy on the Use of derivative financial Instruments:
The instruments used for balance sheet management serve mainly to hedge interest rate and foreign currency risks in the banking book. Interest rate swaps and cross-currency swaps are also primarily used. Credit derivatives are not used.

Micro-hedges are predominantly used for hedging. Selected and clearly identified, interest rate-sensitive client receivables or liabilities are hedged (either individually or grouped together) over the entire remaining period as underlying assets here. Macro-hedges are also occasionally used alongside to hedge sensitivity in a specific maturity bracket.

The objectives and strategies of hedges between the hedging instrument and the hedged item are documented in each case upon conclusion of the derivative hedging transactions.

The effectiveness of the hedging relationship is reviewed periodically by the independent Risk/CRO sector. It monitors whether the sensitivity of the hedging transactions exceeds the sensitivity of the allocated underlying assets by more than 20 percent. The hedging transaction must always reduce the sensitivity of the underlying assets overall.

Hedges where the criteria of effectiveness are no longer met are compared with the non-effective portion of a commercial transaction and the effect from the ineffective portion is booked under income from trading activities. In the reporting year there were no hedges that were not effective or not fully effective.

3. Other Market Risks in the Banking Book
A VaR limit is in place to limit other market risks, which consist in particular of position risks from equities in Swiss Francs and foreign currencies.

C. Liquidity Risk
The primary objective of liquidity management is to ensure the ongoing solvency of the Bank at all times, particularly during bank-specific and/or market-wide periods of stress. The principles, responsibilities and competencies for managing liquidity risks are defined in a specific set of internal regulations.

The LAC is responsible for the central management of tactical liquidity. The LAC reports directly to the LAB committee. The LAC meets twice monthly and, among other duties, is responsible for developing and fleshing out strategies for managing liquidity risk and the liquidity reserves.

The central operational unit Treasury implements the tactical decisions of the LAC and safeguards and manages intraday or short-term liquidity. The Risk/CRO sector conducts the supervision and monitoring of the implementation of tactical decisions by the LAC and its compliance with the limits, independently from the operational units. It is also responsible for daily liquidity reporting to Treasury and monthly risk reporting to the LAC and the LAB. The Audit and Risk Committee and the Board of Directors are updated quarterly on the changes in liquidity risk.

Operational measurement and management of liquidity risks are based on a daily liquidity schedule, which compares the expected cash inflows and outflows in a normal market phase. The liquidity schedule therefore shows the time horizon over which the Bank is still liquid or viable.

Liquidity risks are monitored on the basis of both static and dynamic calculations (including simulations of possible stress scenarios).

Liquidity risks are limited by rules governing the maintenance of liquidity reserves (e.g. on quality and diversification) and guidelines on the financing structure (e.g. on counterparties, maturity bands and currencies). In addition, the Board of Directors limits liquidity risk by setting the liquidity risk tolerance.

The liquidity risk tolerance defines the minimum time horizon, which must be continually maintained in a given stress scenario. Both institution-specific events and the effects of a global economic crisis are considered as stress scenarios.

In order to promptly detect risks in a liquidity position and potential funding options for the Bank, it has defined appropriate early warning indicators and set out potential emergency procedures with potential response measures. The defined early warning indicators are continuously monitored.

D. Operational Risk
Operational Risk Management (OpRisk) is part of the independent risk control function Risk/CRO under the supervision of the Chief Risk Officer (CRO). The risk control function is responsible for the design, implementation and maintenance of an effective and efficient operational risk framework and ensures the full and systematic monitoring and reporting of operational risk.

AKB defines operational risks as the risk of losses arising as a result of inadequate or failed internal procedures, people or systems or as a result of external events. Included are all legal risks, including fines from regulators and settlements. Strategic risks and reputational risks as secondary risks have an indirect effect on operational risks. These are an integral part of the operational risk management.

AKB defines operational risk management as a comprehensive process. The focus is on the risk-oriented protection of persons, services, information and assets of the individual departments as well as the maintenance and restoration of critical business processes in an operational emergency.

The principles, responsibilities and competencies for the management of operational risks and designing the internal control system are defined in a specific set of internal regulations. This also defines an escalation process for results that exceed the expected scope.

The risk tolerance for operational risks is limited annually by the Board of Directors with appropriate early warning indicators. The Executive Management further limits these by defining suitable thresholds or limits. Compliance with the defined thresholds and limits is subject to periodic monitoring.

Any violations of the limits will be remedied promptly with targeted measures.

The basis for the management of operational risks is the inventory of inherent operational risks at the level of the Bank as a whole, which is dynamically tracked by the Risk/CRO sector. For the identification and assessment of operational risks, AKB uses numerous instruments (including periodic risk and control assessments [RCA], continuous recording of loss events, approval process for the introduction of new or major adjustments to existing products, services, processes or systems). Within the framework of RCA, for example, the operational risks of each business are assessed on a bottom-up basis on the basis of a defined methodology.

The operational risks identified are systematically categorised and prioritised.

Both internal and external operational risk events are recorded, assessed and analysed in order to identify the reasons for their occurrence and to close potential gaps in the internal control system. Operational risks are reduced by an effective and suitable internal control system. Internal control is designed so that processes run as intended and in compliance with applicable regulations. The starting point for designing the internal control system is a systematic risk analysis. This is the result of a comprehensive and systematic process to assess the overall risks to which the Bank is exposed. By conducting systematic risk analysis, the Board of Directors ensures that all significant risks in the Bank are recorded, limited and monitored. It is also used as a basis for the regular review of the adequacy and effectiveness of the internal controls.

The Bank uses an ICS tool for documenting, monitoring and evaluating the adequacy and effectiveness of the internal monitoring system.

The adequacy and effectiveness of the internal controls are assessed once a year by the department managers and documented in a report. Another essential criterion of the assessment is the up-to-dateness of the internal control system. The assessment is also the basis for defining and carrying out any necessary corrective actions. To reduce risk, specific insurance policies are also used. The entire insurance portfolio of AKB is reviewed annually by an external insurance broker, discussed with the Bank or approved by the Executive Management.

Potential information security risks are managed on the basis of regular threat assessments. It will provide adequate and effective security measures to protect information and infrastructures in terms of confidentiality, integrity, availability and traceability.

For business-critical processes, precautions have been taken in the context of Business Continuity Management (BCM). In this context AKB takes recognised standards into account. The relevant principles, responsibilities and procedures for BCM are defined in a specific set of internal regulations.

The Audit and Risk Committee and the Board of Directors are updated quarterly on the development of early warning indicators, the assessment of the operational risks and the development of the operational risk profile (including the information security risks). Reporting includes the results of significant internal and relevant external operational risk events.

In addition, the CRO produces an annual report for the Board of Directors, the Audit and Risk Committee and the Executive Management on the assessment of the internal monitoring system of the Bank. This report also includes the findings and developments of the risk situation in the areas of operational risk, information security and Business Continuity Management (BCM).

E. Compliance Risk

Compliance risk refers to any legal, reputational and loss risks which may arise from the violation of legal or professional standards or ethical principles. The principles, responsibilities and competencies for the compliance risks are defined in a specific set of internal regulations.

Compliance with legal, regulatory, professional or internal regulations is monitored by the independent compliance function within the General Counsel – Legal & Compliance sector. Compliance activities relate in particular to combating money laundering, preventing insider dealing, complying with banking and stock exchange law, observing product distribution rules, monitoring the risks from cross-border client transactions, avoiding conflicts of interest and ensuring the tax transparency of the client funds deposited with AKB.

The Compliance unit annually reviews the compliance risk inventory, which it uses to draw up a plan of action. Compliance risks identified are managed and limited through the issue of directives, tailored operational systems and processes, employee training and downstream, independent monitoring and controls. The Compliance unit also advises the Executive Management and employees on compliance-related issues.

SIGNIFICANT EVENTS AFTER THE REPORTING DATE

No significant events occurred after the reporting date that have a significant influence on the financial position and financial performance of the Bank as at 31st December 2018.

KEY PRUDENTIAL METRICS

	in CHF 1000	e 31.12.2017	d 31.03.2018	c 30.06.2018	b 30.09.2018	**a** **31.12.2018**
	Eligible Capital					
1	Common equity tier 1 (CET1)	2 176 448		2 176 448		**2 292 444**
2	Tier 1 capital	2 176 448		2 176 448		**2 292 444**
3	Total capital	2 176 448		2 176 448		**2 292 444**
	Risk-weighted assets (amounts)					
4	RWA	12 731 580		12 909 096		**13 207 556**
4a	**Minimum capital requirement**	**1 018 526**		**1 032 728**		**1 056 604**
	Risk-based capital ratios as a percentage of RWA					
5	Commen equity tier 1 ratio	17.1%		16.9%		**17.4%**
6	Tier 1 capital ratio	17.1%		16.9%		**17.4%**
7	Total capital ratio	17.1%		16.9%		**17.4%**
	Additional CET1 buffer requirements as a percentag of RWA					
8	Capital conservation buffer as per the Basel minimum standards (2.5% from 2019)	1.3%		1.9%		**1.9%**
9	Countercyclical capital buffer (Art. 44a CAO) in accordance with the Basel minimum standards	1.0%		1.0%		**1.0%**
10	Additional capital buffer due to international or national system relevance					
11	Total of bank CET 1 specific buffer requirements	6.7%		7.3%		**7.3%**
12	CET 1 available after meeting the bank's minimum capital requirements	9.1%		8.9%		**9.4%**
	Capital target ratios in accordance with Annex 8 of the CAO (in % of risk-weighted assets)					
12a	Capital conservation buffer in accordance with Annex 8 of the CAO	4.0%		4.0%		**4.0%**
12b	Countercyclical buffer in accordance with Art. 44 and 44a of the CAO	1.0%		1.0%		**1.0%**
12c	CET 1 target ratio in accordance with Annex 8 of the CAO plus the countercyclical buffer in accordance with Art. 44 and 44a of the CAO	8.8%		8.8%		**8.8%**
12d	T1 target ratio in accordance with Annex 8 of the CAO plus the countercyclical buffer in accordance with Art. 44 and 44a of the CAO	10.6%		10.6%		**10.6%**
12e	Total capital target ratio in accordance with Annex 8 of the CAO plus the countercyclical buffer in accordance with Art. 44 and 44a of the CAO	13.0%		13.0%		**13.0%**
	Basel III Leverage Ratio					
13	Total Basel III leverage ratio exposure measure	27 709 127		28 103 386		**29 124 956**
14	Basel III leverage ratio (tier 1 capital in % of total exposures)	7.9%		7.7%		**7.9%**
14a	Basel III leverage ratio under the fully loaded ECL (expected credit loss) accounting model (tier 1 capital in % of total exposures)	7.9%		7.7%		**7.9%**
	Liquidity coverage ratio					
15	LCR Numerator: total high quality liquid assets	3 798 368	3 665 180	3 813 856	3 948 770	**4 269 561**
16	LCR Denominator: net cash outflows	3 168 518	3 167 076	3 207 077	3 004 779	**3 278 030**
17	Liquidity coverage ratio (LCR) %	119.9%	115.7%	118.9%	131.4%	**130.2%**

Aargauische
Kantonalbank

CH-5001 Aarau
Bahnhofplatz 1
+41 (0) 62 835 77 77