This document is a translation of a document originally issued in Polish. The only binding version is the original Polish version.

Bank Hipoteczny

PKO Bank Hipoteczny SA
Directors' Report
for the year ended 31 December 2018

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PKO BANK HIPOTECZNY SA
DIRECTORS' REPORT
FOR THE YEAR ENDED 31 DECEMBER 2018

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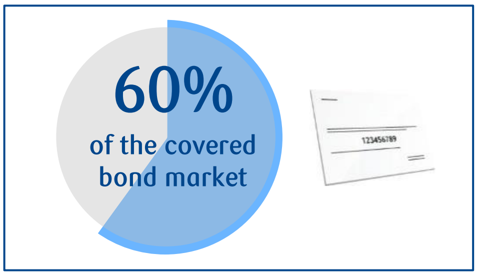
1. INTRODUCTION

PKO Bank Hipoteczny SA ("the Bank") specializes in granting residential mortgage loans to individual customers and purchasing receivables in respect of such loans from PKO Bank Polski SA. The Bank purchases loans for its portfolio based on its strategic cooperation with PKO Bank Polski SA.

PKO Bank Hipoteczny SA is the leader of the Polish mortgage bank market in terms of total assets and the balance of residential mortgage loans. The Bank is Poland's largest regular issuer of covered bonds on Polish and international markets. It was the only bank in Poland to carry out benchmark issues of euro-denominated covered bonds, four issues in total as at 31 December 2018. The outstanding covered bonds issued by the Bank account for nearly two-thirds of the total value of outstanding covered bonds issued by Polish mortgage banks.



The Bank's fast growth was made possible by granting both new housing loans and the purchase of such loans from PKO Bank Polski. In 2018, the Bank's total assets exceeded PLN 22 billion, of which over PLN 21 billion were a high quality portfolio of housing loans. This means that there was a 31% increase in total assets compared with the end of 2017, while at the same time maintaining the stability and safety of operations.

STRATEGY OF PKO BANK HIPOTECZNY SA

In December 2016, the Management Board of PKO Bank Hipoteczny SA adopted, and the Supervisory Board of PKO Bank Hipoteczny SA approved, the strategy of PKO Bank Hipoteczny SA for the years 2017 to 2020.

The mission of the Bank is to responsibly promote the interests of its stakeholders by ensuring:

- for customers – loan products tailored to their needs, for the financing of real estate;
- for investors – long-term covered bonds providing a high level of safety.

PKO Bank Hipoteczny SA's strategy for the years 2017–2020 calls for:

Diversification of sources of funding by obtaining long-term funding in the form of covered bonds, intended for real estate lending	Achieving and maintaining the leading position on the Polish market for covered bond issues while at the same time maintaining a high level of safety of such covered bonds	Establishing a centre of competence of the PKO Bank Polski SA Group in the area of real-estate valuation and residential loans, with the optimal use of PKO Bank Polski SA's assets, for the purpose of achieving synergies within the PKO Bank Polski SA Group.

In 2018, PKO Bank Hipoteczny SA pursued its strategy by building a portfolio of residential mortgage loans under the agency and pooling models in cooperation with PKO Bank Polski SA. In 2019, the Bank intends to similarly obtain housing loans, which, once included in the cover pool, will be the basis for issuing covered bonds.

In 2018, PKO Bank Hipoteczny SA was the leader of the Polish mortgage bank market in terms of total assets and the balance of mortgage housing loans. The Bank intends to continue to be an active issuer of covered bonds in 2019 to maintain its dominant market position.

2. EXTERNAL OPERATING CONDITIONS

Macroeconomic environment
Residential real estate market
Housing loan market
Covered bond market
Regulatory and legal environment

2.1. MACROECONOMIC ENVIRONMENT

The Bank only operates in Poland.

Macroeconomic factors affecting the Polish economy in 2018:

GROSS DOMESTIC PRODUCT

The GDP growth rate affects both the residential real estate market and the mortgage loan market. The sufficiently high GDP growth rate translates into new jobs and higher wages, and, consequently, into consumers' purchasing power and creditworthiness. The data published by the Central Statistical Office of Poland (GUS) in January 2019 show that Poland's GDP grew by 5.1% in 2018 compared with 2017. The European Commission's forecast published in November 2018 assumed that Poland's GDP would grow by 4.8% in 2018, and by another 3.7% in 2019. The high GDP growth rate may have a favourable effect on the employment level and consumers' wages. As a result, it may contribute to generating an increased demand for housing loans granted by banks to finance residential real estate purchases.

UNEMPLOYMENT AND WAGES

Based on the data published by GUS, the number of unemployed people registered with unemployment offices in Poland stood at 968.9 thousand at the end of December 2018, down 112.8 thousand, or 10.4%, compared with December 2017. The unemployment rate at the end of December 2018 was 5.8%, compared with 6.6% at the end of December 2017. The number of people employed at the end of the third quarter of 2018 was 16,617 thousand, up 0.6% y/y, according to GUS's Labour Force Survey (BAEL). Whereas, the average monthly wage in the enterprise sector in Q4 2018 was PLN 5,071.41, up 7.0% y/y, based on GUS data. The increase in the number of professionally active people and the increase in the wage level contribute to the development of the residential real estate market, and thus increases demand for residential mortgage loans.

INFLATION

Price changes affect consumers' purchasing power and the level of interest rates. A low inflation rate has a favourable effect on banking customers' creditworthiness, which in turn affects the value of residential mortgage loans granted. Based on GUS data, the Consumer Price Index (CPI) was 1.1% y/y in December 2018.

INTEREST RATES

Low interest rates translate into reduced credit costs and increased consumer creditworthiness. As at the date of this Report, the National Bank of Poland's (NBP) reference rate was 1.5%, the lowest on record. Maintaining interest rates at the current level may contribute to a further increase in the Bank's lending. This should also favourably influence the meeting of payment obligations by borrowers as and when they fall due.

2.2. RESIDENTIAL REAL ESTATE MARKET

2018 was yet another year of good conditions on the residential real estate market. The ongoing upward trend in real estate prices began in 2013 and has continued uninterruptedly for six years now. Up to and including 2016, the rate of price growth was moderate. It began to accelerate in 2017, and in the third quarter of 2018 it approached 10% per year.

Based on RedNet data, in the third quarter of 2018, prices of apartments sold on the primary market in the seven largest cities[1] rose by 9% on the average compared with the corresponding quarter of 2017, with the highest growth reported in the Tricity (16%), Warsaw (13%), and Łódź (12%), and the lowest growth reported in Wrocław (5%).

The rising prices of investment land and construction costs are the main cause of the growth in prices of residential properties on the primary market. Based on RedNet data, in the third quarter of 2018, the average price of investment land per square metre of usable floor area of an apartment in the seven largest cities was 19% higher than in the corresponding quarter of 2017. Whereas, based on GUS data, the average cost of construction of one square meter (sq m) of usable floor area of a residential building completed in Q3 2018 was 7% higher than a year before. Based on SEKOCENBUD's costing rates for the third quarter of 2018, the cost of construction (excluding the price of land) of selected single and multi-family residential buildings grew by 8.1% to 9.7% per annum.

NBP data for the third quarter of 2018 show that the growth rate of residential real estate prices on the secondary market accelerated in all the market segments except Warsaw, where average transaction prices in the third quarter of 2018 were only 2% higher than in the corresponding quarter of 2017. The low rate of price growth on the secondary market in Warsaw should be attributed to the relatively largest supply of developer apartments in this city, which diverted the demand away from the secondary market. The growth in residential real estate prices clearly accelerated in the other segments of the secondary market, to around 9% in the segment of the six largest cities other than Warsaw[2] and in the segment of the ten medium-sized cities.[3] According to the Bank's internal real estate database, the same high growth rate was reported in the segment of other urban administrative districts (9%) and in the segment of rural administrative districts (10%).

GUS data for the third quarter of 2018 point to a continuation of an upward trend of investors' activity in the residential construction segment in 2018. At the national level, in the first three quarters of 2018, 2% more permits for the construction of apartments were issued than in the corresponding period of 2017, while the number of apartments whose construction began increased by 8% in that period. Based on NBP data, in Q3 2018, the average availability of apartments in the large cities (a measure defining the number of square meters of housing available for an average one-month salary in the enterprise sector based on the average transaction price of an apartment on the given market) was 0.82 sq m. This is 0.34 sq m more than the minimum level reported in Q3 2007. Since the beginning of 2014, there has been a horizontal trend in the level of this indicator, fluctuating around 0.85, which means that the rate of wage growth followed the rate of growth of residential real estate prices.

The good situation on the residential real estate market is supported by the favourable general economic situation in Poland, which has been maintained for the last five years, and strong internal demand. Low unemployment, wage growth, payment of benefits under the 500 Plus programme are the factors which improve consumer sentiment. In consequence, there has been a clear increase in consumer confidence indices (current – describing the assessment of the current situation, and future – describing the situation expected by consumers in the coming months). Moreover, since 2017, these indices have been showing historically unprecedented positive values, which means that there have been more consumers who optimistically assess their situation than those who have been pessimistic about it. Record-high values are also reported for the indicator of consumer willingness to make major purchases, which is important for the real estate market, and which is an element of the current consumer confidence index.

The strength of demand on the residential real estate market is also demonstrated by the structure of the developers' offer, in which, at the end of the third quarter of 2018, the share of unsold finished apartments was only 12%. For comparison, in 2013 this share was 39%. At the moment, the developers' offer is predominantly real estate with a period to completion of one to two years, which means that developers do not have any problems with the sale of their apartments.

Home purchases are financed with household savings and mortgage loans. Based on NBP data, the estimated share of cash purchases of apartments on the primary market in the seven largest cities was 62% in Q3 2018. Over the

[1] Warszawa, Kraków, Poznań, Wrocław, Gdańsk, Gdynia, Łódź
[2] Kraków, Poznań, Wrocław, Gdańsk, Gdynia, Łódź
[3] Białystok, Bydgoszcz, Katowice, Kielce, Lublin, Olsztyn, Opole, Rzeszów, Szczecin, Zielona Góra

last year, it ranged from 62% to 75%. Based on GUS data, household deposits have been steadily increasing, and, at the end of Q3 2018, they were 8% higher than in the previous year.

The impact of government schemes on the residential real estate market is now neutral. The demand for apartments generated by the Apartments for Young People (MdM) scheme came to an end. The remaining funds were fully committed in the first days of January 2018, and continuing the scheme in subsequent years is not foreseen. The Mieszkanie Plus (Apartment Plus) scheme, which is currently undergoing modification, has no significant impact on the real estate market now.

2.3. Housing loan market

Based on NBP data, banks' receivables from housing loans in Poland were PLN 415.7 billion at 31 December 2018, up 7.0% y/y. Loans denominated in PLN were PLN 287.7 billion as at 31 December 2018 (69.2% of the total banks' receivables from housing loans in Poland), up 11.8% y/y.

The total balance of housing loans in relation to gross domestic product expressed at market prices stood at 19.6% at the end of December 2018, which is significantly lower than the average for the European Union, which, according to 2017 data, was nearly 45.4%. This indicates a great potential for further growth of the housing loan market in Poland.

2.4. Covered bond market

As at the end of December 2018, three mortgage banks were operating in Poland, namely:

- PKO Bank Hipoteczny SA;
- mBank Hipoteczny SA;
- Pekao Bank Hipoteczny SA.

The Polish covered bond market is relatively small and moderately liquid. At the end of December 2018, the total value of outstanding covered bonds issued by Polish mortgage banks amounted to approx. PLN 21.2 billion, i.e. PLN 4.6 billion more than at 31 December 2017. As at 31 December 2018, outstanding covered bonds issued by Polish banks corresponded to 5.1% of the amount of housing loans granted by banks. For comparison, in 2017 this ratio was around 15.6% in Germany and around 34.4% in the Czech Republic.

PKO Bank Hipoteczny SA is the largest issuer of mortgage covered bonds in Poland. As at 31 December 2018, the value of outstanding mortgage covered bonds issued by PKO Bank Hipoteczny SA amounted to PLN 12.8 billion, which accounted for approx. 60% of the total value of outstanding covered bonds issued by Polish mortgage banks. The value of mortgage covered bonds issued by PKO Bank Hipoteczny SA in 2018 accounted for 70% of the value of mortgage covered bonds issued by Polish mortgage banks in that period.

2.5. Regulatory and legal environment

In 2018, the following legal and regulatory solutions significantly affecting the operations of PKO Bank Hipoteczny SA came into force:

Prudential and capital requirements	• Regulation of the Minister of Development and Finance of 1 September 2017 on the systemic risk buffer (Official Journal 2017.1776), introducing a systemic risk buffer of 3% of the total risk exposure on individual and consolidated basis;

	• Act of 5 August 2015 on Macroprudential Supervision over the Financial System and on Crisis Management in the Financial System (Official Journal 2017.1934) introducing an increase in the capital conservation buffer from 1.25% to 1.875%. These regulations affect the minimum capital base of banks and the level of capital adequacy.
ACCOUNTING STANDARDS	The financial reporting standard IFRS 9 introducing, among other things, changes to the method of calculating and recording impairment losses and classification of financial instruments – the standard affects the classification and measurement of financial assets and financial liabilities in banks.
INTERNAL CONTROL SYSTEM	Recommendation H of the Polish Financial Supervision Authority concerning the system of internal control in banks, introducing changes to the organization of the internal control system, including the control function, the compliance function and the internal audit function – the regulation impacts the way the internal control system in banks is organized.
PERSONAL DATA	Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (GDPR) – the regulation has an impact on banks' operations in the area of internal processes and customer relations.
REPORTING OBLIGATIONS OF ISSUERS	Regulation of the Minister of Finance of 29 March 2018 on current and periodic information submitted by issuers of securities and on the conditions for recognizing information required by law of a non-member state as equivalent information – which affects the scope and frequency of discharge of issuers' reporting obligations.
TAXES	Act of 27 October 2017 amending the Personal Income Tax Act, the Corporate Income Tax Act, and the Act on Flat-Rate Tax Chargeable on Certain Revenues Earned by Natural Persons, introducing, among other things, regulations on restricting the recognition of expenditures on intangible services as tax-deductible expenses and adapting regulations to the entry into force of IFRS 9 – the regulations affect the manner and outcome of income tax computations.
BENCHMARKS	Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 – the regulation affects banks' operations in the area of customer and counterparty relations, and risk management.
ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM	Act of 1 March 2018 on Anti-Money Laundering and Combating the Financing of Terrorism – the regulation has an impact on banks' operations in the area of internal processes and customer relations

3. FINANCIAL PERFORMANCE AND CAPITAL ADEQUACY

Key financial ratios of PKO Bank Hipoteczny SA
Balance sheet of PKO Bank Hipoteczny SA
Profit and loss account of PKO Bank Hipoteczny SA
Own funds requirements (Pillar 1)
Internal capital (Pillar 2)
Disclosures (Pillar 3)

3.1. KEY FINANCIAL RATIOS OF PKO BANK HIPOTECZNY SA

	31.12.2018	31.12.2017
Total assets (in PLN millions)	22,103.1	16,902.6
ROA[4]	0.4%	0.4%
ROE[5]	6.6%	5.3%
Capital adequacy ratio	15.2%	15.2%
Leverage ratio (LR)	6.3%	6.9%
Cost to income ratio (C/I)[6]	21.5%	27.8%

3.2. STATEMENT OF FINANCIAL POSITION OF PKO BANK HIPOTECZNY SA

in PLN millions	31.12.2018	31.12.2017
Cash and balances with the Central Bank	0.0	0.6
Amounts due from banks	0.0	5.4
Hedging derivative instruments	168.3	0.3
Securities	843.0	830.5
Loans and advances to customers	21,070.5	16,042.5
Other assets[7]	21.3	23.3
TOTAL ASSETS	**22,103.1**	**16,902.6**

in PLN millions	31.12.2018	31.12.2017
Amounts due to banks	4292.3	4,125.4
Hedging derivative instruments	15.3	217.8
Liabilities in respect of covered bonds issued	12,841.5	8,883.2
Liabilities in respect of bonds issued	3,311.1	2,428.0
Other liabilities and provisions[8]	155.0	26.4
Equity	1,487.9	1,221.8
TOTAL LIABILITIES AND EQUITY	**22,103.1**	**16,902.6**

[4] Annualized ratio expressed as the quotient of the net profit (loss) for the period and the average level of assets at the beginning and end of the reporting period and of the interim monthly periods
[5] Annualized ratio calculated by dividing the net profit (loss) for the period by the average level of total shareholders' equity at the beginning and end of the reporting period and of the interim monthly periods
[6] Annualized ratio excluding tax on certain financial institutions
[7] Includes the following items of the statement of financial position: intangible assets, property, plant and equipment, and other assets
[8] Includes the following items of the statement of financial position: amounts due to customers, other liabilities, current tax liabilities, deferred tax liabilities and provisions

As at 31 December 2018, the total assets of PKO Bank Hipoteczny SA were PLN 22,103.1 million, up 31% compared with the end of 2017. Residential mortgage loans were the key component of the Bank's assets. Their carrying amount, taking into account write-downs for expected credit losses recognized as at 31 December 2018, amounted to PLN 21,070.5 million, of which new loans amounted to PLN 8,766.4 million, whereas loans purchased from PKO Bank Polski SA amounted to PLN 12,304.1 million.

As far as liabilities are concerned, the share of covered bonds rose to 58% thereof as at the end of December 2018. In 2018, PKO Bank Hipoteczny SA carried out:

- one benchmark issue of euro-denominated covered bonds of EUR 500 million,
- five issues of złoty-denominated covered bonds with the total value of PLN 1,590 million.

Consequently, the carrying amount of covered bonds was PLN 12,841.5 million at the end of December 2018, up 45% in relation to the end of 2017.

As at 31 December 2018, financial liabilities to PKO Bank Polski SA were a significant item of the Bank's liabilities and equity. They consisted of in the form of lines of credit, overdraft facilities, liabilities in respect of the purchase of receivables, liabilities in respect of the covered bonds and short-term unsecured bonds acquired by PKO Bank Polski SA and other liabilities to PKO Bank Polski SA. Their total balance was PLN 4,296.4 million. Short-term unsecured bonds issued by the Bank were also a significant source of funding the Bank's operations. Their balance as at 31 December 2018 was PLN 3,311.1 million, up 36% in relation to the end of 2017.

3.3. PROFIT AND LOSS ACCOUNT OF PKO BANK HIPOTECZNY SA

in PLN millions	01.01.2018 – 31.12.2018	01.01.2017 – 31.12.2017	Change y/y (in PLN millions)
Net interest income	249.5	151.2	98.3
Net fee and commission income/(expense)	(4.8)	(4.6)	(0.2)
Net income/(expense) on financial instruments measured at fair value through profit or loss	0.1	(0.3)	0.4
Net foreign exchange gains/(losses)	(0.2)	1.0	(1.2)
Net income/(expense) on modification	(0.4)	-	(0.4)
Net write-downs in respect of credit losses	(8.7)	(3.3)	(5.4)
Net other operating income and expenses	0.1	0.0	0.1
Administrative expenses	(52.5)	(41.0)	(11.5)
Tax on certain financial institutions	(60.8)	(31.7)	(29.1)
Operating profit	**122.2**	**71.4**	**50.8**
Profit before tax	**122.2**	71.4	**50.8**
Income tax	(36.4)	(20.0)	(16.4)
Net profit	**85.8**	**51.4**	**34.4**

In the year 2018, PKO Bank Hipoteczny SA generated a net profit of PLN 85.8 million, up PLN 34.4 million compared with the year 2017. The most important driver of this increase was the improvement in net interest income caused by an increase in the scale of the Bank's operations, with a limited increase in costs.

In the analysed period, the Bank generated interest income of PLN 667.6 million, comprising primarily income from housing loans in the amount of PLN 650.2 million, and income from securities. In the same period, the Bank incurred interest expense of PLN 418.1 million. Interest expense resulted mainly from covered bonds issued and costs of hedging transactions. The related interest expense was PLN 271.6 million. The Bank also incurred, among others, interest expense of PLN 34.6 million on loans and overdrafts received, interest expense of PLN 52.4 million on the liability for the deferred payment for receivables purchased from PKO Bank Polski SA, and interest expense of PLN 59.6 million on unsecured bonds issued.

The Bank's turnover in 2018 (understood as the total value of interest income and fee and commission income) amounted to PLN 682.4 million. The realized turnover was generated entirely from the Bank's operations in Poland.

In 2018, the Bank incurred a net fee and commission loss of PLN 4.8 million. As far as costs are concerned, this item comprised, among other things, costs of expert valuations of the mortgage lending value of real estate (MLV), as prepared by real estate appraisers, in the amount of PLN 9.0 million, costs of the bond issue programme of PLN 3.5 million, costs of insuring loans of PLN 3.0 million, and costs of lines of credit of PLN 2.6 million. The Bank also recognized fee and commission income from customers for, among others, real estate valuations performed by the Bank and real estate inspections, and commission for early full or partial loan repayments. The total fee and commission income was PLN 14.8 million.

In 2018, the Bank incurred administrative expenses of PLN 52.5 million. Non-personnel expenses of PLN 26.7 million, including costs related to services rendered by PKO Bank Polski SA in the amount of PLN 19.1 million under an outsourcing agreement, were a significant component of administrative expenses. Costs of employee benefits, whose amount during the reporting period was PLN 16.7 million, were also a significant component of administrative expenses. The increase in administrative expenses compared with the corresponding period of 2017 was mainly caused by:

- an increase in costs of contribution to the Forced Resolution Fund as calculated by the Bank Guarantee Fund for 2018 (up PLN 4.5 million);
- an increase in costs of services provided by PKO Bank Polski SA under an outsourcing agreement (up PLN 5.7 million), which resulted from an increase in the number of loans in the Bank's balance sheet.

Tax on certain financial institutions, which amounted to PLN 60.8 million in the reporting period, was a significant cost of the Bank's activities.

Thanks to a faster growth of income than costs, the Bank reported an improved C/I ratio, whose annualized level was 21.5% as at 31 December 2018 (excluding tax on certain financial institutions), down 6.3 pp compared with the year 2017.

The Bank's net additions to credit losses were PLN 8.7 million in 2018.

In 2018, there were no unusual events with a material effect on the Bank's operations.

FUNDING STRUCTURE OF THE BANK

The table below presents the structure of the Bank's funding sources:

	31.12.2018	31.12.2017
Shareholders' equity	6.7%	7.2%
Funds from the parent	18.7%	23.6%
Issues of covered bonds	58.1%	52.6%
Issues of unsecured bonds	15.0%	14.4%
Other	1.5%	2.2%
Total	**100.0%**	100.0%

Neither as at 31 December 2018 nor as at 31 December 2017 did the Bank have any liabilities in respect of which it had defaulted on contractual payments.

3.4. OWN FUNDS REQUIREMENTS (PILLAR I)

GENERAL INFORMATION

In accordance with the CRR Regulation, the Bank calculates own funds requirements for the following risks:

- credit risk – using the Standardized Approach;
- credit valuation adjustment risk (CVA) – using the Standardized Approach;
- settlement and delivery risk – using the Standardized Approach;
- operational risk – using the Basic Indicator Approach (BIA);
- market risk (foreign-exchange risk only) – using basic methods.

At 31 December 2018, the own funds requirements concerning the credit valuation adjustment, settlement and delivery, and market risk were nil, therefore the total own funds requirement was comprised of the requirements for credit and operational risks.

Own funds requirements	31.12.2018	31.12.2017
Credit risk (in PLN millions)	719.0	611.9
Operational risk (in PLN millions)	15.6	15.1
Total own funds requirement (in PLN millions)	734.6	626.9
Common Equity Tier 1 capital ratio (CET1)	15.2%	15.2%
Tier 1 capital ratio (T1)	15.2%	15.2%
Total capital ratio (TCR)	**15.2%**	**15.2%**

The tables below present the values of exposures, risk-weighted assets and own funds requirements by exposure class:

31.12.2018	Gross exposure	Exposure value [9]	Risk-weighted assets (RWA)	Own funds requirement
Retail exposures [10]	3,985.8	3,658.9	2,744.2	219.5
Exposures secured by mortgages on real estate	17,824.0	17,768.4	6,218.9	497.5
Exposures to central governments or central banks	843.0	843.0	0.0	0.0
Exposures to institutions	729.1	729.1	0.0	0.0
Exposures in default	8.1	6.1	7.1	0.6
Other exposures	16.8	16.8	16.8	1.4
Total	**23,406.8**	**23,022.3**	**8,987.0**	**719.0**

31.12.2017	Gross exposure	Exposure value [9]	Risk-weighted	Own funds requirement

[9] The value of balance-sheet exposures and the balance-sheet equivalent of contingent liabilities and transactions, taking into account specific credit risk adjustments and the CCF (Credit Conversion Factor).
[10] These result from that part of the exposure which is not fully and completely secured, i.e. which exceeds an MLV of 80% or is in a transitional period, i.e. until collateral has been put up.

			assets (RWA)	
Retail exposures [10]	5,043.0	4,730.7	3,548.0	283.8
Exposures secured by mortgages on real estate	11,684.6	11,654.3	4,079.0	326.3
Exposures to central governments or central banks	831.1	831.1	0.0	0.0
Exposures to institutions	455.1	455.1	0.0	0.0
Exposures in default	2.8	2.8	3.5	0.3
Other exposures	17.7	17.7	17.7	1.4
Total	**18,034.4**	**17,691.6**	**7,648.2**	**611.9**

CREDIT RISK ADJUSTMENTS

For the purpose of specific credit risk adjustments, the Bank uses impairment loss, which was recognized in the Bank's Tier 1 capital in accordance with the CRR Regulation and the implementing legislation.

The approach applied by the Bank to identifying exposures at risk of impairment and methods for estimating write-downs for expected credit losses and provisions for financial liabilities granted are described in Note 4.2 "Impairment" of the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2018.

USE OF CREDIT RISK MITIGATION TECHNIQUES

The Bank uses mortgage collateral for the classification of exposures to classes of exposures secured by mortgages on real estate and the use of preferential risk weighting. Detailed information about the main types of collateral adopted by the Bank and the method of determining the mortgage lending value is presented in Note 44 "Residual risk management" of the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2018.

3.5. INTERNAL CAPITAL (PILLAR II)

Internal capital is the estimated amount of capital required to cover all identified material risks in the Bank's activities, as well as the effect of changes in the business environment, taking into account the expected level of risk.

PKO Bank Hipoteczny SA regularly monitors the materiality of different risks involved in the Bank's operations.

The Bank separately assesses its internal capital for the following risks considered as material:

- credit risk;
- liquidity risk;
- operational risk;
- model risk;
- interest rate risk.

The internal capital to cover the risks is determined in accordance with the methods set out in the Bank's internal regulations. The total internal capital is the sum of internal capital amounts necessary to cover all the risks material for the Bank. The Bank has adopted a prudent approach to risk aggregation and does not take advantage of the diversification effect.

Structure of internal capital	31.12.2018	31.12.2017
For credit risk	93.5%	90.7%
For operational risk	2.0%	2.2%
For liquidity risk	2.2%	4.4%
For interest rate risk	2.1%	1.9%
For business risk [11]	0.0%	0.5%
For model risk	0.2%	0.2%
Total	100.0%	100.0%

As at 31 December 2018, the relationship between the Bank's own funds and internal capital remained above the statutory and internal limits.

In order to estimate the amount of capital necessary to operate safely in recessionary conditions, the Bank conducts regular stress tests.

3.6. Disclosures (Pillar III)

Considering the scale and specific nature of its operations, in the financial statements and in the Directors' Report the Bank discloses in particular the following information:

- risk management objectives and strategies;
- own funds for capital adequacy purposes;
- capital buffers;
- leverage ratio;
- capital requirements;
- credit risk adjustments;
- credit risk mitigation techniques used;
- remuneration policy for those categories of personnel whose professional activities have a material impact on the Bank's risk profile;
- requirements referred to in Article 111a of the Banking Act and Recommendation H;
- operational risk in accordance with Recommendation M;
- liquidity risk management system and the liquidity position, in accordance with Recommendation P.

Being part of the PKO Bank Polski Group, the Bank also supplies information to the parent company for consolidation purposes.

Details of the disclosures made, the methods of their verification and publication are presented in the *Information policy of PKO Bank Hipoteczny SA on capital adequacy and other information to be published*, which is available on the Bank's website (www.pkobh.pl).

[11] As at 31 December 2018, business risk was not a material risk at the Bank, therefore internal capital was not estimated in respect of it.

4. BUSINESS OF PKO BANK HIPOTECZNY SA

4.1. SALES OF RESIDENTIAL MORTGAGE LOANS UNDER THE AGENCY MODEL

PKO Bank Hipoteczny SA has been granting residential mortgage loans in Polish złotys since 1 April 2015. New residential mortgage loans are sold under the agency model, through Poland's largest network of branches, agents and intermediaries, organized by PKO Bank Polski SA. The Bank accepts apartments and single-family homes as collateral.

The year 2018 saw record sales of residential mortgage loans. In that period, the Bank granted PLN 3,918.7 million worth of housing loans, which is an increase of 24.8% compared with the year 2017.

In accordance with Recommendation S of the Polish Financial Supervision Authority, in 2018 the Bank granted only loans for which the loan-to-value ratio did not exceed 80%. Where a low down payment insurance policy was used, the Bank approved loans for which this ratio was not higher than 90%.

Moreover, in compliance with the Polish Act on Covered Bonds and Mortgage Banks, the Bank only grants loans whose value in relation to the mortgage lending value of the real estate does not exceed 100%.

The following table shows the main criteria applied by PKO Bank Hipoteczny SA in the process of granting loans secured with mortgages.

CRITERIA	AGENCY MODEL
Loan amount/market value of the real estate	Max 80%[12]
Loan amount/mortgage lending value of the property	Max 100%
Legal form of real estate	Ownership or public lease
Loan collateral	Mortgage recorded as the first in Section IV of the Land and Mortgage Register
Currency	PLN
Purpose	Residential

In 2018, the Bank launched a residential mortgage loan with an interest rate based on a 5-year fixed base rate.

4.2. ACQUISITION OF RECEIVABLES IN RESPECT OF RESIDENTIAL MORTGAGE LOANS

Purchase of receivables, i.e. residential mortgage loans, on the basis of a framework agreement signed in 2015 with PKO Bank Polski S.A. is an important element of business of PKO Bank Hipoteczny S.A.

[12] Where a low down payment insurance policy is used, the Bank approves loans for which this ratio is not higher than 90%.

In 2018, PKO Bank Hipoteczny SA acquired from PKO Bank Polski SA a portfolio of receivables in respect of mortgage housing loans totalling PLN 2,524.1 million. The following table shows the main criteria applied by PKO Bank Hipoteczny SA in the process of acquiring residential mortgage loans.

CRITERIA	POOLING MODEL
Loan amount/mortgage lending value of the property	Max 100%
Legal form of real estate	Ownership or public lease
Loan collateral	Mortgage recorded as the first in Section IV of the Land and Mortgage Register
Currency	PLN
Days past due or impairment indicators	None
Purpose	Residential

4.3. STRUCTURE OF THE MORTGAGE HOME LOAN PORTFOLIO

PORTFOLIO STRUCTURE BY LTV

The structure of the gross portfolio of loans granted to customers in the balance sheet of PKO Bank Hipoteczny SA according to the LtV ratio based on market valuation[13] and the LtV ratio based on the mortgage lending value is presented in the following tables.

Gross loans granted to customers at LtV based on market valuation	31.12.2018	31.12.2017
below 50%	29%	28%
51% - 60%	18%	16%
61% - 70%	23%	21%
71% - 80%	21%	23%
80% - 90%	9%	12%
above 90%	0%	0%
Total, gross	**100%**	**100%**
Average LtV based on market valuation	58.7%	60.3%

Gross loans granted to customers at LtV based on MLV	31.12.2018	31.12.2017
below 50%	14%	15%
51% - 60%	10%	10%
61% - 70%	13%	13%
71% - 80%	18%	18%
80% - 90%	25%	22%
above 90%	20%	22%
Total, gross	**100%**	**100%**
Average LtV based on MLV	72.7%	72.5%

[13] The current LtV level, based on the value of the real estate at the moment the loan is granted, updated using statistical methods on the basis of a real estate market analysis.

In 2018, the average LtV ratio based on the market valuation of the loan portfolio declined by 1.6 p.p., which was the result of a rise in the market value of the real estate provided as loan collateral. For the LtV ratio based on MLV this relationship is not observed because the mortgage lending value of the real estate did not need to be updated.

INTEREST ON LOANS

The main reference interest rate applied by the Bank to loans was WIBOR 3M, whose average value was 1.71% in 2018.

4.4. COVERED BONDS

The key objective of PKO Bank Hipoteczny SA is issuing covered bonds which are the main source of the long-term financing for loans secured with real estate.

POLISH ISSUES OF COVERED BONDS

On 27 April 2018, PKO Bank Hipoteczny SA carried out its fifth benchmark issue of Series 7 złoty-denominated mortgage covered bonds, which was yet another issue carried out under the firm commitment underwriting procedure[14]. The Bank offered securities of PLN 700 million to institutional investors. During the book-building process, the spread on the Series 7 covered bonds was set at 0.49% above WIBOR 3M . The period from the date of issue to redemption of the covered bonds was set at 5 years, 11 months and 28 days, and the maturity date was set at 25 April 2024.

The Series 7 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsa w Stock Exchange's parallel market and on the BondSpot OTC market on 8 May 2018; they have also been accepted in repo transactions by the National Bank of Poland.

On 18 May 2018, PKO Bank Hipoteczny SA carried out an issue of Series 8 złoty-denominated covered bonds. The Bank offered securities of PLN 100 million to institutional investors. The spread on the Series 8 covered bonds was set at 0.32% above WIBOR 3M. The period from the date of issue to redemption of the covered bonds was set at 3 years, 11 months and 11 days, and the maturity date was set at 29 April 2022.

Chart: Purchasers of domestic issues of PKO Bank Hipoteczny SA's covered bonds in the years 2015 - 2018

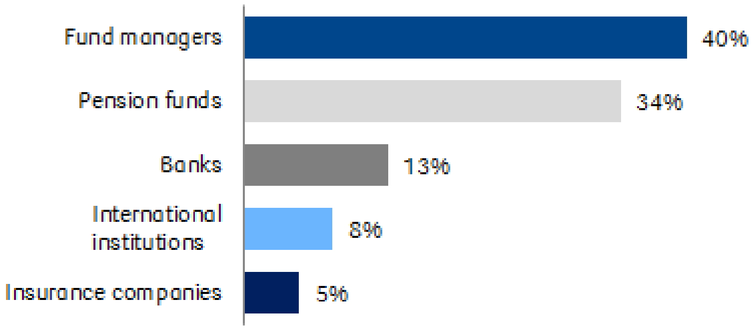
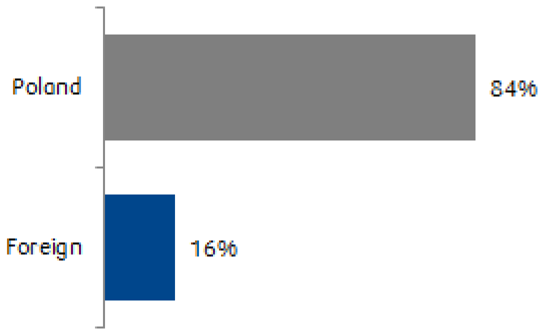


Chart: Geographical distribution of purchasers of domestic issues of PKO Bank Hipoteczny SA's covered bonds 2015-2018



The Series 8 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the BondSpot OTC market on 28 May 2018; they have also been accepted in repo transactions by the National Bank of Poland.

[14] The firm commitment underwriting procedure is an agreement in which the underwriter makes a commitment to the issuer to purchase, on its own account, a given issue of securities or a part thereof (which is offered to this entity only) for the purpose of its resale in a public offering.

On 27 July 2018, PKO Bank Hipoteczny SA carried out its sixth benchmark issue of Series 9 złoty-denominated covered bonds, which was yet another issue carried out under the firm commitment underwriting procedure. The Bank offered securities of PLN 500 million to institutional investors. During the book-building process, the spread on the Series 9 covered bonds was set at 0.62% above WIBOR 3M. The period from the date of issue to redemption of the covered bonds was set at seven years and the maturity date was set at 25 July 2025.

The Series 9 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the BondSpot OTC market on 10 August 2018. They were also accepted in repo transactions by the National Bank of Poland.

On 24 August 2018, PKO Bank Hipoteczny SA carried out its issue of Series 10 złoty-denominated covered bonds. The Bank offered securities of PLN 60 million to institutional investors, with a fixed interest rate of 3.4875% over the entire period. The period from the date of issue to redemption of the covered bonds was set at 10 years and the maturity date was set at 24 August 2028.

The Series 10 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the BondSpot OTC market on 11 September 2018. They were also accepted in repo transactions by the National Bank of Poland.

On 26 October 2018, PKO Bank Hipoteczny SA carried out its issue of Series 11 złoty-denominated covered bonds, which was yet another issue carried out under the firm commitment underwriting procedure. The Bank offered securities of PLN 230 million to institutional investors. During the book-building process, the spread on the Series 11 covered bonds was set at 0.66% above WIBOR 3M. The period from the date of issue to redemption of the covered bonds was set at 6 years, 6 months, and 2 days, and the maturity date was set at 28 April 2025.

The Series 11 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the BondSpot OTC market on 13 November 2018. They were also accepted in repo transactions by the National Bank of Poland.

Złoty-denominated issues of mortgage covered bonds of PKO Bank Hipoteczny SA carried out up to and including 31 December 2018:

Series	Covered bond number (ISIN)	Issue date	Redemption date	Value (PLN millions)	Interest rate	Currency	Rating	Listing
1	PLPKOHP00017	11.12.2015	11.12.2020	30	WIBOR 3M + 0.75%	PLN	Aa3	BondSpot, WSE parallel market
2	PLPKOHP00025	27.04.2016	28.04.2021	500	WIBOR 3M + 0.65%	PLN	Aa3	BondSpot, WSE parallel market
3	PLPKOHP00033	17.06.2016	18.06.2021	500	WIBOR 3M + 0.59%	PLN	Aa3	BondSpot, WSE parallel market
4	PLPKOHP00041	28.04.2017	18.05.2022	500	WIBOR 3M + 0.69%	PLN	Aa3	BondSpot, WSE parallel market
5	PLPKOHP00058	22.06.2017	10.09.2021	265	2.69%	PLN	Aa3	BondSpot, WSE parallel market
6	PLPKOHP00066	27.10.2017	27.06.2023	500	WIBOR 3M + 0.60%	PLN	Aa3	BondSpot, WSE parallel market
7	PLPKOHP00074	27.04.2018	25.04.2024	700	WIBOR 3M + 0.49%	PLN	Aa3	BondSpot, WSE parallel market
8	PLPKOHP00082	18.05.2018	29.04.2022	100	WIBOR 3M + 0.32%	PLN	Aa3	BondSpot, WSE parallel market

9	PLPKOHP00090	27.07.2018	25.07.2025	500	WIBOR 3M + 0.62%	PLN	Aa3	BondSpot, WSE parallel market
10	PLPKOHP00108	24.08.2018	24.08.2028	60	3.4875%	PLN	Aa3	BondSpot, WSE parallel market
11	PLPKOHP00116	26.10.2018	28.04.2025	230	WIBOR3M +0.66%	PLN	Aa3	BondSpot, WSE parallel market

INTERNATIONAL ISSUES OF COVERED BONDS

On 22 March 2018, PKO Bank Hipoteczny SA carried out its fourth benchmark issue of Series 6 euro-denominated covered bonds. The Bank offered fixed-rate instruments of EUR 500 million to institutional investors. During the book-building process, their spread was set at 0.769% (and the coupon at 0.75%). In the process, investors expressed interest in purchasing securities for a total of approx. EUR 850 million. The period from the date of issue to redemption of the covered bonds was set at 5 years, 10 months and 2 days, and the maturity date was set at 24 January 2024.

Chart: Purchasers of EUR-denominated covered bonds of PKO Bank Hipoteczny in the years 2016-2018

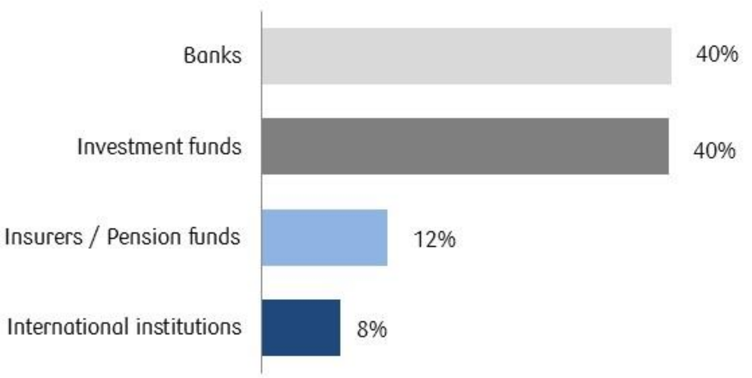
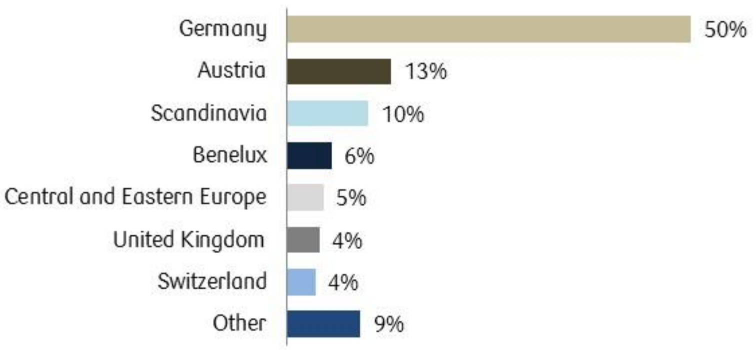


Chart: Geographical distribution of purchasers of EUR-denominated covered bonds of PKO Bank Hipoteczny in 2016-2018



Series 6 euro-denominated covered bonds of PKO Bank Hipoteczny SA were listed on the Luxembourg Stock Exchange and the Warsaw Stock Exchange (parallel market) on 27 March 2018 and 10 April 2018, respectively. Since 27 March 2018, they have also been accepted in repo transactions by the European Central Bank.

Euro-denominated issues of mortgage covered bonds of PKO Bank Hipoteczny SA carried out up to and including 31 December 2018:

Series	Covered bond number (ISIN)	Issue date	Redemption date	Value (EUR)	Coupon	Price	Currency	Rating	Listing
1	XS1508351357	24.10.2016	24.06.2022	500	0.125%	99.702%	EUR	Aa3	LuxSE, WSE parallel market
2	XS1559882821	02.02.2017	02.02.2024	25	0.82%	100.00%	EUR	Aa3	LuxSE

3	XS1588411188	30.03.2017	24.01.2023	500	0.625%	99.972%	EUR	Aa3	LuxSE, WSE parallel market
4	XS1690669574	27.09.2017	27.08.2024	500	0.75%	99.906%	EUR	Aa3	LuxSE, WSE parallel market
5	XS1709552696	02.11.2017	03.11.2022	54	0.467%	100.00%	EUR	Aa3	LuxSE
6	XS1795407979	22.03.2018	24.01.2024	500	0.75%	99.892%	EUR	Aa3	LuxSE, WSE parallel market

The funds raised from the issues of covered bonds have been used by PKO Bank Hipoteczny SA to grant housing loans and to acquire receivables for such loans from PKO Bank Polski SA.

THE COVERED BOND LABEL

On 6 February 2018, PKO Bank Hipoteczny, as the first issuer of covered bonds from Poland, joined The Covered Bond Label. The Covered Bond Label is a quality certificate, the purpose of which is to build awareness among investors of the safety and high quality of assets, such as covered bonds.

The Bank's details on the website of The Covered Bond Label are available at:

https://coveredbondlabel.com/issuer/161/

4.5. FINANCIAL MARKET OPERATIONS

PKO Bank Hipoteczny SA concludes treasury transactions on the wholesale financial market. The purpose of the transactions is to manage liquidity (over short-, mid- and long-term time horizons) and the Bank's foreign-currency position. Additionally, the Act on Covered Bonds and Mortgage Banks imposes an obligation on PKO Bank Hipoteczny SA to mitigate the risk caused by fluctuations in exchange rates.

For the purpose of financing the granting of housing loans and the purchase of receivables for housing loans granted by PKO Bank Polski SA, PKO Bank Hipoteczny SA issues mortgage covered bonds, unsecured bonds, and takes out credit lines and assumes liabilities for purchased receivables. However, in accordance with the Act on Covered Bonds and Mortgage Banks, the level of liabilities arising from taking out the loans and advances (including liabilities for purchased receivables) and issuing bonds cannot exceed in aggregate ten times the Bank's own funds over the first five years of operating activities or six times the Bank's own funds after that period.

In the Management Board's opinion, as at 31 December 2018, there were no indicators of a risk of late payment of the liabilities incurred by the Bank. In 2018, the Bank did not exceed any of the liquidity limits. Details of the levels of the Bank's liquidity limits are provided in Note 45 "Liquidity risk management" to the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2018.

As far as the issue of euro-denominated covered bonds is concerned, for the purpose of hedging interest-rate risk and currency risk, PKO Bank Hipoteczny SA entered into Cross-Currency Interest Rate Swap (CIRS) transactions, under which the Bank pays a coupon in Polish złoty based on a variable interest rate, and receives a coupon based on a fixed interest rate for euro. If a court declares PKO Bank Hipoteczny SA bankrupt, the CIRS transactions will automatically be extended by 12 months on the terms determined on the transaction date and indicated in the Final Terms of issue of mortgage covered bonds. Additionally, the Bank has executed a series of FX-Forward contracts, which constitute a hedge of currency exposure with maturities on the payment dates of the coupons for euro-denominated covered bonds.

As far as the issue of fixed-interest rate covered bonds in PLN is concerned, PKO Bank Hipoteczny SA entered into IRS transactions to hedge interest rate risk in 2017 and 2018. Under the IRS transactions, the Bank pays a coupon based on a floating PLN rate, and receives a coupon based on a fixed PLN rate.

PKO Bank Hipoteczny SA is and intends to remain a regular issuer of covered bonds both on the Polish and international market.

4.6. SHORT-TERM BONDS

On 30 September 2015, PKO Bank Hipoteczny SA established a non-public short-term bond issue programme. In 2018, the Bank issued bonds with a total par value of PLN 7,486.4 million under the programme. The balance of issued bonds was PLN 2,961.1 million as at 31 December 2018. The Bank intends to continue seeking financing in the form of short-term bond issues.

4.7. MEDIUM-TERM BONDS

On 18 December 2018, PKO Bank Hipoteczny S.A. signed an agreement with a European financial institution for issuing unsecured bonds based on a variable interest rate with a total par value of PLN 350.0 million, maturing on 21 February 2020.

4.8. RATINGS OF THE BANK AND ITS COVERED BONDS

As at the date of this Report, PKO Bank Hipoteczny SA had the following ratings assigned by Moody's:

	Rating	Outlook	Rating assignment/rating confirmation date
Long-term issuer rating	Baa1	Stable	19.12.2017
Short-term issuer rating	P-2	n/a	19.12.2017
Long-term Counterparty Risk Rating	A3	n/a	18.06.2018
Short-term Counterparty Risk Rating	P-2	n/a	18.06.2018
Long-term Counterparty Risk (CR) Assessment	A3(cr)	n/a	19.12.2017
Short-term Counterparty Risk (CR) Assessment	P-2(cr)	n/a	19.12.2017

As at the date of this Report, the covered bonds of PKO Bank Hipoteczny SA had the following ratings assigned by Moody's:

	Rating	Date of initial rating	Rating confirmation date
Covered bonds denominated in PLN	Aa3	08.09.2015	12.12.2015
Covered bonds denominated in EUR	Aa3	29.09.2016	24.10.2016

The rating assigned to the covered bonds of PKO Bank Hipoteczny SA is the highest rating achievable for Polish securities. The rating of Polish securities is limited by Poland's national ceiling for debt instruments, which is currently at Aa3 level.

5. INTERNAL OPERATING CONDITIONS

5.1. QUALIFIED MANAGEMENT TEAM

The Bank implements mechanisms and procedures to guarantee that managers employed in the Bank have the highest qualifications in key business areas. The Bank constantly improves the qualifications of its employees, and makes efforts to ensure the stability and continuity of management. These factors have an important influence on the implementation of the Bank's strategy and business goals and, consequently, on its operations and results of operations.

5.2. LENDING PROCESS AND RELATIONSHIP WITH PKO BANK POLSKI SA

PKO Bank Hipoteczny SA acquires residential mortgage loans for its portfolio as part of its strategic relationship with PKO Bank Polski. The banks work together under two models:

- agency model;
- pooling model.

The relationship with PKO Bank Polski SA is governed in detail by an outsourcing agreement executed on 16 January 2015. The agreement governs the scope of the relationship and describes in detail the method of performing the outsourced functions, above all in offering and administering housing loans and performing support functions for PKO Bank Hipoteczny SA. Furthermore, the agreement imposes obligations on PKO Bank Polski SA to properly perform the functions entrusted to it, as well as broad reporting and controlling obligations towards PKO Bank Hipoteczny SA.

On 17 November 2015, the Receivables Sale Framework Agreement was signed with PKO Bank Polski SA. On the basis thereof, the Bank has been acquiring portfolios of receivables for residential mortgage loans since December 2015.

PKO Bank Polski SA, as part of the regulatory approval process for establishing a mortgage bank before the Polish Financial Supervision Authority, undertook to ensure that, if necessary and if PKO Bank Hipoteczny SA's capital or liquidity ratios fall below the level required by law or by other regulations of relevant domestic banking supervision authorities that are applicable to PKO Bank Hipoteczny SA, PKO Bank Polski SA will immediately provide PKO Bank Hipoteczny SA with appropriate financial support.

5.3. INTERNAL CONTROL SYSTEM

The internal control system in PKO Bank Hipoteczny SA is one of the elements of managing the Bank. The objective of the internal control system is to support the Bank's decision-making processes to ensure:

- effectiveness of the Bank's operations;

- reliability and accuracy of financial reporting, administrative and accounting procedures, and reliable internal and external reporting;
- compliance with the risk management policy;
- compliance of the Bank's operations with the generally applicable laws, internal regulations and market standards adopted by the Bank, taking into account regulatory recommendations, if any.

The Bank's internal control system includes:

- the control function designed to ensure compliance with controls relating, in particular, to risk management; this function covers all of the Bank's and the Head Office's business units which are responsible for carrying out the tasks assigned to this function;
- the compliance function, which, together with the Bank's and the Head Office's business units, is responsible for identifying, assessing, controlling and monitoring the risk of the Bank's non-compliance with the generally applicable laws and with the Bank's internal regulations and market standards adopted by the Bank, taking into account regulatory recommendations, and for the submission of the relevant reports;
- the independent internal audit function to evaluate and assess, independently and objectively, the adequacy and effectiveness of the risk management system, the internal control system and corporate governance, except for the aspects relating to the internal audit function itself.

The internal control system is arranged at the Bank on three independent levels (lines):

- the first level (line) consists of organizational structures that perform risk-generating operational tasks and operate under internal regulations;
- the second level (line) is composed of specialized organizational structures operating under applicable policies, methodologies and procedures; the purpose of these structures is to ensure that the activities implemented at the first level are properly designed and effectively reduce the risk, support risk measurement and analysis and business effectiveness. This level comprises the activities of the compliance function, as well as identification, measurement or estimation, control, monitoring and reporting of risks material to the Bank, and identified threats and irregularities;
- the third level (line) is internal audit, which carries out independent audits of elements of the Bank's management system, including the risk management system and the internal control system. The internal audit operates separately from, and can support the activities carried out by, the first and second level. The support involves consultation without affecting the decisions made.

The Bank's Management Board ensures the continuity of operation of the internal control system and proper cooperation of all business units within the internal control system in place. The Management Board also identifies corrective actions to be taken to remedy any irregularities identified by the internal control system, including specific corrective and disciplinary measures. The Bank's Management Board approves criteria for distinguishing the relevant processes taking into account the management strategy, the business model and the impact on the Bank's financial performance and capital adequacy, as well as risk appetite. The Bank's Management Board also approves the list of significant processes and their connection with the internal control system's objectives.

Supervision of the internal control system is exercised by the Supervisory Board with the support of the Audit and Finance Committee of the Bank's Supervisory Board. The Supervisory Board approves, in particular, the principles of operation of the internal control system and assesses the adequacy and effectiveness of the system. The Audit and Finance Committee supports the Supervisory Board by monitoring and reviewing the adequacy and effectiveness of the internal control system based on the reports obtained from compliance, internal audit and the control function matrix coordinator, as well as by reviewing draft resolutions of the Management Board in terms of the internal control system, the approval of which falls within the competence of the Supervisory Board.

In 2018, the reporting within the internal control system and the remedial actions taken indicated that the internal control system in PKO Bank Hipoteczny SA was effective and commensurate with the business model and the scale of the Bank's operations.

5.4. RISK MANAGEMENT

The risk management process is a key process in PKO Bank Hipoteczny SA. Its purpose is to ensure control of the risk level in a changing macroeconomic and legal environment and to ensure it is maintained within the risk tolerance established by the Bank and the system of limits that is in place. The assumed level of risk constitutes an important component of the planning and decision-making process.

Risk management in the Bank is based in particular on the following principles:

- the Bank manages identified types of risk associated with its operations;
- the process of risk management is adequate to the scale of the Bank's operations and to the materiality, scale and complexity of a given risk;
- the risk management process supports the execution of the Bank management strategy, while maintaining compliance with the risk management strategy, in particular in the area of the risk tolerance level;
- the process of risk management is continuously adjusted to new factors and sources of risk;
- methods of risk management and risk measurement systems are adjusted to the scale and complexity of the Bank's operations and to the nature and size of the risk to which the Bank is exposed;
- methods of risk management are periodically reviewed and validated;
- risk management is integrated with planning and controlling processes;
- the risk level is regularly monitored and compared against the system of limits that apply in the Bank, while the Bank's management receives regular information on the level of risk;
- the risk management process is cohesive with the risk management principles in the PKO Bank Polski SA Group.

PKO Bank Hipoteczny SA identifies and manages the following types of risk:

MATERIAL RISKS	• Credit risk • Liquidity risk • Interest rate risk • Model risk • Operational risk
POTENTIALLY MATERIAL RISKS	• Concentration risk • Residual risk • Currency risk • Business risk, including macroeconomic risk • Compliance risk • Reputation risk • Capital risk, including leverage risk

The significance of individual types of risk is defined at Bank level. While determining the criteria of considering a certain risk to be significant, the impact of such risk on the Bank's activities is taken into account, provided that there are three types of risk:

- material risks, which are subject to active management;
- monitored risks, for which the monitoring of materiality is performed;
- other undefined risks or risks that do not exist in the Bank (immaterial or unmonitored).

For monitored risks, PKO Bank Hipoteczny SA performs periodic monitoring of whether they should be designated as material. The Bank has defined significance criteria; when they are met, a risk will be recognized as significant.

In its risk management strategy, the Bank defined a range of strategic limits defining the tolerance to particular types of risk. The Bank monitors these limits on an ongoing basis. In 2018, as well as during the whole period of the Bank's activities, none of them was exceeded.

A detailed description of the Bank's risk management objectives and methods is provided in the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2018, in the chapter "Risk Management Objectives and Policies." It also includes important information on the level of financial risk in the Bank's operations, together with the methods of hedging significant types of planned transactions for which hedge accounting is applied.

5.5. MEASUREMENT OF MORTGAGE LOAN COLLATERALS

PKO Bank Hipoteczny SA's policy concerning loan collaterals and their measurement is based on the provisions of the following legal acts:

- the Act on Covered Bonds and Mortgage Banks;
- the Act on Land and Mortgage Registers;
- the Banking Law.

Additionally, the question of loan collaterals is addressed by:

- the recommendations of the Polish Financial Supervision Authority, including Recommendations F, S and J;
- the Bank's internal regulations.

The Bank has in place and applies the Rules for Setting the Mortgage Lending Value of Real Estate, approved (as amended) by the Polish Financial Supervision Authority on 30 October 2017. The Rules take into account the provisions of Recommendation F concerning the basic criteria applied by the Polish Financial Supervision Authority in approving rules for setting the mortgage lending value of real estate issued by mortgage banks.

The mortgage lending value of real estate is the value determined by the mortgage bank which, in the Bank's opinion, reflects the level of risk associated with the real estate as the loan collateral. The mortgage lending value of real estate is used to determine the maximum amount of a loan that can be secured by a mortgage on a given property, and to make a decision on whether a receivable secured by a particular property can be acquired by the Bank. The mortgage lending value of real estate is determined in a prudent manner, taking into consideration long-term parameters.

PKO Bank Hipoteczny SA sets the mortgage lending value of real estate based on an expert mortgage lending value of real estate, which is prepared with due diligence and prudence. It takes into account only characteristics of the real estate and investments necessary for its construction that will have a permanent nature and which, assuming rational use, can be realized by any keeper of the property. In the expert opinion, prepared as at a specific date, the assumptions and parameters of the analysis are documented, as is the process of setting the mortgage lending value of real estate and the proposed mortgage lending value of real estate that results. The expert opinion takes into account analyses and forecasts concerning specific parameters for a given property, which influence the evaluation of credit risk, as well as factors of a general nature, e.g. population growth, the unemployment rate and urban development planning.

The process of setting the MLV is carried out in the Bank by a dedicated team.

In the agency model, the process of setting the mortgage lending value of real estate comprises three stages:

PREPARATION OF THE MLV EXPERT OPINION	Appraiser with appropriate experience and the ability to estimate bank risk in the area of securing mortgage loans
CONFIRMATION OF THE OPINION	PKO Bank Polski SA, under the Outsourcing Agreement, or a dedicated organizational unit of the Bank: the Collateral Valuation Team at the Loan Office
REVIEW OF AN EXPERT OPINION ON MORTGAGE LENDING VALUE OF REAL	A dedicated organizational unit of the Bank: the Collateral Valuation Team at the Loan Office

ESTATE AND DETERMINING THE MORTGAGE LENDING VALUE OF THE REAL ESTATE	

In the case of an acquisition of a receivable, the process of setting the mortgage lending value of real estate comprises four stages:

CONFIRMATION OF THE PROPERTY'S LEGAL STATUS	PKO Bank Polski SA, under the outsourcing agreement
PREPARATION OF AN INSPECTION PROTOCOL OF THE PROPERTY, TOGETHER WITH MARKET RESEARCH	Appraiser with appropriate experience and the ability to estimate bank risk in the area of securing mortgage loans
PREPARATION OF THE MLV EXPERT OPINION	A dedicated organizational unit of the Bank: the Collateral Valuation Team at the Loan Office
REVIEW OF AN EXPERT OPINION ON MORTGAGE LENDING VALUE OF REAL ESTATE AND DETERMINING THE MORTGAGE LENDING VALUE OF THE REAL ESTATE	A dedicated organizational unit of the Bank: the Collateral Valuation Team at the Loan Office

The processes of preparing an MLV expert opinion and setting the mortgage lending value of a property described above are executed by two independent individuals.

5.6. THE COVER POOL FOR COVERED BONDS

PKO Bank Hipoteczny SA maintains a cover pool for its mortgage covered bonds. The bank includes in the cover pool receivables on residential mortgage loans, and rights and funds that constitute the basis for issuing covered bonds, as well as additional funds that constitute the excess to cover interest on mortgage covered bonds in circulation which is due in the following six months. Only receivables secured by mortgages written into the first position in section IV of the Land and Mortgage Registry serve as security for mortgage covered bonds. Certain bank funds can also constitute the basis for issuing mortgage covered bonds:

- funds invested in securities issued or guaranteed by the National Bank of Poland, the European Central Bank, governments and central banks of members of the European Union and/or the Organization for Economic Cooperation and Development, excluding countries that are restructuring or have restructured their foreign debt in the past 5 years;
- funds deposited with the National Bank of Poland;
- funds held in cash.

The nominal value of loans included in the cover pool and constituting collateral for issues of mortgage covered bonds as at 31 December 2018 stood at PLN 16,947.7 million. The nominal value of the over-collateralization in the form of securities issued by the State Treasury, denominated in PLN, stood at PLN 251 million. As at 31 December 2017, these figures were PLN 11,103.7 million and PLN 251 million respectively. The cover pool also takes into account CIRS transactions hedging currency risk and the interest rate on EUR-denominated covered bonds, FX-Forward transactions hedging the currency risk of issued EUR-denominated covered bond and an IRS transaction hedging the interest rate risk of Polish złoty-denominated covered bonds issued on a fixed-rate basis.

In 2018 and in previous years, the cover pool did not include asset-backed securities that do not meet the requirements described in paragraph 1 art. 80 of Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60) (recast).

The method of managing the cover pool is laid out by:

- the Act on Covered Bonds and Mortgage Banks of 29 August 1997 (Journal of Laws of 2003, No 99, item 919, as amended);
- Resolution No 633/2015 of the Polish Financial Supervision Authority of 1 December 2015 on defining the form of a cover pool;
- Recommendation K of the Financial Supervision Authority of 9 February 2016 on the principles for maintenance of cover pools by mortgage banks.

The Cover Pool Monitor and the Deputy Cover Pool Monitor provide continuous supervision of the management of the cover pool.

The following table presents basic data on Cover pool as at 31 December 2018:

	31.12.2018	31.12.2017
Total cover pool, including:	**17,198.7**	**11,354.7**
loans secured by mortgages (in PLN millions)	*16,947.7*	*11,103.7*
other assets [15] (in PLN millions)	*251.0*	*251.0*
Liquidity buffer[16] (in PLN millions)	100.4	50.6
Nominal value of hedging transactions [17] (in PLN millions)	9,262.7	6,849.3
Number of loans	92,561	60,597
Average loan value	183.1	183.2
Average weighted time since loan issuance (seasoning)	44.9	39.7
Average weighted maturity	258.1	257.8
Average LtV (loan amount to market value)	55.8%	57.5%
Average weighted loan to mortgage lending value of real estate	71.2%	70.8%
Over-collateralization [18]	34.6%	25.8%

5.7. THE COVER POOL MONITOR

The purpose of the cover pool monitor is to ensure protection of the material interests of the holders of covered bonds. The Law on covered bonds and mortgage banks guarantees protecting the independence of the monitor and their deputy. Monitors are appointed by the Polish Financial Supervision Authority, at the request of the Bank's Supervisory Board, for a period of six years.

On 6 March 2015 the Financial Supervision Authority appointed the following cover pool monitor and deputy cover pool monitor for PKO Bank Hipoteczny SA:

	Position	Date of appointment	Date of dismissal/resignation
Tadeusz Swat	Cover Pool Monitor	06.03.2015	-
Grzegorz Kędzia	Deputy Monitor	06.03.2015	-

15 Article 18(3) of the Act on Covered Bonds and Mortgage Banks
16 Article 18(3a) of the Act on Covered Bonds and Mortgage Banks
17 The nominal value of the hedging transaction corresponds to the issue price of the covered bond
18 It includes the net value of hedging transactions but excludes NPL

5.8. STATUTORY LIMITS

Acting under the Act on covered bonds and mortgage banks, PKO Bank Hipoteczny SA is obliged to monitor and comply with the designated limits related to the operations of a mortgage bank.

The statutory limits and the level to which they have been met as of 31 December 2018 were as follows:

Limit	Legal basis	Limit level	Actual level	
			31.12.2018	31.12.2017
Total value of receivables on loans secured by mortgages, and receivables on such loans acquired from other banks, in which the value exceeds 60% of the mortgage lending value, in proportion to the total value of receivables secured by mortgages	Article 13(1)	≤30.0%	18.7%	18.7%
Value of funds received from the issuance of mortgage bonds designated for refinancing loans secured by mortgages or receivables on such loans acquired from other banks, in proportion to 80% of the mortgage lending value of particular residential properties that constitute the collateral	Article 14	≤100.0%	63.5%	58.0%
Total value of acquired shares in other entities, in proportion to the Bank's own funds	Article 15(1)(5)	≤10.0%	0.0%	0.0%
Total value of credits and loans taken out and bonds issued, in proportion to the Bank's own funds	Article 15(2)	≤1000.0%	551.3%	548.5%
Total value of credits and loans taken out and bonds issued, in proportion to the amount designated for refinancing of activities described in art. 12 of the Act, i.e. issuing loans secured and unsecured by mortgages, receivables acquired from other banks on loans granted by them and secured or unsecured by mortgages	Article 15(3)	≤100.0%	36.5%	41.0%
Total nominal value of covered bonds outstanding, in proportion to the Bank's own funds and general risk provision	Article 17	≤4000.0%	920.7%	743.1%
Total nominal value of receivables secured by mortgages and value of rights and additional funds constituting the basis for issuing mortgage covered bonds, in proportion to the total value of outstanding mortgage covered bonds (taking into account hedging instruments)	Article 18(1)	≥110.0%	134.6%	125.8%
Total nominal value of receivables secured by mortgages constituting the basis for issuing mortgage covered bonds, in proportion to the total nominal value of mortgage covered bonds outstanding	Article 18(1)	≥85.0%	132.1%	125.08%
Interest expense on mortgage covered bonds outstanding (cumulative from the beginning of the financial year and on any given day), in proportion to interest income on receivables secured by mortgages and rights and additional funds constituting the basis for issuing mortgage covered bonds (cumulative from the beginning of the financial year and on any given day), taking into account hedging instruments	Article 18(2)	≤100.0%	35.1%	61.6%

Bank funds constituting the excess described in Article 18(3a) over the nominal value of interest on mortgage bonds outstanding due in the following 6 months	Article 18(3a)	≥100.0%	139.9%	133.0%
Value of receivables secured by mortgages established during the course of construction investments, in proportion to the total value of receivables secured by mortgages that constitute the basis for issuing mortgage covered bonds	first sentence of Article 23(1)	≤10.0%	8.6%	8.3%
Value of receivables secured by mortgages established on land designated for construction in accordance with development plans, in proportion to the value of receivable secured by mortgages established during the course of construction investments that constitute the basis for issuing mortgage covered bonds	second sentence of Article 23(1)	≤10.0%	0.0%	0.0%

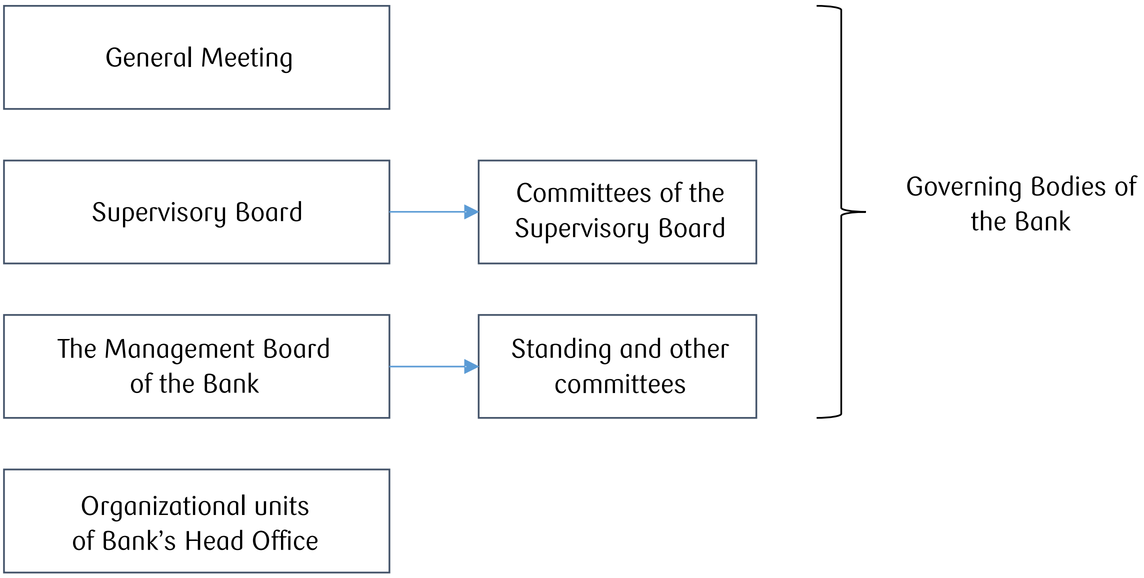
PKO Bank Hipoteczny SA did not breach any of these limits during the entire period covered by this Report.

The Bank achieved positive results on the coverage test and liquidity test performed at the end of December 2018.

6. STRUCTURE AND GOVERNING BODIES OF PKO BANK HIPOTECZNY SA

6.1. ORGANIZATIONAL STRUCTURE OF PKO BANK HIPOTECZNY SA

The management of PKO Bank Hipoteczny SA is carried out on the basis of the organizational structure presented in the chart below and within the framework of the duties of the Bank's Governing Bodies, described in the following portion of this chapter.



6.2. POWERS OF THE GOVERNING BODIES AND COMMITTEES OF PKO BANK HIPOTECZNY SA

The powers of the **General Shareholders' Meeting of the Bank** include in particular:

- appointing and dismissing members of the Supervisory Board;
- adopting resolutions on settlement of claims for damages caused on the establishment of the Bank, or by exercising management or supervision;
- establishing the procedure for redemption of shares and the level of compensation for the redemption of shares and expressing consent to the acquisition of the Bank's own shares for the purpose of redemption;
- creating and dissolving special funds created from net profit;
- adopting resolutions on issuing bonds convertible into shares or other instruments entitling the holder to acquire or take up shares in the Bank;
- adopting resolutions on the liquidation, disposal or lease of enterprises of the Bank or an organized part of the Bank's enterprises, and establishing limited property rights over them.

The competencies of the **Bank's Supervisory Board** include in particular:

- approving the Bank's annual financial plan and long-term development plans (in particular the Bank's strategy);
- approving the foundations of the Bank's policy in the area of compliance risk;
- approving the Bank management strategy, the risk management strategy, including the general level of risk at the Bank, the policy for estimating internal capital and capital management and reviewing the internal capital assessment strategies and procedures and capital management procedures;
- approving the Bank's product, pricing and discount policy;
- approving the audit charter, the internal audit function's strategy, the annual and long-term internal audit plans and the principles for cooperation with the internal audit function at PKO Bank Polski SA and the registered auditor;
- approving and periodically reviewing the general principles of the remuneration policy concerning persons whose professional activities significantly affect the Bank's risk profile;
- approving the Management Board regulations;
- approving the Regulations for Setting the Mortgage Lending Value of Property, which take effect after the approval by the Financial Supervision Authority;
- affirming the Code of Ethics and the Rules for Management of Conflicts of Interest;
- approving the framework organizational structure of the Bank, adjusted to the scale and profile of the risk taken on by the Bank;
- approving and reviewing cooperation agreements with PKO Bank Polski SA;
- adopting the Supervisory Board By-laws;
- appointing and dismissing, by secret ballot, individual members of the Management Board;
- representing the Bank in agreements with members of the Management Board;
- approving the policy and procedure for selecting an audit firm responsible for auditing the Bank's financial statements and the policy for providing permitted non-audit services by the audit firm performing the audit, its related entities and members of its network;
- selecting an audit firm to conduct an audit or review of the Bank's financial statements;
- assessing the Directors' report on the Bank's activities and the financial statements for the previous financial year in terms of their consistency with the books of accounts and documents and the proposals of the Management Board concerning the distribution of profit or the financing of losses and presenting, to the General Shareholders' Meeting, a written annual report on the results of these assessments;
- applying to the Polish Financial Supervision Authority for consent to the appointment of two members of the Management Board, including the President and for the appointment of a Bank cover pool monitor and deputy cover pool monitor;
- granting prior approval for actions that meet designated criteria, including acquiring or disposing of Bank assets, concluding agreements that exceed the normal scope of the Bank's operations, concluding transactions between the Bank and its shareholders or related parties or members of the Bank's governing bodies, changing the Bank's registered office or location (address);
- assessing the functioning of the remuneration policy in the Bank and presenting a report on this area to the General Shareholders' Meeting;
- assessing the application by the Bank of the Principles of Corporate Governance for Supervised Institutions.

In 2018, the following **Supervisory Board committees** operated:

AUDIT AND FINANCE COMMITTEE	• monitoring and expressing periodic opinions on the adequacy and effectiveness of the internal control system, the adequacy and effectiveness of the risk management system, the effectiveness of the Bank's compliance risk management, the application of the Corporate Governance Principles for Supervised Institutions, the principles of operation of internal audit and compliance functions, the adequacy and effectiveness

	of the whistleblowing policy and the ethical procedures and standards in force at the Bank; • developing the policy of selecting an audit firm, submitting to the Supervisory Board a recommendation of an audit firm to conduct an audit of the Bank's financial statements; • monitoring the process of financial reporting, including reviewing the Bank's periodic and annual financial statements; • monitoring financial audit proceedings and the independence of the statutory auditor and the entity authorized to audit the financial statements; • consulting the rules of functioning of the internal control system, the approval of which is the responsibility of the Supervisory Board.
Risk Committee	• reviewing the Bank's overall current and future risk appetite, strategic risk directions and tasks in the context of the Bank's strategy and the conditions resulting from the macroeconomic situation and the regulatory environment, and, in particular, the risk management strategy developed by the Management Board and the Bank's acceptable overall risk level; • monitoring compliance of the Bank's policy in the area of taking on risk with the strategy and financial plan; • analysing periodic risk-related reports, including the utilization of strategic risk tolerance limits, and developing appropriate guidelines on the basis thereof, as well as reviewing periodically the implementation of the risk management strategy; • giving opinions on capital adequacy, creditworthiness evaluation principles, the risk measurement model, the impairment measurement model; • giving opinions on the principles of the information policy in the area of capital adequacy, managing capital adequacy, managing liquidity, operational and model risk and impairment measurement; • providing opinions on the draft Rules on setting the mortgage lending value of real estate.
Remuneration and Nomination Committee	• evaluating and conducting periodic reviews of nominations for key managerial positions in the Bank; • submitting, to the Supervisory Board, proposals relating to appropriate forms of contracts with members of the Bank's Management Board; • preparing opinions on the Code of Ethics and the Principles for Managing Conflicts of Interest; • preparing opinions on requests concerning the consent for a member of the Management Board to engage in competitive activities or to participate in a competing company as a shareholder of a civil law company, a sole proprietorship or as a member of a governing body of a capital company, or to participate in another competing legal person as a member of a governing body; • evaluating and performing periodic reviews, subject to the approval of the Supervisory Board, of the general principles for the policy on variable remuneration components of individuals holding managerial positions; • evaluating and monitoring the variable remuneration components of individuals whose activities have a significant impact on the Bank's risk profile, second-level risk management, the compliance unit manager and the internal audit unit manager; • reviewing detailed rules and procedures for recruiting members of the Bank's Management Board and assessing the suitability of members of the Bank's Management Board;

	• preparing and carrying out, with potential support from external, independent entities, the programme for raising the qualifications of members of the Supervisory Board.
Commercial Committee	• reviewing cooperation agreements concluded between PKO Bank Polski SA and PKO Bank Hipoteczny SA; • providing opinions and approving product regulations, including the criteria for selecting products for the mortgage bank; • providing opinions on the price and discount policy.

The powers of the Bank's Management Board include in particular:

- defining PKO Bank Hipoteczny SA's strategy, taking into account the risk of the operations it conducts and the bank management strategy;
- setting the general level of risk acceptable for the Bank;
- setting the annual financial plan, including the conditions for its execution;
- adopting the Organizational Regulations of the Bank and the rules for division of competencies;
- establishing and closing down standing Committees of the Bank and defining their powers;
- adopting the Management Board by-laws;
- adopting the Regulations for setting the mortgage lending value of property;
- adopting the regulations for the use of special funds created from net income;
- setting the dividend pay-out date within the period set by the General Shareholders' Meeting;
- adopting the rules for the functioning of internal control system and the annual internal audit plan;
- establishing, restructuring and closing down branches and other organizational units of the Bank in Poland and abroad;
- taking decisions on issues of covered bonds.

The Bank's Management Board established the following standing committees:

Asset and Liability Committee	• supporting the liquidity, interest rate, macroeconomic changes, currency, capital and related model risk management functions; • managing the Bank's capital adequacy; • examining materials on capital adequacy, equity, internal capital, stress tests, risks mentioned above, as well as tolerance limits for these risks; • making decisions regarding the Bank's operations, in particular as regards risk measures and limits as well as the initiation of capital and liquidity emergency actions; • issuing recommendations for the Bank's competent authorities, organizational units, members of the Bank's Management Board, project teams or task forces – within the scope of their competencies.
Credit Committee	• supporting the credit, concentration, residual and related model risk management functions; • examining materials on the risks mentioned above, the profile and quality structure of the loan portfolio, impairment losses on assets, acquisition of loan portfolios, the real estate market; • making decisions on the Bank's operations, in particular as regards risk measures and limits, risk model validation results, the methodology and models of calculating

	impairment losses on loan assets, cut-offs used as part of credit risk assessment, credit receivables purchased by the Bank, single loan transactions; • issuing recommendations for the Bank's competent authorities, organizational units, members of the Bank's Management Board, project teams or task forces – within the scope of their competencies.
Data Quality Committee	• determining the strategic directions of operations in the area of managing the quality of data and data architecture in the Bank, in the context of the Data Management System (DMS); • oversight over the functioning of the DMS, including evaluation of its efficiency and the operations of particular organizational units of the Head Office.
Strategy and Business Initiatives Committee	• supporting the business, operational, reputation, compliance and related model risk management functions; • examining materials on the risks mentioned above, directions of the Bank's development, the Bank's strategy and IT strategy, initiatives related to the implementation of the Bank's strategy and IT strategy together with the operational risk analysis, product offer, product profitability, credit process; • making decisions regarding the Bank's operations, in particular as regards managing the risks mentioned above, the related risk measurement models and the related risk measures and limits; • issuing recommendations for the Bank's competent authorities, organizational units, members of the Bank's Management Board, project teams or task forces – within the scope of their competencies.

6.3. The Management Board of PKO Bank Hipoteczny SA

In the period from 1 January to 31 December 2018, the composition of the Management Board of PKO Bank Hipoteczny SA was as follows:

	Position	Position holding period
Paulina Strugała	President acting President, Vice President	12.06.2018 – until now 16.04.2018 – 12.06.2018
Agnieszka Krawczyk	Vice President	01.01.2018 - until now
Jakub Niesłuchowski	Vice President acting President, Vice President	01.04.2015 – until now 01.01.2018 – 16.04.2018
Marek Szcześniak	Vice President	01.06.2015 – 26.11.2018

Due to the resignation of Mr Rafał Kozłowski as President of the Management Board, the Supervisory Board of PKO Bank Hipoteczny SA instructed as of 28 December 2017 Mr Jakub Niesłuchowski to act in the capacity of President of the Bank's Management Board with regard to organizational and administrative matters until the appointment of the President of the Bank's Management Board, and appointed Ms Agnieszka Krawczyk Vice-President of the Bank's Management Board as of 1 January 2018.

On 4 April 2018 the Supervisory Board of PKO Bank Hipoteczny SA appointed Ms Paulina Strugała President of the Bank's Management Board as of 16 April 2018, subject to and as of the date of the Polish Financial Supervision Authority's (PFSA) approval of her appointment as President of the Bank' Management Board. Until the PFSA granted its approval on 12 June 2018, Ms Paulina Strugała was Vice President of the Bank's Management Board and acting President of the Board.

On 12 June 2018, the Polish Financial Supervision Authority approved the appointment of Ms Paulina Strugała as President of the Management Board of PKO Bank Hipoteczny SA.

Due to the resignation of Mr Marek Szcześniak as Vice President of the Management Board as of 26 November 2018, on 12 December 2018 the Supervisory Board of PKO Bank Hipoteczny SA appointed Mr Piotr Kochanek Vice President of the Bank's Management Board effective from 1 January 2019. Furthermore, the Bank's Supervisory Board appointed Mr Piotr Kochanek Vice President of the Bank's Management Board responsible for managing risks with a material impact on the Bank's operations, subject to and as of the date of PFSA's approval referred to in Article 22b of the Banking Law.

The terms of office of members of the Management Board, who are appointed for a joint term of office, expire on the date when the General Shareholders' Meeting approves the financial statements for the year ended 31 December 2018, at the latest.

The Bank's Supervisory Board has established the following internal division of key competencies within the Bank's Management Board:

PAULINA STRUGAŁA	President of the Management Board responsible for supervising compliance and reputation risk, the internal audit function, human resources management, communication and legal services
Other functions performed:	Chairperson of the Strategy and Business Initiatives Committee
AGNIESZKA KRAWCZYK	Management Board member responsible for supervising the development, creation and functioning of the product offer for individuals and business entities, as well as for coordinating activities in respect of sales of mortgage products in all distribution channels
Other functions performed:	Member of the Strategy and Business Initiatives Committee Member of the Credit Committee
JAKUB NIESŁUCHOWSKI	Management Board member responsible for supervising financial planning and financial control issues, accounting and financial reporting, supervising issues of securities, obtaining financing and treasury
Other functions performed:	Chairperson of the Asset and Liability Committee Deputy Chairperson of the Strategy and Business Initiatives Committee
MAREK SZCZEŚNIAK[19]	Management Board member responsible for supervising the management of all risks relating to the Bank's operations except compliance risk and reputation risk, supervising restructuring and debt collection, supervising the lending process and process of obtaining loan receivables by the Bank, as well as IT and outsourcing
Other functions performed:	Chairperson of the Credit Committee Chairperson of the Data Quality Committee Deputy Chairperson of the Asset and Liability Committee Member of the Strategy and Business Initiatives Committee

OTHER MANAGEMENT FUNCTIONS OF THE MANAGEMENT BOARD MEMBERS

	Function	Period of performing the function

18 Marek Szcześniak was Vice President of the Bank's Management Board and performed functions in the Bank's standing committees until 26.11.2018; these functions were vacant as at 31.12.2018.

Paulina Strugała	Member of the Supervisory Board of PKO BP Finat Sp. z o.o.	From 30 June 2018
Agnieszka Krawczyk	Director of the Mortgage Banking Products Department at PKO Bank Polski SA, on a part-time (0.2 FTE) basis	Throughout the reporting period
Jakub Niesłuchowski	did not hold any additional Management Board or Supervisory Board member positions and did not occupy any other managerial positions	
Marek Szcześniak	Deputy Chairperson of the Supervisory Board at Kredobank SA in Ukraine	Throughout the reporting period

Recruitment policy concerning the selection of Management Board members and evaluation of Management Board members

The process of selecting and evaluating candidates for members of the Management Board in PKO Bank Hipoteczny SA is carried out by the Remuneration and Nomination Committee of the Bank's Supervisory Board. The Committee takes into consideration the guidelines of the European Banking Authority dated 21 March 2018 with regard to evaluating the suitability of members of a management body and persons performing key functions (the EBA guidelines) and the Regulation of the Minister of Development and Finance of 10 March 2017 on information and documents concerning the founders and the management board of the bank to be submitted to the Polish Financial Supervision Authority. During the candidate selection process, the Committee takes into account PKO Bank Hipoteczny SA's profile, area and scale of operations. During the evaluation of a candidate, the Committee also verifies that the candidate's experience and knowledge will strengthen the abilities possessed by the other members of the Bank's Management Board, and complement them, so as to ensure the coverage of all areas managed in the Bank. The examination of this criterion has as its purpose ensuring variety in the selection of members of the managing body, its purposes, tasks and area of operation.

Before their appointment, all members of the Management Board of PKO Bank Hipoteczny SA were subjected to an evaluation of their suitability, in accordance with the EBA guidelines.

Members of the Management Board are subject to continuous evaluation by the Supervisory Board's Remuneration and Nomination Committee, beginning from the moment of recruitment and continuing through their entire term of office. In addition, in accordance with Article 395 § 2(3) of the Code of Commercial Companies and Partnerships, each year the ordinary general meeting of shareholders grants each individual member of the Management Board a vote of approval. The granting of this vote of approval constitutes an evaluation of the Management Board members, independent of the approval by the general meeting of shareholders of the Management Board's report on the Bank's operations. On 29 March 2018, by resolutions of the ordinary general meeting, all members of the Bank's Management Board, who fulfilled their functions in 2017, were granted a vote of approval for the period ended 31 December 2017.

The process described above for appointments to perform functions on the Management Board and the positive evaluation of members of the Bank's Management Board constitutes a confirmation of their proper performance of their duties, based on adequate knowledge, abilities and experience, in accordance with the requirements of art. 22aa of the Banking Law.

6.4. The Supervisory Board of PKO Bank Hipoteczny SA

In 2018, the composition of the Supervisory Board of PKO Bank Hipoteczny SA was as follows:

	Function in the Supervisory Board	Date of appointment	Date of dismissal / resignation	qualifications in finance	Independent member[20]	Audit and Finance Committee	Risk Committee	Remuneration and Nomination Committee	Commercial Committee
Jakub Papierski	Chairperson	06.10.2014		✓				Ch	Ch
Piotr Mazur	Deputy Chairperson	06.10.2014		✓			Ch		D
Justyna Borkiewicz	Board Member	28.10.2016		✓			M		
Mieczysław Król	Board Member	28.10.2016		✓			D	D	
Bartosz Drabikowski	Board Member	18.10.2017	15.01.2018						
Artur Kluczny	Board Member	18.10.2017		✓	✓	Ch			
Piotr Kwiecień	Board Member	18.10.2017		✓	✓	M			
Jan Emeryk Rościszewski	Board Member	18.10.2017		✓					M
Rafał Kozłowski	Board Member	09.02.2018		✓		D			M

Ch – Chairperson of the Committee; D – Deputy Chairperson of the Committee; M – Member of the Committee

The composition of the Committees is presented as at 31 December 2018.

In accordance with Article 395 § 2(3) of the Code of Commercial Companies, each year the ordinary General Shareholders' Meeting grants a vote of approval to each individual member of the Supervisory Board. Granting of this vote of approval constitutes an evaluation of the Supervisory Board members, independent of the approval by the General Shareholders' Meeting of the Supervisory Board's report on the Bank's operations. On 29 March 2018, by resolution of the ordinary General Shareholders' Meeting, all members of the Bank's Supervisory Board received a vote of approval for the period ended 31 December 2017.

This constitutes a confirmation that members of the Supervisory Board duly performed their duties, based on adequate knowledge, abilities and experience, in accordance with the requirements of art. 22aa of the Banking Law.

The Bank has a Policy on the Selection and Evaluation of Members of the Supervisory Board of PKO Bank Hipoteczny SA. The policy defines the criteria for suitability of the members of the Supervisory Board at the stage of their appointment and in the course of exercising their functions and governs the procedure for their evaluation. In accordance with this Policy, on 9 February 2018, the General Shareholders' Meeting evaluated the qualifications of a candidate for a member of the Supervisory Board.

[19] in accordance with the Act on Registered Auditors, Registered Audit Companies and Public Oversight of 11 May 2017

INFORMATION ON THE AUDIT AND FINANCE COMMITTEE

In 2018, the composition of the Audit and Finance Committee of PKO Bank Hipoteczny SA was as follows:

	Function in the Audit and Finance Committee	Independent member [21]	knowledge and skills in the area of accounting or financial statements audit	knowledge and skills in the area of mortgage banking
Artur Kluczny	Chairperson of the Committee	✓		
Rafał Kozłowski	Deputy Chairperson of the Committee		✓	✓
Piotr Kwiecień	Member of the Committee	✓		

During his professional career, Mr Rafał Kozłowski acquired knowledge and skills in accounting, financial reporting and mortgage banking.

The Audit and Finance Committee met five times in 2018.

6.5. REMUNERATION AND HUMAN RESOURCES MANAGEMENT POLICY

EMPLOYMENT LEVEL

As at 31 December 2018, 67 people were employed in PKO Bank Hipoteczny SA (67 FTEs). This means a decrease of 2 employees compared with the end of 2017.

REMUNERATION POLICY

The Remuneration Policy of PKO Bank Hipoteczny SA, introduced by Order of the President of the Management Board, is the basic internal regulation in the remuneration policy. In accordance with the Order, Bank employees are entitled to the following remuneration components:

- basic salary;
- bonuses and awards for special achievements in professional work;
- additional remuneration for working overtime and at night.

Basic salaries and additional benefits granted to employees are determined on the basis of an analysis of market remuneration in the banking sector. The remuneration policy of PKO Bank Hipoteczny SA is consistent with the principles of appropriate and effective risk management.

There is no employee share programme in place at the Bank.

[20] in accordance with the Act on Registered Auditors, Registered Audit Companies and Public Oversight of 11 May 2017

BASIC SALARIES

The Bank assigns basic salaries in accordance with an internal system of salary levels. The levels are assigned based on an independent and objective scoring method. The positions are evaluated on an ongoing basis, in particular in the case of significant organizational changes at the Bank. The Bank engages specialist external entities to verify the adequacy of basic salaries by performing regular benchmark tests.

VARIABLE REMUNERATION

The Bank regulates the process of granting variable remuneration in the Rules and regulations for variable components of remuneration of persons holding managerial positions at the Bank, the Principles for employing and remunerating members of the Bank's Management Board and the Principles for granting bonuses to Bank employees.

The targets assigned are aimed at ensuring that the risk associated with the Bank's operations is taken into account. All targets result from target grids approved by the Bank's Management Board, which are cascaded to the employees of the individual structures. MRT (Material Risk Takers) are additionally responsible for special projects aimed at executing the Bank's strategy.

MRTs, who have significant influence on the safety level and stable development of the Bank, are subject to additional remuneration restrictions. Variable remuneration components are granted to MRTs, including the Management Board members, for a particular appraisal year (calendar year) following the settlement of bonus targets in the non-deferred and deferred form. In order to ensure that the results are sustainable, deferred variable remuneration components can be reduced if the Bank's financial results have deteriorated, the Bank incurred a loss or other variables deteriorated.

Moreover, half of the value of each component is payable in the form of a financial instrument linked to the carrying amount of the Bank's net assets. Bonus parametrization takes into account the Bank's situation and the market benchmarks of the financial sector. The Supervisory Board had rights to set bonus parameters for the Management Board (bonus indices, bonus adjustment indices, targets whose execution is rewarded with a bonus). The President of the Bank's Management Board had the same rights with respect to the MRTs and other employees.

In addition to the bonus system, an employee awards system functions in the Bank, as part of which an award fund is created, designated for individual discretionary awards for employees who achieve distinctive results in their professional work or for achievements as a result of which important outcomes are achieved for the Bank.

EMPLOYEE BENEFITS

EXTRA MEDICAL CARE	The Bank provides its employees with extra medical care (in addition to occupational medical care provided in accordance with the Labour Code). Different medical packages are assigned to specific job categories.
GROUP INSURANCE	The possibility of joining group insurance, which is paid for by the employees through the Bank.
MYBENEFIT CAFETERIA SYSTEM	Under this system, every employee of the Bank can manage the funds assigned to him/her from the Company Social Fund as he/she chooses.

THE PRINCIPLES FOR REMUNERATING THE MANAGEMENT BOARD MEMBERS

On 14 February 2018, the Bank's Supervisory Board, in resolution no. 1/2018, determined the rules for appointing and remunerating members of the Bank's Management Board, thus adjusting the form of employment and compensation of members of the Bank's Management Board to the provisions of the Act on the rules for setting the remuneration of persons managing certain companies of 9 June 2016 (Journal of Laws of 2016, item 1202, as amended). Based on the said rules, the members of the Bank's Management Board are entitled to:

- fixed remuneration in the amount specified in the Supervisory Board resolution for each Management Board member separately;
- variable remuneration – additional remuneration granted and payable after the appraisal period, in particular in the form of: bonuses, rewards for special achievements at work, severance pay (other than fixed remuneration and benefits granted based on the applicable laws).

The information on remuneration components and other benefits payable to Management Board members in the reporting period is presented in the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2018 (Notes 38.3 and 38.4).

VARIABLE REMUNERATION COMPONENTS FOR MEMBERS OF THE MANAGEMENT BOARD AND MATERIAL RISK TAKERS (MRT)

In accordance with the requirements of CRD IV, i.e. Commission Delegated Regulation (EU) 604/2014 (as amended) supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile, as well as in connection with the Regulation of the Minister of Development and Finance of 6 March 2017 on the risk management system, the internal control system, the remuneration policy and detailed method of estimating internal capital in banks, the following policies and procedures laying down the principles of determining variable remuneration components are in force in the Bank:

- The *Policy for employing and remunerating members of the Management Board of the Bank*, adopted by Resolution of the Supervisory Board;
- The list of positions where professional activities have a significant impact on the institution's risk profile, adopted by Resolution of the Management Board (the MRT list);
- The *Policy on variable remuneration components for persons holding managerial positions in the Bank*, adopted by order of the President of the Bank's Management Board.

The policy on variable remuneration components for Management Board members and MRTs as at 31 December 2018 was applicable to three Management Board members and 16 MRT positions.

The list of MRTs covered by the Policy on variable components of the remuneration of persons holding managerial positions at the Bank is determined by the Bank's Management Board based on qualitative and quantitative criteria for identifying the categories of employees whose professional activities have a significant effect on the risk profile, which are specified in the Commission delegated Regulation (EU) No 604/2014 of 4 March 2014. Based on such criteria, MRTs include in particular:

- senior management;
- positions accountable to the managing body for the operations of the independent risk management, compliance or internal audit functions;
- managerial positions responsible for legal matters, finance, HR, IT, economic analysis and launching new products;
- positions where employees receive total remuneration exceeding the relevant threshold defined by law (as long as such employees actually have a significant impact on the risk profile);
- positions in which employees fall in the same remuneration range as senior management and individuals assuming operational risk (as long as they have a significant impact on the risk profile).

Variable remuneration components are awarded for the purpose of achievement of objectives assigned as part of the Management by Objectives (MbO) system. Variable remuneration components for a given assessment period (a calendar year) are awarded after verification whether the objectives which entitle to a bonus have been met. The maximum amount of variable remuneration cannot exceed 50% of the fixed remuneration for a given assessment period.

Variable remuneration is awarded and paid in the following forms:

- in a non-deferred form – 60% of variable remuneration (in the first year after the assessment period);
- in a deferred form – 40% of variable remuneration (in equal instalments over the next three years after the first year following the assessment period).

Both non-deferred and deferred remuneration is granted in equal parts in cash and in the form of financial instruments (i.e. phantom shares) converted to cash after the retention period, and in the case of deferred remuneration – after the period of deferral). In the case of employees included in the MRT list, the amount of PLN 50,000 is excluded from obligatory deferral. If the amount of variable remuneration for a year has exceeded PLN 1 million, the amount deferred will be PLN 400 thousand plus 60% of the excess over the amount of PLN 1 million.

Each of the accrued components of variable remuneration may be reduced as a consequence of:

- a breach of the employee's duties;
- material non-compliance with the legal regulations or customer service standards;
- inadequate performance of the assigned professional duties;
- a violation of the principles of community life in relation to other employees.

For members of the Management Board, variable remuneration may only be assigned and paid provided that the Directors' Report and the financial statements for the previous financial year have been approved and the Management Board member has been granted a discharge in respect of his/her duties. The amount of the bonus for a member of the Management Board may be adjusted by a specified ratio, depending on the financial performance of the Bank, as specified in the annual Note of the Bank (a set of key management indicators specified for the calendar year),

If:

- the Bank's financial performance has materially deteriorated;
- it has been found that there has been a material negative change in the Bank's equity;
- a member of the Management Board or an MRT has violated the provisions of law, rules, policies, procedures or duties arising from his/her employment relation, or has committed significant errors;
- the performance and the degree of completion of a Management Board member's or an MRT's outcomes or objectives has been adjusted;
- the performance of the structures supervised or managed by the above-mentioned persons has deteriorated;
- variable remuneration has been granted on the basis of incorrect or misleading information or as a result of fraud by a member of the Management Board or an MRT,

the Supervisory Board or the Management Board, respectively, may apply *malus* solutions that reduce the amount of the variable remuneration due.

If severance pay related to dismissal from office in connection with termination of the employment relationship is awarded to a member of the Management Board, other than severance pay resulting from the generally applicable provisions of law, the amount of the severance pay shall reflect the assessment of the performance over the last three years of employment and must be consistent with the maximum level of severance pay specified in the Bank's policies. The Bank's Supervisory Board decides on the level and payment of severance pay.

Both members of the Management Board and selected MRTs are covered by non-competition agreements. These provide for payment of compensation for refraining from undertaking employment with a competitor after termination of employment with the Bank.

In 2018, none of the employees at PKO Bank Hipoteczny SA received total remuneration of at least EUR 1 million.

The policy on variable remuneration components for members of the Management Board and material risk takers is reviewed annually by the Internal Audit Office, the Remuneration and Nomination Committee of the Bank's Supervisory Board and by the Supervisory Board of PKO Bank Hipoteczny SA.

In the reporting period, 5 meetings of the Remuneration and Nomination Committee of the Supervisory Board of PKO Bank Hipoteczny SA were held.

AGREEMENTS BETWEEN THE BANK AND PERSONS HOLDING MANAGERIAL POSITIONS

Within the meaning of the provisions of § 2(1)(30)(a) of the Regulation of the Minister of Finance of 29 March 2018 on current and periodical information to be reported by issuers of securities and the conditions for treating information required by the laws of a state other than a member state as equivalent, the persons managing the Bank are the Management Board members.

Until 14 February 2018, the following two agreements were signed with each member of the Management Board of PKO Bank Hipoteczny:

- an employment contract;
- a non-competition agreement.

On 14 February 2018, as a result of the implementation of the rules for appointing and remunerating members of the Management Board of PKO Bank Hipoteczny SA, each Management Board member who performed the function as at that day signed a management contract with the Bank, which specified among other things remuneration and non-competition terms and conditions. As a result of the aforementioned changes, previous employment contracts were settled.

7. Corporate governance and information for investors

7.1. Representation on compliance with the rules for corporate governance

The Bank has adopted the Principles of Corporate Governance for Supervised Institutions, as issued by the Polish Financial Supervision Authority, on the basis of the following decisions by the Bank's bodies:

- the Resolution of the Bank's Management Board of 15 December 2014 – in relation to the powers and duties of the Management Board, i.e. conducting the Bank's affairs and its representation, in accordance with the generally applicable laws and the Bank's Articles of Association;
- the Resolution of the Supervisory Board of 18 December 2014 – in relation to the powers and duties of the Supervisory Board, i.e. supervising the conduct of the Bank's affairs, in accordance with the generally applicable laws and the Bank's Articles of Association;
- the Resolution of the General Shareholders' Meeting of 22 December 2015 – in relation to the powers reserved for the General Shareholders' Meeting.

Pursuant to and to the extent arising from the aforementioned decisions, the Bank opted out of the following provisions of the Principles of Corporate Governance for Supervised Institutions:

- the provisions referring to the principles of cooperation and rights of multiple shareholders (§ 8(4), § 9(1) and (6), § 10(3), § 11(3) and § 31(3)), which are not applied because the Bank only has a single shareholder;
- chapter 9, concerning the management of assets at the client's risk, because the Bank does not conduct operations in this area;
- the principle described in § 22(1), concerning the independence of Supervisory Board members, manifesting itself primarily in the lack of direct and indirect ties to the supervised institution, members of the management and supervisory bodies, significant shareholders and related parties; in addition, on 18 October 2017 two members meeting the independence requirements set out in the Act of 11 May 2017 on statutory auditors, audit firms and public supervision were appointed members of the Bank's Supervisory Board. (Journal of Laws, item 1089 as amended).

In accordance with the requirement arising from § 27 of the Principles of Corporate Governance for Supervised Institutions, on 17 May 2018, the Supervisory Board evaluated the application of the said Principles in the Bank in 2017. In the Supervisory Board's opinion, the Bank ensured that the Principles, to the extent adopted by the Bank's bodies, were applied adequately to the scale, nature of operations and the specific character of a mortgage bank.

The text of the Principles is available on the website of the Polish Financial Supervision Authority –

https://www.knf.gov.pl/knf/pl/komponenty/img/knf_140904_Zasady_ladu_korporacyjnego_22072014_38575.pdf

Diversity policy

Diversity management at the Bank concerns all employees, the Bank's authorities and key managers. Diversity activities affect many aspects of the Bank's operations and are aimed at respecting other persons, equal treatment of the employees and making use of their potential. Diversity means that people are important regardless of their gender, age, health, sexual orientation, religion, marital status or country of origin. Therefore, the following solutions were implemented in the form of regulations, processes and HR policies:

- The Code of Ethics and the Rules and regulations of the Bank's operations concerning, among other things, preventing discrimination due to gender, age, disability, race, religion, nationality, political views, trade union membership, ethnicity, religion or sexual orientation, as well as due to employment for a specified or unspecified period or full- or part-time.

- When conducting recruitment projects, the Bank observes the principles of equal treatment during the hiring process and at work. The processes of selecting candidates are based on the principles of objectivity, and their individual stages follow the established patterns and principles.
- Positions at the Bank are evaluated based on technical criteria to prevent discrimination.
- The Bank employs students and graduates from different types of universities and offers them development opportunities.
- Employee appraisal is performed every year based on a competence model, which covers general, leadership and job-specific competencies. As part of the periodic performance appraisal system, every employee determines his or her individual development plan during the interview with his/her superior.

Diversity policy concerning the management and supervisory staff as at 31 December 2018

Diversity management also concerns the PKO Bank Hipoteczny SA Supervisory Board and Management Board members and the key managers. The management and supervisory staff includes persons of different gender, age and experience.

Gender	Women	Men
Supervisory Board	1	7
Management Board	2	1
Key managers	9	7

Age	30 - 40 years	41 - 50 years	51 - 60 years	over 60 years
Supervisory Board	-	3	4	1
Management Board	1	2	-	-
Key managers	7	8	1	-

Period of employment with PKO Bank Hipoteczny SA	Up to 1 year	1 - 5 years
Supervisory Board	1	7
Management Board	2	1
Key managers	1	15

MAIN CHARACTERISTICS OF THE INTERNAL CONTROL AND RISK MANAGEMENT SYSTEM IN RELATION TO THE PROCESS OF PREPARING THE FINANCIAL STATEMENTS

The internal control system covers the process of preparing financial statements. In accordance with the rules adopted at the Bank, one of the purposes of the internal control system is to support decision-making processes contributing to ensuring the reliability and accuracy of the financial reporting, accounting procedures and reliable internal and external reporting.

The Director of the Finance and Accounting Office is responsible for ensuring compliance with controls in the area of financial reporting, while the internal audit function is reviewing and independently evaluating the adequacy and effectiveness of controls over the financial reporting processes and evaluating risk management in these processes, in accordance with the approved internal audit plans. No issues which would cast doubt on the reliability of the financial reporting have been observed so far as part of the internal audit operations.

LIST OF DIRECT OR INDIRECT HOLDERS OF SIGNIFICANT BLOCKS OF SHARES WITH AN INDICATION OF THE NUMBER OF SHARES HELD AND THE NUMBER OF VOTES ATTACHED TO THESE SHARES

As at 31 December 2018, the share capital of PKO Bank Hipoteczny SA amounted to PLN 1,295 million and comprised 1,295,000,000 shares with PLN 1.00 par value. The shares are paid up in full. The share capital increased by PLN 95 million in relation to the end of the year 2017. The PKO Bank Hipoteczny SA shares are non-preference shares. The holders of the PKO Bank Hipoteczny SA shares do not have any control rights due to holding such shares. 100% of the shares of PKO Bank Hipoteczny SA are held by Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna.

Structure of the share capital of PKO Bank Hipoteczny SA

Series	Type of shares	Number of shares	Par value of one share	Number of votes at the GSM	Amount paid in for the shares
A	Ordinary registered shares	300,000,000	PLN 1	300,000,000	PLN 300,000,000.00
B	Ordinary registered shares	200,000,000	PLN 1	200,000,000	PLN 200,000,000.00
C	Ordinary registered shares	200,000,000	PLN 1	200,000,000	PLN 200,000,000.00
D	Ordinary registered shares	100,000,000	PLN 1	100,000,000	PLN 100,000,000.00
E	Ordinary registered shares	150,000,000	PLN 1	150,000,000	PLN 150,000,000.00
F	Ordinary registered shares	150,000,000	PLN 1	150,000,000	PLN 150,000,000.00
G	Ordinary registered shares	100,000,000	PLN 1	100,000,000	PLN 100,000,000.00
H	Ordinary registered shares	95,000,000	PLN 1	95,000,000	PLN 95,000,000.00

Shareholder	31.12.2018		31.12.2017	
	Number of shares	Percentage of votes at the GSM	Number of shares	Percentage of votes at the GSM
Powszechna Kasa Oszczędności Bank Polski SA	1,295,000,000	100%	1,200,000,000	100%

DESCRIPTION OF THE RULES FOR APPOINTING AND DISMISSING MANAGERS

Members of the Management Board are appointed and dismissed by resolution of the Supervisory Board. When appointing Management Board members, the Supervisory Board determines the number of members. The appointment of two members of the Management Board, including the President and the member responsible for risk, requires the consent of the Polish Financial Supervision Authority. The terms of office of members of the Management Board expire on the date when the General Shareholders' Meeting approves the financial statements for the last full financial year during which a member served, at the latest. Furthermore, the term of office of a Management Board member also expires as a result of his/her death, resignation or dismissal from the Management Board, as of the date of the event causing the expiration, unless the resolution on dismissal provides a different date of expiration. Management Board members may be dismissed before the end of their term of office at any time.

The Supervisory Board notifies the Polish Financial Supervision Authority of the composition of the Management Board and of any changes in the composition thereof immediately after its appointment or after any changes in the composition thereof. The Supervisory Board also notifies the Polish Financial Supervision Authority of the members of the Management Board who, as a result of the division of responsibilities, shall be in charge of the risk management and the internal audit unit. The Supervisory Board notifies the Polish Financial Supervision Authority of the intention to dismiss, and the reasons for dismissal of, a member of the Management Board who, as a result of the division of responsibilities, is in charge of risk management and the internal audit unit, immediately after the relevant item has been placed on the agenda of the Supervisory Board meeting.

Additional information on the powers of management are provided in Chapter 6, Structure and Governing Bodies of PKO Bank Hipoteczny SA.

DESCRIPTION OF AUTHORIZATIONS TO DECIDE ON SHARE ISSUES OR BUYBACKS

The powers of the General Shareholders' Meeting include adopting resolutions on establishing the share redemption method and the level of compensation for redeemed shares, approving the acquisition of the Bank's treasury shares for redemption, and approving the issue of bonds convertible into shares or other instruments giving the right to acquire or take up shares in the Bank.

INDICATION OF ANY LIMITATIONS ON THE TRANSFER OF OWNERSHIP RIGHTS TO THE ISSUER'S SECURITIES

There are no limitations on the transfer of ownership rights to the issuer's securities.

PRINCIPLES FOR AMENDING THE BANK'S ARTICLES OF ASSOCIATION

Amendments to the Bank's Articles of Association require a resolution of the General Shareholders' Meeting and must be entered in the Business Register of the National Court Register. To the extent defined by Article 34(2) of the Banking Law, an amendment to the Articles of Association requires the consent of the Polish Financial Supervision Authority.

COMPOSITION AND CHANGES DURING THE LAST FINANCIAL YEAR, AND A DESCRIPTION OF THE OPERATIONS OF THE MANAGEMENT, SUPERVISORY AND ADMINISTRATIVE BODIES OF THE ISSUER AND OF THEIR COMMITTEES

Information concerning the description of the management, supervisory and administrative bodies of the issuer, their committees and their composition and changes during the last financial year is presented in Section 6, Structure and Governing Bodies of PKO Bank Hipoteczny SA.

THE GENERAL SHAREHOLDERS' MEETING AND RELATIONS WITH SHAREHOLDERS

The method of operation of the General Shareholders' Meeting and its key powers as well as a description of the shareholder rights and the method of their execution follow directly from the applicable laws and the Bank's Articles of Association. In consideration of the fact that all shares in the Bank's share capital are held by a single shareholder, i.e. PKO Bank Polski SA, the resolutions of the General Shareholders' Meeting are adopted without formally convening a General Shareholders' Meeting, in accordance with the principles arising from Article 405 of the Polish Commercial Companies Code.

7.2. ENTITY AUTHORIZED TO AUDIT FINANCIAL STATEMENTS

On 3 March 2017 the Supervisory Board of PKO Bank Hipoteczny SA selected KPMG Audyt Spółka z ograniczoną odpowiedzialnością sp.k. as the entity authorized to audit and review the Bank's financial statements for the years 2017–2019, based on the recommendation of the Supervisory Board's Audit and Finance Committee, which complied with the applicable terms and conditions.

KPMG Audyt Spółka z ograniczoną odpowiedzialnością sp. k. with its registered office in Warsaw at ul. Inflancka 4A ("KPMG") is entered on the list of entities authorized to audit financial statements is maintained by the National Board of Statutory Auditors, with the number 3546. The Bank's Supervisory Board appointed the auditor authorized to audit and review financial statements in accordance with applicable laws and occupational standards, on the basis of Section 18(1)(4) of the Bank's Articles of Association.

On 19 June 2017, an agreement was signed by and between PKO Bank Hipoteczny SA and KPMG on the performance of an audit of the financial statements for the years ended 31 December 2017, 2018 and 2019, respectively, and on a review of the financial statements for the periods ended 30 June 2017, 2018 and 2019, respectively.

The following table presents the services provided by KPMG and the fees for such services:

Net fee of KPMG (PLN '000)	2018	2017
Audit of the financial statements	132.5	110.0
Review of the financial statements, audit and review of group packages	105.3	100.0
Other assurance services – attestation letters	250.0	340.1
Translation of financial statements	-	10.0

In 2018, the audit firm KPMG provided to the Bank permitted services other than audit, which related to the issue of attestation letters. The Audit and Finance Committee of the Bank's Supervisory Board assessed the audit firm's independence and approved the provision of such services.

In accordance with the policy for selecting an audit firm to perform an audit of the Bank's financial statements, the Supervisory Board conducts an open tender procedure to commission an audit of the financial statements. The Audit and Finance Committee of the Bank's Supervisory Board makes a recommendation concerning the audit firm selection to the Supervisory Board. Unless it concerns renewing an existing audit contract, the recommendation contains at least two suggestions with justifications and indicates the preferred firm. The Bank's Supervisory Board selects an audit firm based on the recommendation of the Audit and Finance Committee of the Bank's Supervisory Board. The offers made by audit firms are assessed based on transparent and non-discriminatory selection criteria.

In accordance with the policy for providing to the Bank permitted non-audit services by the audit firm conducting the audit, its related entities and members of its network, the provision of non-audit services by the audit firm conducting the audit, its related entities and members of its network to the Bank requires an approval of the Audit and Finance Committee of the Bank's Supervisory Board and an approval of the Audit Committee of the Supervisory Board of PKO Bank Polski SA.

7.3. OTHER INFORMATION

CHANGES IN THE HOLDING OF SHARES AND RIGHTS TO SHARES IN PKO BANK HIPOTECZNY SA BY INDIVIDUALS IN MANAGEMENT AND SUPERVISORY ROLES

In 2018 there were no changes in the holdings of shares and rights to shares of PKO Bank Hipoteczny SA by individuals in management and supervisory roles.

EVALUATION OF PKO BANK HIPOTECZNY SA'S FINANCIAL CREDIBILITY

On 27 March 2015, the Bank requested the rating agency Moody's Investors Service ("Moody's") to assign ratings to the Bank and to mortgage covered bonds issued by PKO Bank Hipoteczny SA.

On 7 September 2015, Moody's assigned Baa1/P-2 long- and short-term issuer ratings to PKO Bank Hipoteczny SA, with a stable outlook. On 19 December 2017, Moody's announced that the ratings had been maintained.

On 8 September 2015, Moody's assigned a long-term (P) rating (a provisional rating) of Aa3 to PKO Bank Hipoteczny SA's EUR-denominated covered bonds. This rating was confirmed by the agency on 12 December 2015, i.e. immediately after PKO Bank Hipoteczny SA conducted its first issue of covered bonds. The rating has been maintained for all issues of Polish złoty-denominated covered bonds of PKO Bank Hipoteczny SA.

On 29 September 2016, Moody's assigned a long-term (P) rating (a provisional rating) of Aa3 to PKO Bank Hipoteczny SA's EUR-denominated covered bonds. This rating was confirmed by the agency on 24 October 2016, i.e. immediately after PKO Bank Hipoteczny SA conducted its first issue of EUR-denominated covered bonds. The rating has been maintained for all issues of EUR-denominated covered bonds of PKO Bank Hipoteczny SA.

The rating assigned to the covered bonds of PKO Bank Hipoteczny SA is the highest rating achievable for Polish securities. The rating of Polish securities is limited by Poland's national ceiling for debt instruments, which is currently Aa3.

On 18 June 2018, Moody's Investors Service assigned new counterparty risk ratings (CRR) to the Bank. The long-term counterparty risk rating was set at A3, and the short-term counterparty risk rating – at P-2. The new ratings were assigned in connection with updating of the bank rating methodology by the agency in June 2018. At the same time, new ratings were assigned to 32 other banks in Central and Eastern Europe. Counterparty risk ratings reflect an entity's ability to settle an unsecured portion of the counterparty's financial liabilities not related to a debt (CRR liabilities) and the expected financial losses in the case of failing to settle such liabilities.

SIGNIFICANT AND MATERIAL AGREEMENTS WITH THE CENTRAL BANK OR SUPERVISORY BODIES

On 25 June 2018, an agreement was signed with the National Bank of Poland for a Lombard loan and a pledge securing the loan, and on technical loan and a transfer of rights from securities.

FINANCIAL LIABILITIES AND GUARANTEES GRANTED

In 2018 PKO Bank Hipoteczny SA did not issue any guarantees.

Financial liabilities under loans granted and not disbursed as at 31 December 2018 stood at PLN 719.2 million, up by PLN 36.3 million compared to 31 December 2017.

OFF-BALANCE-SHEET LIABILITIES TO RELATED PARTIES

In 2018, PKO Bank Hipoteczny SA did not grant any off-balance sheet liabilities to related parties.

LOANS TAKEN OUT AND LOAN AND GUARANTEE AGREEMENTS UNRELATED TO THE BANK'S OPERATIONS

In 2018, Bank Hipoteczny SA did not take out any loans or enter into any loan or guarantee agreements unrelated to the Bank's operations.

UNDERWRITING AGREEMENTS AND GUARANTEES GRANTED TO SUBSIDIARIES

In 2018, PKO Bank Hipoteczny SA did not conclude any underwriting agreements and did not grant any guarantees to its subsidiaries.

IDENTIFICATION OF PENDING PROCEEDINGS BEFORE COURTS, ARBITRATION BODIES OR PUBLIC ADMINISTRATION AUTHORITIES

As at 31 December 2018, no proceedings were under way before courts, arbitration bodies or public administration authorities concerning liabilities or receivables whose value constituted at least 10% of PKO Bank Hipoteczny SA's equity.

FACTORS WHICH WILL INFLUENCE FUTURE FINANCIAL PERFORMANCE OVER THE HORIZON OF AT LEAST ONE QUARTER

Among the significant factors and threats which may affect the Bank's results over the following quarter, the following should be mentioned:

- the development of the residential market in Poland;
- the development of the housing loans market in Poland;
- the possibility and timing of further transfers to the Bank of portions of the portfolio of housing loans previously granted by PKO Bank Polski SA;
- the situation on the domestic and foreign mortgage bond markets;
- demand for mortgage bonds issued by the Bank.

INFORMATION ON LOAN GUARANTEES OR OTHER GUARANTEES ISSUED BY THE BANK OR ITS SUBSIDIARY – IN AGGREGATE TO A SINGLE ENTITY OR ITS SUBSIDIARY, IF THE TOTAL AMOUNT OF THE EXISTING GUARANTEES IS EQUIVALENT TO AT LEAST 10% OF THE ISSUER'S EQUITY

In 2018 PKO Bank Hipoteczny SA did not grant any loan or credit guarantees to a single entity or a subsidiary of such an entity with a total value equivalent to at least 10% of the Bank's equity.

INFORMATION ON LOAN AND CREDIT AGREEMENTS ENTERED INTO AND TERMINATED DURING THE FINANCIAL YEAR

On 17 May 2018, PKO Bank Hipoteczny SA concluded annex no. 2 to the medium-term working capital loan agreement of 5 June 2017 with an external financial institution, decreasing the limit from PLN 150 million to PLN 100 million and extending the financing period to 10 June 2019.

On 13 July 2018, PKO Bank Hipoteczny SA concluded annex no. 3 to the medium-term working capital loan agreement of 5 June 2017 with an external financial institution, increasing the limit from PLN 100 million to PLN 150 million.

On 27 December 2018, PKO Bank Hipoteczny SA concluded a medium-term non-revolving loan agreement with an external financial institution for PLN 100 million for a period of 2 years.

Moreover, as at 31 December 2018 the Bank had a liability arising from purchased receivables of PLN 2,300.3 million resulting from the acquisition from PKO Bank Polski SA of residential mortgage loan portfolios, which are described in Note 27 to the financial statements. The payment date of the liability resulting from the acquisition of the receivables is agreed each time by the parties in the Receivables Sale Agreement. For receivables purchased in

2018, the parties agreed that payment would be made no later than within 12 months from the transfer date. In the case of failing to settle the liability within one month from the transfer date, the price shall be increased by interest.

Information on transaction(s) with related parties concluded by the issuer or its subsidiary, if material and not concluded on an arm's length basis

The Bank's related entities are PKO Bank Polski SA and members of the PKO Bank Polski SA Group. In 2018 PKO Bank Hipoteczny SA did not conclude any significant non-arm's length transactions with related parties.

Subsequent events

In the period from 1 January 2019 to the date of signing of these financial statements, PKO Bank Hipoteczny SA acquired another portfolio of receivables in respect of mortgage-secured housing loans in the amount of PLN 861.1 million under the Framework Agreement for Sale of Receivables signed on 17 November 2015 with PKO Bank Polski SA.

On 28 January 2019, PKO Bank Hipoteczny issued covered bonds denominated in EUR with a value of EUR 500 million and with a redemption period of 2 years and 10 months from the date of issue. The fixed interest over the period of issue is 0.250%. The covered bonds were purchased by investors for a price amounting to 99.933% of the nominal value. The covered bonds issued are quoted on the stock exchanges in Luxembourg and in Warsaw. Subsequently, on 25 February 2019, PKO Bank Hipoteczny executed a transaction increasing the issue value (tap) by issuing the second tranche with a nominal value of EUR 100 million. The issue date of the second tranche was set on 1 March 2019.

On 21 February 2019, the share capital of PKO Bank Hipoteczny was increased by PLN 100 000 000 to PLN 1 395 000 000 due to the registration of I-series shares in the business register of the National Court Register.

On 22 February 2019, Mr Jakub Niesłuchowski resigned as Vice-President of the Bank's Management Board with effect from 28 February 2019.

On 26 February 2019, the Polish Financial Supervision Authority granted its consent to the appointment of Mr Piotr Kochanek to the position of member of the Management Board of PKO Bank Hipoteczny SA responsible for supervising the management of material risk for the Bank's activities.

Information on changes in the key principles of managing the Bank's enterprise

In 2018 there were no changes in the key principles of managing the Bank's enterprise in PKO Bank Hipoteczny SA.

Financial support agreements

PKO Bank Hipoteczny SA did not conclude financial support agreements with other entities subject to consolidated supervision operating within the same holding, or with closely related parties.

Deposits and guarantees and sureties issued

PKO Bank Hipoteczny SA does not accept any deposits or issue any guarantees or sureties.

Information on the value of security established on the accounts or assets of borrowers

PKO Bank Hipoteczny SA did not establish any security on the borrowers' accounts in 2018.

The value of collateral in respect of mortgage loans secured with real estate as at 31 December 2018 amounted to PLN 42.7 billion.

8. STATEMENT OF THE MANAGEMENT BOARD OF PKO BANK HIPOTECZNY SA

The Management Board of PKO Bank Hipoteczny SA declares that, to the best of their knowledge:

- the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2018 have been prepared in accordance with the applicable accounting policies and give a true, fair and clear view of the financial position of PKO Bank Hipoteczny SA and of the result of its operations;
- the Directors' Report on the activities of PKO Bank Hipoteczny SA for the year ended 31 December 2018 gives a true view of the development and achievements as well as of the position of PKO Bank Hipoteczny SA, including a description of the key risks and threats.

The Management Board of PKO Bank Hipoteczny SA declares that the entity authorized to audit the financial statements which conducted the audit of the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2018 was selected in compliance with applicable law and that both the entity and the statutory auditor who conducted the audit fulfilled all the criteria for providing an unbiased and independent audit opinion on the financial statements, in compliance with applicable law and professional standards.

This Directors' Report on the activities of PKO Bank Hipoteczny SA for the year ended 31 December 2018 comprises 51 sequentially numbered pages.

Signatures of all Management Board members

27 February 2019	Paulina Strugała	President of the Management Board	*Signed on the Polish original* …………//……………… (signature)
27 February 2019	Jakub Niesłuchowski	Vice President of the Management Board	*Signed on the Polish original* ……………//……………… (signature)
27 February 2019	Piotr Kochanek	Vice President of the Management Board	*Signed on the Polish original* ……………//……………… (signature)
27 February 2019	Agnieszka Krawczyk	Vice President of the Management Board	*Signed on the Polish original* ……………//……………… (signature)