Bank Hipoteczny

PKO Bank Hipoteczny SA
Directors' Report
for the year ended 31 December 2017

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1. INTRODUCTION

PKO Bank Hipoteczny SA ('Bank') specialises in granting residential mortgage loans for individual clients. It also purchases receivables on 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 banks market in terms of the total assets and volume of mortgage loans. The Bank is also Poland's largest regular issuer of covered bonds on both the domestic and the international markets. The outstanding mortgage covered bonds issued by the Bank half of the total amount of outstanding covered bonds issued by Polish mortgage banks.

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

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

- for clients – loan products, adapted to their needs, for the financing of real estate,
- for investors – long-term covered bonds with a high level of safety.

PKO Bank Hipoteczny SA's strategy for 2017-2020 calls for:

- diversification of financing sources by obtaining long-term financing in the form of covered bonds designated for real-estate lending,
- achieving and maintaining the position of leader on the Polish market for covered bond issuance while maintaining their high level of safety,
- creating a centre of competence within the PKO Bank Polski SA Group in the area of mortgage loans and real-estate valuation, with the optimal use of PKO Bank Polski SA's assets, for the purpose of achieving synergies within the PKO Bank Polski SA Group.

2. EXTERNAL OPERATING CONDITIONS

The macroeconomic environment

- *Gross Domestic Product:* The GDP growth rate has an influence both on the residential real estate market and on the mortgage loan market. Fast enough GDP growth translates into growth in jobs and wages, and thus into consumer purchasing power and creditworthiness. Preliminary data published by the Central Statistics Office (GUS) in February 2018 show that Poland's GDP grew in Q4 2017 by 5.1% year on year. The European Commission forecast published in February 2018 assumes that Poland's GDP will grow by 4.2% in 2018, and by another 3.6% in 2019. The rapid pace of GDP growth may have a positive influence on the employment level and on consumers' wages. As a result, it may contribute to generating increased demand for housing loans granted by banks to finance residential real estate purchases.
- *Unemployment and wages.* According to data published by GUS, the number of unemployed registered at labour offices in Poland at the end of Q4 2017 stood at 1,081.7 thousand people, down by 253.5 thousand people or 19.0% from a year earlier. The unemployment rate at the end of December 2017 stood at 6.6% compared to 8.3% a year earlier. The number of people employed at the end of September 2017 stood at 16,510 thousand, up by 1.5% year on year, according to GUS's Labour Force Survey (BAEL). Also, the average monthly wage in the enterprise sector in December 2017 stood at PLN 4,973.73, up 7.3% year on year, according to GUS data. An increase in the number of professionally active people and growth in the wage level supports the development of the residential real estate market, and thus increases demand for mortgage loans.
- *Inflation:* Changes in prices affect consumers' purchasing power and the level of interest rates. A low inflation rate has a positive effect on banking clients' creditworthiness, which in turn translates into the volume of housing loans granted. According to data published by GUS, the Consumer Price Index (CPI) for December 2017 was 2.1% year on year.
- *Interest rates:* Low interest rates translate into a decline in credit costs and an increase in consumer creditworthiness. As at the date of this Report, the National Bank of Poland's (NBP) reference rate stood at 1.5%, the lowest in history. Maintaining interest rates at the current level can support a further increase in the Bank's credit action. It should positively influence the timely meeting of payment obligations by borrowers.

Residential real estate market

- 2017 was another year of prosperity on the residential real estate market since the growing demand for housing was accompanied by a high supply resulting, in particular, from the high activity of developers. Despite the high power of demand, the price increase on the primary and secondary markets was moderate and similar to the results from previous years.
- NBP's hedonic index in all analysed groups of cities (Warsaw, the 6 largest cities[1], 10 other provincial cities[2]) showed a moderate price increase in the secondary market in the first three quarters of 2017. The fastest growth was recorded in the 6 largest cities (6.9%), and the slowest growth was recorded in Warsaw (1.1%). According to the NBP data, the prices of units sold in the Q3 2017 on the primary market, compared to the situation from the analogous quarter of 2016, also increased, and the scale of increases was similar to the secondary market, i.e. from 1.6% in Warsaw to 6.9% in the 6 largest cities.

[1] Wrocław, Gdańsk, Gdynia, Kraków, Łódź, Poznań

[2] Białystok, Bydgoszcz, Katowice, Kielce, Lublin, Olsztyn, Opole, Rzeszów, Szczecin, Zielona Góra

- According to GUS data, 2017 was another year of growth in the number of units completed, units the construction of which began and apartments for which construction permits were issued. In 2017, 178,258 units were completed or 9% more year on year. An even greater increase was recorded for the earlier stages of construction projects: 205,990 units whose construction began (up by 18% compared to 2016) and 250,218 units for which construction permits were issued (up by 18% compared to 2016).
- According to data on the developer market from REAS, on the six markets with the highest turnover (Warsaw, Kraków, Wrocław, the Gdańsk-Gdynia-Sopot Tricity, Poznań and Łódź) 2017 was record breaking in terms of the number of new flats sold by developers. 67.3 thousand flats were offered for sale in 2017 (compared to 65 thousand in 2016 and 52 thousand in 2015), and 72.7 thousand flats were bought (compared to 62 thousand in 2016 and 52 thousand in 2015). As a result of very good sales results, the volume of the offer, i.e. the number of units on sale, dropped from 52.7 thousand at the end of 2016 to 48.2 thousand at the end of 2017. The drop in the number of units on offer at the end of the year occurred for the first time since 2013.
- According to NBP data, in Q3 2017 the average availability of units in large cities decreased slightly compared to the previous quarter (0.84 sq. m, as compared to 0.88 sq. m in Q2 2017). The current housing availability indicator is 0.35 sq. m higher than the minimum level recorded in Q3 2007.
- The demand for flats generated by the Flats for Young People (MdM) scheme comes to an end. The funds planned for payments in 2017 were exhausted and the limit for 2018 had been used up in 50% by August 2017. Funds for 2018 were fully allocated in the first days of January 2018, and the scheme's continuation in the following years is not planned.
- According to data published by the National Bank of Poland, the estimated share of cash purchases of flats in the primary market in 7 largest cities was 65% in Q3 2017. Over the last year it fluctuated between 63% and 70%, with an upward trend observed since Q1 2013.

Residential lending market

- According to NBP data, banks' receivables from housing loans in Poland as at 31 December 2017 stood at PLN 388.0 billion, down by 1.0% year on year. Of that amount, loans denominated in PLN accounted for 66% (a 7 p.p. increase compared to 31 December 2016).
- The total volume of mortgage loans in relation to gross domestic product at market prices stood at 21.4% at the end of December 2016. That is significantly lower than the average for European Union countries, which according to 2016 data was close to 47,1%. This indicates great potential for further development of the housing loan market in Poland.
- The value of new housing loans in the first three quarters of 2017 stood at PLN 33.6 billion, up 13.2% year on year.

Covered bond market

- As at the date of this Report, three mortgage banks were operating in Poland, namely PKO Bank Hipoteczny SA, mBank Hipoteczny SA and Pekao Bank Hipoteczny SA.
- The Polish covered bond market is relatively small, and characterised by moderate liquidity. At the end of December 2017, the total value of outstanding covered bonds issued by Polish mortgage banks stood at about PLN 16.5 billion and was by PLN 6.7 billion higher than at the end of 2016. As at 31 December 2017, outstanding covered bonds issued by Polish banks accounted for 4.2% of the volume of mortgage loans granted by banks. For comparison, in 2016 this ratio was around 15.6% in Germany and around 37.4% in the Czech Republic.

- PKO Bank Hipoteczny SA is largest issuer of mortgage covered bonds in Poland. As at 31 December 2017, the volume of outstanding mortgage covered bonds issued by PKO Bank Hipoteczny SA stood at PLN 8.9 billion, which accounted for approx. 54% of the total volume of outstanding covered bonds issued by Polish mortgage banks. For mBank Hipoteczny SA and Pekao Bank Hipoteczny SA, this amount was PLN 6.4 billion and PLN 1.2 billion, respectively, as per issued reports.
- On 1 January 2016, an amendment to the Polish Covered Bonds Act and other regulations became effective. The changes in the regulations removed barriers to investment in covered bonds issued by Polish banks for both domestic and foreign investors. The amendments also introduced mechanisms and requirements concerning covered bonds and mortgage banks, which increase the safety of covered bonds from the investor's point of view. The amendments allowed banks to achieve a higher proportion of residential mortgage loans refinanced with covered bonds than before. The changes in the laws regulating the covered-bond market and the operations of mortgage banks had a positive influence on the size and liquidity of Poland's covered-bond market.

3. FINANCIAL PERFORMANCE

Basic financial indicators for PKO Bank Hipoteczny SA

	31/12/2017	31/12/2016
Total assets (million PLN)	16,902.6	8,610.4
ROA[3]	0.4%	0.3%
ROE[4]	5.3%	2.5%
Capital adequacy ratio	15.2%	17.1%
Leverage ratio	6.9%	8.8%
Cost to income ratio (C/I)[5]	27.8%	59.1%

The balance sheet of PKO Bank Hipoteczny SA

million PLN	31/12/2017	31/12/2016
Cash and balances with the central bank	0.6	16.0
Amounts due from banks	5.4	13.0
Financial derivative instruments	0.3	27.8
Net loans and advances to customers	16,042.5	8,247.9
Securities	830.5	283.0
Other assets	23.3	22.7
TOTAL ASSETS	**16,902.6**	**8,610.4**
Line of credit liabilities	1,627.5	393.8
Amounts due to PKO Bank Polski SA for purchased receivables	2,497.9	3,038.0
Mortgage covered bonds issued	8,883.2	3,232.1
Unsecured bonds issued	2,428.0	1,151.2
Financial derivative instruments	217.8	0.1
Other liabilities	26.4	13.9
Equity	1,221.8	781.3
TOTAL LIABILITIES AND EQUITY	**16,902.6**	**8,610.4**

[3] Annualised ratio expressed as the quotient of profit (loss) for the year and the average level of assets at the beginning and at the end of the reporting period and intermediate monthly periods
[4] Annualised ratio calculated by dividing the profit (loss) after tax by the average level of equity at the beginning and at the end of the reporting period and intermediate monthly periods
[5] Annualized ratio excluding tax on certain financial institutions

Total assets of PKO Bank Hipoteczny SA as at 31 December 2017 stood at PLN 16,902.6 million, up by 96% compared to the end of 2016. Mortgage loans were the key item on the assets side of the Bank's balance sheet. Their carrying amount, including impairment write-downs as at 31 December 2017, was PLN 16,042.5 million, of which new loans amounted to PLN 5,249.2 million, whereas loans purchased from PKO Bank Polski SA amounted to PLN 10,793.3 million.

On the equity and liabilities side, the share of covered bonds rose significantly and reached 53% of total assets at the end of December 2017. In 2017, PKO Bank Hipoteczny SA conducted:

a) two benchmark issues of EUR-denominated covered bonds of EUR 500 million each,
b) two benchmark issues of PLN-denominated covered bonds of PLN 500 million each,
c) an issue of PLN-denominated covered bonds of PLN 265 million,
d) two issues of EUR-denominated covered bonds, by way of a private placement, of EUR 25 million and EUR 54 million,

Consequently, the carrying amount of covered bonds at the end of December 2017 was PLN 8,883.2 million.

Financial liabilities to PKO Bank Polski SA in the form of revolving line of credit and liabilities arising from the acquisition of loan receivables were significant items in the Bank's equity and liabilities as at 31 December 2017. The total amount of these liabilities was PLN 3,975.4 million. Short-term bonds issued by the Bank were also a significant source of funding the Bank's operations. Their total amount as at 31 December 2017 stood at PLN 2,428.0 million.

In 2017, PKO Bank Polski SA subscribed for a total of PLN 400 million worth of new shares in PKO Bank Hipoteczny. As a result of this capital increase, the equity of PKO Bank Hipoteczny SA increased to PLN 1,221.8 million.

Profit and loss account of PKO Bank Hipoteczny SA

million PLN	01/01/2017 - 31/12/2017	01/01/2016 – 31/12/2016
Net interest income	151.2	63.6
Net fee and commission income	(4.6)	(3.6)
Net income from financial instruments measured at fair value	(0.3)	0.0
Net foreign exchange gains	1.0	(0.8)
Other operating income and expenses	0.0	0.0
Impairment allowance and write-downs	(3.3)	(1.6)
General administrative expenses	(41.0)	(35.0)
Tax on certain financial institutions	(31.7)	(4.3)
Operating result	**71.4**	**18.3**
Profit / (Loss) before income tax	71.4	18.3
Income tax expense	(20.0)	(5.1)
Net profit / (loss)	**51.4**	**13.2**

PKO Bank Hipoteczny SA ended 2017 with a profit for the year of PLN 51.4 million, which means an increase of PLN 38.2 million year on year. The most significant driver of the positive financial result was the improvement in net interest income as a result of the significant expansion in the scale of the Bank's operations, coupled with limited growth in the cost base.

In the analysed period the Bank generated interest income of PLN 410.5 million, comprising primarily income from mortgage loans in the amount of PLN 399.5 million, and income from securities. During this time, the Bank incurred interest expense of PLN 259.3 million. Interest expense resulted mainly from issued covered bonds (including costs of hedging transactions). The related interest expenses amounted to PLN 151.2 million. The Bank also incurred interest expense of PLN 27.8 million on account of revolving lines of credit, interest expense of PLN 40.5 million on account of the liability arising from the purchase of receivables from PKO Bank Polski SA, and interest expense of PLN 39.8 million on account of bonds issued.

In 2017, the Bank incurred a negative net fee and commission income of PLN -4.6 million. This item comprised, inter alia, costs of expert valuations of the mortgage lending value of real estate (MLV), as prepared by real estate appraisers, in the amount of PLN 7.6 million, as well as income from clients for real estate valuations performed by the Bank, in the amount of PLN 5.1 million.

In 2017, the Bank incurred administrative expenses of PLN 41.0 million. The costs of materials in the amount of PLN 20.6 million, including costs related to services rendered by PKO Bank Polski SA in the amount of PLN 13.5 million under an outsourcing agreement, were a significant item in the structure of administrative expenses. Costs of employee benefits, whose amount during the reporting period reached PLN 16.1 million, were another significant item in the structure of administrative expenses. The increase in administrative expenses in comparison to 2016 was caused mainly by an increase in costs of services provided by PKO Bank Polski SA (+ PLN 5.9 million), which resulted from a 95% increase in the volume of the loan portfolio in the Bank's balance sheet.

The tax on certain financial institutions, which amounted to PLN 31.7 million in the reporting period, was a significant expense of the Bank's activities.

Thanks to a faster growth of income than the growth of costs, the Bank reported an improvement in the annualized C/I ratio, which amounted to 27.8% for 2017 (excluding tax on certain financial institutions).

The Bank's net impairment write-down and provision income in 2017 stood at PLN -3.3 million, including provisions for incurred but not reported (IBNR) loss in the amount of PLN -2.5 million.

4. OPERATIONS AND DEVELOPMENT DIRECTIONS OF PKO BANK HIPOTECZNY SA

Sale of residential mortgages under the agency model

PKO Bank Hipoteczny SA has been granting mortgage loans for residential purposes in PLN since 1 April 2015. The issuance of new residential loans is conducted based on the agency model, through Poland's largest network of branches, agents and intermediaries, which is organised by PKO Bank Polski SA. As a loan collateral, the Bank accepts flats and single-family houses.

In 2017, the Bank granted PLN 3,139.4 million worth of mortgage loans, which means an increase of 25.7% compared to 2016.

In accordance with the provisions of Recommendation S of the Polish Financial Supervision Authority, in 2017 the Bank granted only loans for which the loan to real estate market value ratio did not exceed 80%; where a low down payment insurance policy was used, the Bank could grant a loan for which this ratio is not higher than 90%.

Additionally, in compliance with the Polish Covered Bonds Act, 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 by mortgages.

Criterion	Agency model
Loan value / market value of the real estate	max. 80%[6]
Loan value / mortgage lending value of the real estate	100%
Legal form of real estate	Ownership or perpetual usufruct
Loan collateral	Mortgage recorded in Position No 1 in section IV of the Land and Mortgage register
Currency	PLN
Designation	Residential purposes

Acquisition of receivables under residential mortgage loans

In addition to the sale of new residential mortgage loans, PKO Bank Hipoteczny SA also acquires receivables on such loans granted by PKO Bank Polski SA (the pooling model).

On 17 November 2015, PKO Bank Hipoteczny SA signed a receivables sale framework agreement with PKO Bank Polski SA. Under this agreement, in 2017 PKO Bank Hipoteczny SA acquired from PKO Bank Polski SA a portfolio of receivables arising from residential mortgage loans with a total amount of PLN 5,550.8 million, which means a 149% increase compared to 2016. The following table shows the main criteria applied by PKO Bank Hipoteczny SA in the process of acquiring loans secured by mortgages (the pooling model, which is based on PKO Bank Hipoteczny SA acquiring receivables on mortgage loans from PKO Bank Polski SA).

Criterion	Pooling model
Loan value / mortgage lending value of the real estate	100%
Legal form of real estate	Ownership or perpetual usufruct
Loan collateral	Mortgage recorded in Position No 1 in section IV of the Land and Mortgage

[6] Where a low down payment insurance policy is used, the Bank may grant a loan for which this ratio is not higher than 90%.

	register
Currency	PLN
Days past due or impairment indicators	None
Designation	Residential purposes

Structure of the residential mortgage loan portfolio

The structure of the portfolio of gross loans on the balance sheet of PKO Bank Hipoteczny SA according to the LtV ratio at market value[7] and LtV at the mortgage lending value of property is presented in the following tables.

Gross loans at LtV on the marked-to-market basis	31/12/2017	31/12/2016
below 50%	28%	31%
51% – 60%	16%	17%
61% – 70%	21%	19%
71% – 80%	23%	23%
80% – 90%	12%	10%
above 90%	0%	0%
Total	**100%**	**100%**
Average LtV based on market valuation	60.3%	60.0%

Gross loans by LtV at MLV	31/12/2017	31/12/2016
below 50%	15%	18%
51% – 60%	10%	12%
61% – 70%	13%	14%
71% – 80%	18%	16%
80% – 90%	22%	19%
above 90%	22%	21%
Total	**100%**	**100%**
Average LtV based on MLV	72.5%	71.3%

Covered bonds

The main purpose of PKO Bank Hipoteczny SA is the issuance of covered bonds, which are to serve as the main source of long-term financing for loans secured by real estate.

Domestic issuance of covered bonds

On 28 April 2017, PKO Bank Hipoteczny SA conducted a third benchmark PLN-denominated issue of Series 4 mortgage covered bonds. The bank offered PLN 500 million of securities to institutional investors. During the book-building process, the spread on the Series 4 covered bonds was set at 0.69 % above WIBOR 3M. During the process, investors expressed interest in purchasing bonds for a total amount of PLN 645.5 million. The period from the date of issue to redemption of covered bonds was set at 5 years plus 20 days, and the maturity date was set at 18 May 2022.

[7] The current LTV level, based on the value of the real estate at the moment the loan is issued, updated using statistical methods on the basis of analysis of the real estate market.

The Series 4 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the Bondspot OTC market on 15 May 2017. Since 26 May 2017, they have also been accepted in repo transactions with the National Bank of Poland.

On 22 June 2017, PKO Bank Hipoteczny carried out its pilot issue of PLN-denominated fixed rate mortgage covered bonds. The Bank offered PLN 265 million of securities to institutional investors. At the time of book-building, the interest rate on covered bonds was set at 2.69%. The period from the date of issue to redemption of covered bonds was set at 4 years plus 3 months, and the maturity date was set at 10 September 2021.

The Series 5 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the Bondspot OTC market on 6 July 2017. Since 11 July 2017, they have also been accepted in repo transactions with the National Bank of Poland.

On 27 October 2017 PKO Bank Hipoteczny SA conducted the fourth benchmark PLN-denominated issue of series 6 mortgage covered bonds and at the same time the first one in the firm commitment underwriting procedure. The bank offered PLN 500 million of securities to institutional investors. During the book-building process, the spread on the series 6 covered bonds was set at 0.60% above WIBOR 3M. The period from the date of issue to redemption of covered bonds was set at 5 years plus 243 days, and the maturity date was set at 27 June 2023.

The Series 6 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 November 2017. Since 29 November 2017, they have also been accepted in repo transactions with the National Bank of Poland.

Chart: Purchasers of domestic issues of PKO Bank Hipoteczny SA's covered bonds in 2015-2017

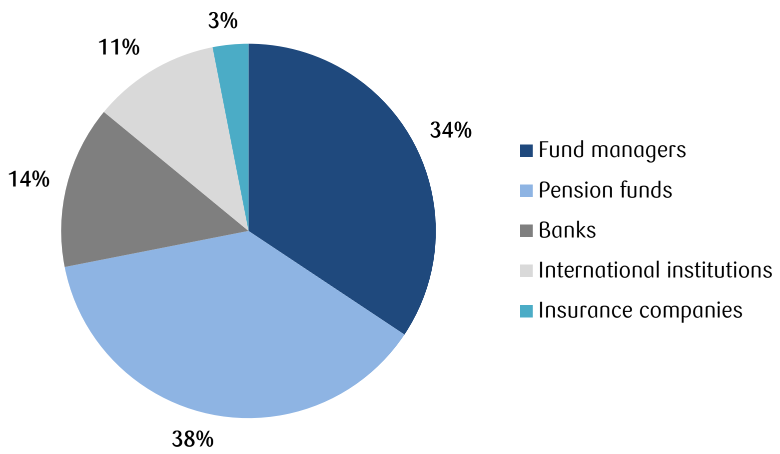


Chart: Geographical distribution of purchasers of domestic issues of PKO Bank Hipoteczny SA's covered bonds in 2015-2017

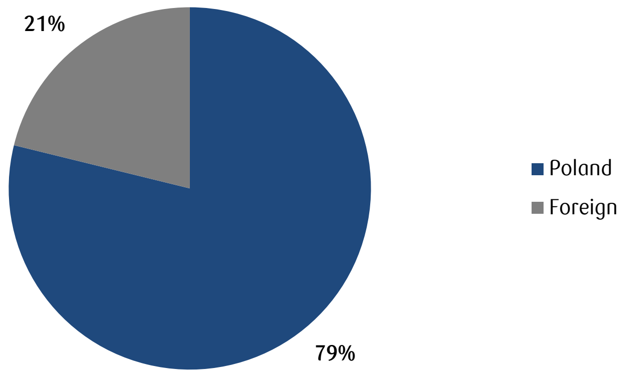


Table: PLN-denominated issues of mortgage covered bonds by PKO Bank Hipoteczny SA by 31 December 2017

Series	Covered bond number (ISIN)	Issuance date	Maturity date	Value (PLN)	Interest	Currency	Rating	Listing
1	PLPKOHP00017	11/12/2015	11/12/2020	30 000 000	WIBOR3M+ 0.75%	PLN	Aa3	Bondspot, WSE parallel market
2	PLPKOHP00025	27/04/2016	28/04/2021	500 000 000	WIBOR3M+ 0.65%	PLN	Aa3	Bondspot, WSE parallel market
3	PLPKOHP00033	17/06/2016	18/06/2021	500 000 000	WIBOR3M+ 0.59%	PLN	Aa3	Bondspot, WSE parallel market
4	PLPKOHP00041	28/04/2017	18/05/2022	500 000 000	WIBOR3M +0.69%	PLN	Aa3	Bondspot, parallel market Warsaw Stock Exchange
5	PLPKOHP00058	22/06/2017	10/09/2021	265 000 000	2.69%	PLN	Aa3	Bondspot, parallel market Warsaw Stock Exchange
6	PLPKOHP00066	27/10/2017	27/06/2023	500 000 000	WIBOR3M +0.60%	PLN	Aa3	Bondspot, parallel market Warsaw Stock Exchange

Poland
Foreign countries

International issuance of covered bonds

On 2 February 2017, PKO Bank Hipoteczny carried out its pilot issue of EUR-denominated mortgage covered bonds by way of series 2 private placement. The Bank offered EUR 25 million worth of instruments based on a fixed interest rate of 0.82% p.a. to institutional investors. The period from the date of issue to redemption of covered bonds was set at 7 years, and the maturity date was set for 2 February 2024.

PKO Bank Hipoteczny SA's euro-denominated Series 2 covered bonds were placed on the Luxembourg Stock Exchange on 2 February 2017. Since 2 February 2017 they have also been accepted in repo transactions with the European Central Bank.

On 30 march 2017, PKO Bank Hipoteczny SA carried out its second benchmark issue of EUR-denominated covered bonds. The issue was preceded by a series of meetings with European investors, in which representatives of the PKO Bank Polski SA Group took part. The Bank offered EUR 500 million worth of series 3 fixed interest rate-based securities to institutional investors. During the book-building process, the yield was set at 0.63% (whereas the coupon at 0.625%). During the process, investors expressed interest in purchasing bonds for a total of EUR 800 million. The period from the date of issue to redemption of covered bonds was set at 5 years plus 10 months, and the maturity date was set at 24 January 2023.

Series 3 EUR-denominated covered bonds of PKO Bank Hipoteczny SA were placed on the Luxembourg Stock Exchange and the Warsaw Stock Exchange (parallel market) on 30 March and 15 May 2017, respectively. Since 30 March 2017 they have also been accepted in repo transactions with the European Central Bank.

On 27 September 2017, PKO Bank Hipoteczny SA carried out its third benchmark issue of series 4 EUR-denominated covered bonds. The issue was preceded by a series of meetings with European investors, in which representatives of the PKO Bank Polski SA Group took part. The Bank offered EUR 500 million worth of fixed interest rate-based instruments to institutional investors. During the book-building process, the yield was set at 0.764% (whereas the coupon at 0.75%). During the process, investors expressed interest in purchasing bonds for a total of EUR 1 400 million. The period from the date of issue to redemption of covered bonds was set at 6 years plus 11 months, and the maturity date was set at 27 August 2024.

Series 4 EUR-denominated covered bonds of PKO Bank Hipoteczny SA were placed on the Luxembourg Stock Exchange and the Warsaw Stock Exchange (parallel market) on 27 September and 18 October 2017, respectively. Since 27 September 2017 they have also been accepted in repo transactions with the European Central Bank.

On 2 November 2017, PKO Bank Hipoteczny carried out its second issue of EUR-denominated mortgage covered bonds by way of *series 5* private placement. The Bank offered EUR 54 million worth of instruments based on a fixed interest rate of 0.467% p.a. to institutional investors. The period from the date of issue to redemption of covered bonds was set at 5 years and 1 day, and the maturity date was set for 3 November 2022.

Series 5 EUR-denominated covered bonds of PKO Bank Hipoteczny SA were placed on the Luxembourg Stock Exchange on 8 November 2017. Since 8 November 2017 they have also been accepted in repo transactions with the European Central Bank.

Chart: Purchasers of EUR-denominated covered bonds of PKO Bank Hipoteczny in the years 2016-2017

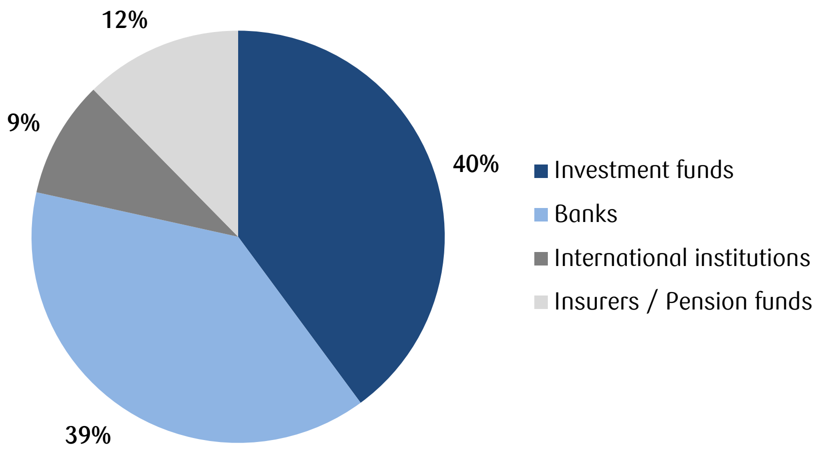


Chart: Geographical distribution of purchasers of EUR-denominated covered bonds of PKO Bank Hipoteczny in 2016-2017

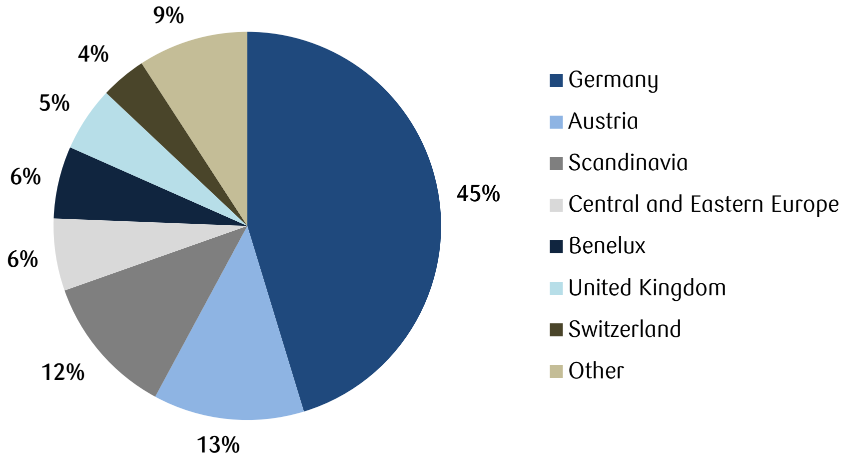


Table: EUR-denominated issues of mortgage covered bonds by PKO Bank Hipoteczny SA by 31 December 2017.

Series	Covered bond number (ISIN)	Issuance date	Maturity date	Value (EUR)	Coupon	Price	Currency	Rating	Listing
1	XS1508351357	24/10/2016	24/06/2022	500 000 000	0.125%	99.702%	EUR	Aa3	LuxSE, WSE parallel market
2	XS1559882821	02/02/2017	02/02/2024	25 000 000	0.82%	100.00%	EUR	Aa3	LuxSE
3	XS1588411188	30/03/2017	24/01/2023	500 000 000	0.625%	99.972%	EUR	Aa3	LuxSE, WSE parallel market
4	XS1690669574	27/09/2017	27/08/2024	500 000 000	0.75%	99.906%	EUR	Aa3	LuxSE, WSE parallel market
5	XS1709552696	02/11/2017	03/11/2022	54 000 000	0.467%	100.00%	EUR	Aa3	LuxSE

The funds raised from the issues of covered bonds have been used by PKO Bank Hipoteczny SA to grant housing loans secured by mortgages and to acquire receivables on 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 label, the purpose of which is to highlight the security and quality of covered bonds to investors and to further enhance recognition of and trust in the covered bond asset class.

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. These ratings were confirmed by Moody's on 19 December 2017.

Rating type	Rating	Outlook
Long-term Counterparty Risk (CR) Assessment	A3(cr)	n/a
Short-term Counterparty Risk (CR) Assessment	P-2(cr)	n/a
Long-term issuer rating	Baa1	Stable
Short-term issuer rating	P-2	n/a

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

Rating type	Rating	Date of initial rating	Rating confirmation date
Mortgage bonds denominated in PLN	Aa3	08/09/2015	12/12/2015
Mortgage 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 country ceiling for debt instruments, which currently is at the level of Aa3.

Short-term bonds

On 30 September 2015, PKO Bank Hipoteczny SA established a non-public short-term bond issue programme. In 2017, the Bank issued a total of PLN 6,188.8 million worth of bonds under that programme. The balance of issued bonds as at 31 December 2017 was PLN 2,428.0 million.

Financial-market operations

PKO Bank Hipoteczny SA executes treasury transactions on the wholesale financial market. The purpose of the transactions is managing 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 related to fluctuations in currency rates.

For the purpose of financing operations related to the granting of mortgage loans and the acquisition of receivables under mortgage loans granted by PKO Bank Polski SA, PKO Bank Hipoteczny SA issues mortgage covered bonds and unsecured short-term bonds, and takes out lines of credit and liabilities related to purchased receivables. Still, in accordance with the Polish Covered Bonds Act, the level of liabilities arising from taking out loans (including liabilities under acquired receivables) and issuing bonds cannot exceed in total 10 times the Bank's own funds during the first five years of operations or 6 times the Bank's own funds after this period.

In the Management Board's opinion, as at 31 December 2017 there were no factors that could indicate a risk of delay in payment of liabilities incurred by the Bank. In 2017, the Bank did not breach any of the liquidity limits. Detailed information on the levels of the Bank's liquidity limits is provided in Note 41 to the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2017.

As far as the issue of covered bonds in EUR 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 the Polish zloty based on a variable interest rate, and receives a coupon based on a fixed rate for EUR. If a court declares PKO Bank Hipoteczny SA bankrupt, the CIRS transactions would automatically be extended by 12 months on the terms set on the transaction date and indicated in the Final Terms of issue of mortgage covered bonds. Additionally, the Bank has executed a series of forward contracts, which constitute a hedge of currency exposure with maturity on the payment dates of the coupons on the EUR-denominated covered bonds.

When issuing fixed interest covered bonds in PLN, the Bank entered into IRS transactions to hedge interest rate risk. In the IRS transaction, 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 a regular issuer of covered bonds on both the domestic and the international markets. The Bank also intends to continue seeking short-term financing in the form of short-term bond issues. Potential issues of covered bonds in convertible currencies will involve the need to enter into financial risk mitigating transactions on the interbank market.

The development directions of PKO Bank Hipoteczny SA:

The strategy adopted by PKO Bank Hipoteczny SA calls for:

- diversification of financing sources by obtaining long-term financing in the form of covered bonds designated for real-estate lending,
- achieving and maintaining the position of leader on the Polish market for covered bond issuance while maintaining their high level of safety,
- creating a centre of competence within the PKO Bank Polski SA Group in the area of mortgage loans and real-estate valuation, with the optimal use of PKO Bank Polski SA's assets, for the purpose of achieving synergies within the PKO Bank Polski SA Group.

5. INTERNAL OPERATING CONDITIONS

Qualified leadership

The Bank implements mechanisms and procedures to guarantee that managers employed in the Bank have the highest qualifications in key business areas. The Bank systematically increases the qualifications of its employees, and makes efforts to ensure the stability of the management. These factors have an important influence on the execution of the Bank's strategy and business goals and, which follows, on its operations and financial results.

The lending process and the relationship with PKO Bank Polski SA

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

- the agency model,
- the pooling model.

The relationship with PKO Bank Polski SA is regulated in detail by an outsourcing agreement concluded 16 January 2015 between the two entities. The agreement regulates the scope of the relationship and describes in detail the method of performing the outsourced functions, first and foremost in the area of offering and administering mortgage loans and performing functions supporting PKO Bank Hipoteczny SA. Additionally, 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 for the benefit of 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 acquired portfolios of receivables under 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 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 the suitable financial support.

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:

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

The internal control system in the Bank includes:

- the control function designed to ensure compliance with controls relating to, in particular, risk management; this function covers all of the Bank's and the Head Office's organizational units which are responsible for carrying out the tasks assigned to this function,

- the compliance unit, which, in cooperation with the Bank's and the Head Office's organizational units, is responsible for the identifying, assessing, controlling and monitoring the risk of the Bank's compliance with 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,
- an independent internal audit unit to evaluate and assess, independently and objectively, the adequacy and effectiveness of the risk management system and the internal control system, except for the aspects relating to the internal audit unit itself.

The internal control system is organized 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) comprises the activities of the compliance unit as well as identification, measurement or estimation, control, monitoring and reporting of risks material to the Bank, as well as identified threats and irregularities; these tasks are carried out by specialized organizational structures operating under applicable principles, 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 the efficiency of operations,
- the third line is the internal audit, which performs independent audits of the elements of the Bank's management system, including the risk management system and the internal control system. The internal audit functions separately from, and can support the activities carried out by, the first and second level. The support involves consultations without affecting the decisions made.

The Bank's Management Board ensures the continuity of the internal control system's operations and the proper cooperation of all organisational units under the implemented internal control system. The Management Board also identifies the 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 adopts 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 functioning 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 the compliance unit, the internal audit unit 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.

The internal audit unit and the compliance unit within the competence of the President of the Management Board. The heads of these units report directly to the President of the Bank's Management Board.

The Internal Audit Unit is responsible for performing the following tasks:

- preparing and updating the Bank's internal rules for the functioning of the internal control system and detailed rules of conducting internal audits at the Bank,
- preparing proposals for annual and three-year (strategic) internal audit plans and submitting them for approval,

- preparing the rules of functioning of the internal audit unit, including at least the purpose, scope and detailed rules of functioning of the internal audit unit,
- conducting audits based on the rules of functioning of the internal audit unit as well as audit internal procedures and methodologies for auditing adequacy and effectiveness of the risk management system and the internal control system in the Bank's all operations, including risk controls and controls,
- conducting audits in accordance with the scope and frequency specified in the audit plans, as adapted to the identified risk areas and the respective materiality levels,
- conducting audits in accordance with the scope and frequency specified in the external laws and oversight regulations,
- documenting audits appropriately,
- checking the effectiveness of implementation of audit recommendations issued by the internal audit unit,
- evaluating, annually, independently and in an objective way, the adequacy and effectiveness of the internal control system and the risk management system;
- forwarding, on a periodic basis, reports to the Bank's Management Board, the Audit and Finance Committee and the Supervisory Board regarding audit plans, the results of audits conducted and the status of implementation of audit recommendations.

The Compliance Unit is responsible for performing the following tasks:

- designing the Bank's internal regulations in the area of compliance risk management at the Bank, as well as information security, personal and property protection, anti-money laundering and business continuity,
- designing compliance risk controls, monitoring the implementation of, and compliance with, such mechanisms,
- analyzing laws, market standards, announcements by financial supervision bodies and other public administration bodies to identify issues requiring the adaptation measures to be taken by the Bank,
- coordinating and performing the tasks of identification, assessment, control and monitoring of compliance risk,
- coordinating the cooperation with external supervisory and control bodies, e.g. coordinating and monitoring the implementation of recommendations issued after audits conducted at the Bank by these bodies,
- preparing quarterly reports on compliance risk, anti-money laundering and combating the financing of terrorism and personal data protection,
- performing compliance tests in selected areas related to the special character of mortgage bank operations,
- formulating recommendations regarding compliance risk management in the Bank and monitoring their implementation, advising on compliance regulations and standards, managing compliance risk,
- reviewing drafts of internal regulations on compliance issues (including concepts of new products) as well as information, advertising and marketing materials directed to clients and investors,
- developing the conceptual framework for training on compliance issues,
- taking measures related to anti-money laundering and combating the financing of terrorism,
- examining breaches of security regulations (excluding breaches of the Bank's IT security), determining the perpetrators of such breaches and taking actions aimed at removing their consequences,
- shaping and monitoring the functioning of system solutions for the control function in relation to processes other than those considered material for the needs of the internal control system,

- reviewing independently, through on-going verification and testing, the implementation of, and compliance with, controls.

The bank has the following mechanisms in place to ensure independence of its internal audit unit and compliance unit:

- The Management Board and the Supervisory Board approve the rules of procedure governing the functioning of the compliance unit and the internal audit unit,
- the heads of the internal audit unit and of the compliance unit may contact the members of the Management Board and of the Supervisory Board directly,
- the heads of the internal audit unit and of the compliance unit, or their substitutes, participate in the meetings of the Management Board,
- the heads of the internal audit unit and of the compliance unit, or their substitutes, participate in the meetings of the Supervisory Board and the Audit and Finance Committee when a meeting concerns issues related to the internal control system, including compliance assurance, internal audit or risk management;
- the head of the internal audit unit or of the compliance unit is appointed or dismissed (after being given a fair hearing) with the consent of the Supervisory Board,
- the Bank has a detailed procedure of controlling the remuneration of employees of the internal audit unit and of the compliance unit to ensure their independence and objectivity in performing tasks and to hire people with suitable qualifications, experience and skills,
- there are mechanisms in place at the Bank that protect the employees of the internal audit unit and of the compliance unit against unjustified termination of their employment contracts,
- when the head of the internal audit unit or of the compliance unit changes, the Bank immediately informs the Polish Financial Supervision Authority (KNF) and provides the reason for the change,
- the internal audit unit cannot be combined with other organizational units, functions or positions in the Bank, and the employees of that unit cannot perform other duties than those resulting from the unit's tasks,
- the compliance unit cannot be combined with other organizational units, functions or positions in the Bank, and the employees of that unit cannot perform other duties than those resulting from the unit's tasks,

The annual assessment of the adequacy and effectiveness of the internal control system is performed by the Supervisory Board based on obtained management reports, information from the Bank's Management Board, Audit and Finance Committee, compliance unit and annual information of the internal audit unit on the effectiveness and adequacy of the internal control system and of the risk management system.

An independent and objective evaluation of the adequacy and effectiveness of the internal control system and the risk management system by the internal audit unit comprises the assessment of all aspects of the Bank's functioning in relation to:

- the internal control environment, namely people performing specific tasks and their readiness and motivation,
- setting strategic, operational, reporting and compliance goals,
- identifying positive and negative internal and external events affecting the achievement of goals,
- risk assessment in terms of analysis and probability of risk occurrence, risk factors, their degree and negative impact on the performance of tasks, and the effects they may cause,
- response to risk (risk avoidance, acceptance, mitigation, sharing) which involves designing measures aimed at linking risk with its acceptable level,

- control activities provided for in policies and procedures and implemented to effectively respond to risks,
- information and communication by assessing whether the information provided is sufficient for the effective operation of the internal control system and for the monitoring of internal control in order to continuously improve their effectiveness.

The assessment performed by the internal audit unit concerns the operation of the first and second line of defence and includes in particular:
- opinions issued in the reporting period by the Polish Financial Supervision Authority and by an external auditor regarding the adequacy and effectiveness of internal control and risk management systems;
- assessment of control and risk management measures taken as part of the first and second line of defence on the basis of:
    a. the results of audits carried out and corrections and improvements made,
    b. expert evaluation of processes as part of updating the internal audit risk map,
    c. adaptation of internal control and risk management systems to the specific nature and scale of the Bank's operations and the risk assumed,
    d. analyzing the results of KRI monitoring and of compliance with limits,
    e. whether internal procedures are up to date, sufficient, complied with and consistent with laws,
    f. corrective and management measures taken in response to detected weaknesses of internal control and risk management systems,
    g. identified cases where one person combines back, front, middle office, control or risk management functions and assessing whether the reporting line is appropriate from the risk monitoring point of view,
    h. assessment of corporate governance,
    i. the impact of the internal control systems of entities to which the Bank outsourced the performance of banking or actual activities on the internal control system,
    j. reliability and consistency of its the internal and external financial reporting.

In 2017, the reporting under the internal control system and the remedial actions taken indicated that the internal control system in PKO Bank Hipoteczny SA was effective and adequate to the scale of the Bank's operations.

Risk management

The risk management process is a key process in PKO Bank Hipoteczny SA. Its purpose is to ensure, in a changing macroeconomic and legal environment, control of the risk level, 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

Risk type	Significance
Credit risk – the risk of losses due to a client defaulting on his liabilities to the Bank as a result of deterioration of the client's ability to service the liabilities or the risk of a decrease in the economic amount of the Bank's receivables.	material
Concentration risk – a threat arising from the excessive concentration arising from exposures: a) to individual clients, b) to groups of related clients, c) subject to joint or correlated risk factors characterised by the potential to generate losses large enough to threaten the financial condition of the Bank or the ability to conduct basic operations or to lead to a significant change in the Bank's risk profile.	potentially material
Residual risk: the risk arising from lower effectiveness than the one assumed by the Bank in applying credit risk mitigation techniques.	potentially material
Liquidity risk: the risk of inability to pay liabilities in a timely manner as a result of a lack of liquid funds; liquidity risk includes **financing risk**, which is the risk of losing sources of funding, inability to roll over maturing sources of funding or losing access to new sources of funding.	material
Interest rate risk: the risk of losses on balance-sheet items and off-balance-sheet items that are sensitive to fluctuations in interest rates, as a result of fluctuations in market interest rates.	material
Currency risk: the risk of losses on fluctuations in currency rates, generated by maintaining open positions in certain foreign currencies.	potentially material
Business risk, understood also as **strategic risk**: the risk of failure to achieve the assumed financial targets, including the risk of incurring losses, which results from unfavourable changes in the business environment, unfavourable decisions, improper implementation of decisions or failure to take appropriate action in response to changes taking place in the business environment, including in particular strategic risk.	material
Macroeconomic risk: a risk of worsening of the Bank's financial position as a result of an unfavourable influence of changing macroeconomic conditions.	potentially material
Model risk: a risk of losses as a result of erroneous business decisions on the basis of the models in operation.	material
Operational risk: a risk of losses resulting from failure by, or faults in, internal processes, individuals or systems, or from external events, including **legal risk** (the risk of losses arising from lack of familiarity with, misunderstanding of and failure to apply legal norms and accounting standards, the inability to enforce the provisions of agreements, disadvantageous interpretations or decisions by courts or bodies of public administration); and **outsourcing risk** (the risk of losses arising from outsourcing certain activities to third parties); operational risk does not include reputation risk or business risk.	material
Compliance risk: a risk of legal sanctions, financial losses or the loss of reputation as a result of failure by the Bank, Bank employees or entities operating on its behalf to comply with the law, the Bank's internal regulations or the market standards adopted by the Bank.	potentially material
Reputation risk: a risk of deterioration of the Bank's reputation among clients, counterparties, investors, supervisory and control bodies and the public, as a result of business decisions by the Bank, operational events, cases of non-compliance or other events.	potentially material
Capital risk: a risk of failure to ensure the adequate level and structure of own funds or	potentially material

inability to achieve the level adequate to the risk arising from operations conducted by the Bank, as necessary to absorb unexpected losses and meet the regulatory requirement to enable the Bank to continue to function independently; capital risk includes **risk of excessive leverage:** a risk arising from susceptibility to the threat arising from financial leverage or conditional financial leverage, which may require unplanned actions to correct business plans, including emergency asset sale that may bring losses or cause the need for a correction of the measurement of the remaining assets.

The significance of individual types of risk is defined at the level of the Bank. While determining the criteria of considering a certain risk to be significant, an 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.
- potentially material risks, for which a monitoring of materiality is performed,
- other undefined risks or risks that do not exist in the Bank (immaterial or unmonitored).

For potentially material 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 recognised as significant.

In its Risk Management Strategy, the Bank defined a range of strategic limits defining the appetite for particular types of risk. The Bank monitors these limits on an ongoing basis. In 2017, 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 2017 in the chapter "*Risk Management Objectives and Principles*" (Notes 37-50). It also includes important information on the level of financial risk in the Bank's operations and a description of the adopted risk management objectives and methods, together with the methods of hedging significant types of planned transactions for which hedge accounting is applied.

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 acts:

- the Polish Covered Bonds Act,
- 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.

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, will be able to be realised 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:

No.	Stage	Implementation
1	Preparation of the MLV expert opinion	Appraiser with appropriate experience and the ability to estimate bank risk in the area of securing mortgage loans
2	Confirmation of the opinion	PKO Bank Polski SA, under the outsourcing agreement
3	Review of an expert opinion on mortgage lending value of real estate and determining the mortgage lending value of the real estate	A dedicated organisational unit of the Bank: the Collateral Valuation Team at the Loan Office

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

No.	Stage	Implementation
1	Confirmation of the property's legal status	PKO Bank Polski SA, under the Outsourcing Agreement
2	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
3	Preparation of the MLV expert opinion	A dedicated organisational unit of the Bank: the Collateral Valuation Team at the Loan Office
4	Review of the MLV expert opinion and setting of the mortgage lending value of the real estate	A dedicated organisational 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.

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 issuance of 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 can 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 Organisation for Economic Cooperation and Development, excluding countries who are restructuring or have restructured their foreign debt in the past 5 years, and the Polish State Treasury,
- 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 2017 stood at PLN 11,103.7 million. The nominal value of the over-collateralisation in the form of securities issued by the State Treasury stood at PLN 251 million. As at 31 December 2016, these figures were PLN 4,650.4 million and PLN 85 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 zloty-denominated covered bonds issued on a fixed-rate basis.

In 2017 and 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 Polish Covered Bonds Act of 29 August 1997 (Journal of Laws of 2003, No 99, item 919, as amended),
- Resolution No. 633/2015 of the Financial Supervision Authority of 1 December 2015 on establishing the form of a cover pool.
- Recommendation K of the Financial Supervision Authority of 9 February 2016 on the principles for maintenance by mortgage banks of cover pools.

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 2017

	31/12/2017	31/12/2016
Total cover pool, including:	**PLN 11,354.7 million**	**PLN 4,735.4 million**
loans secured by mortgages	*PLN 11,103.7 million*	*PLN 4,650.4 million*
other assets[8]	*PLN 251.0 million*	*PLN 85.0 million*
Liquidity buffer[9]	PLN 50.6 million	PLN 16.1 million
Nominal value of hedging transactions[10]	PLN 6,849.3 million	PLN 2,205.4 million
Number of loans	60,597	25,179
Average loan value	PLN 183.2 thousand	PLN 184.7 thousand
Average weighted time since loan issuance (seasoning)	39.7 months	38.7 months
Average weighted maturity	257.8 months	256.5 months
Average LtV (loan amount to market value)	57.5%	55.9%
Average weighted loan to mortgage lending value of real estate	70.8%	68.7%
Over-collateralisation[11]	25.8%	47.6%

PKO Bank Hipoteczny SA regularly publishes detailed data on the cover pool and the receivables it contains, in the Reports placed on the Bank's website at the address www.pkobh.pl, in the investor relations section.

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 protection of the independence of the monitor and their deputy. Monitors are appointed by the Polish Financial Supervision Authority, upon 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:

No.	Name & surname	Position	Date of appointment	Date of dismissal/resignation
1	Tadeusz Swat	The Cover Pool Monitor	06/03/2015	-
2	Grzegorz Kędzia	Deputy Monitor	06/03/2015	-

[8] Article 18(3) of the *Polish Covered Bonds Act*
[9] Article 18(3a) of the *Polish Covered Bonds Act*
[10] The nominal value of the hedging transaction corresponds to the issue price of the covered bond
[11] It includes the net value of hedging transactions but excludes NPL

Statutory limits

Acting under the Act on covered bonds and mortgage banks, PKO Bank Hipoteczny SA is obliged to monitor and comply with 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 2017 were as follows:

Limit	Legal basis	Limit level		Actual level	
		statutory	internal	31/12/2016	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	Article13(1)	≤30.0%	≤28.0%	16.9%	18.7%
Value of funds received from issuance of mortgage bonds designated for refinancing of 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	Article14	≤100.0%	≤95.0%	72.1%	58.0%
Total value of acquired shares in other entities, in proportion to the Bank's own funds	Article15(1)(5)	≤10.0%	0.0%	0.0%	0.0%
Total value of term deposits accepted, credits and loans taken out and bonds issued, in proportion to the Bank's own funds	Article15(2)	≤1000.0%	≤900.0%	586.5%	548.5%
Total value of term deposits accepted, 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. issuance of loans secured and unsecured by mortgages, receivables acquired from other banks on loans granted by them and secured or unsecured by mortgages	Article15(3)	≤100.0%	≤95.0%	55.6%	41.0%
Total nominal value of covered bonds outstanding, in proportion to the Bank's own funds and general risk provision	Article17	≤4000.0%	≤3600.0%	415.7%	743.1%
Total nominal value of receivables secured by mortgages and value of rights and additional funds constituting the basis for issuance of mortgage covered bonds, in proportion to the total value of outstanding mortgage covered bonds (taking into account hedging instruments)	Article18(1)	≥110.0%	≥112.0%	147.6%	125.8%
Total nominal value of receivables secured by mortgages constituting the basis for issuance of mortgage covered bonds, in proportion to the total nominal value of mortgage covered bonds outstanding	Article18(1)	≥85.0%	≥90.0%	143.4%	125.0%
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	Article18(2)	≤100.0%	≤90.0%	23.7%	61.6%

funds constituting the basis for the issuance of mortgage covered bonds (cumulative from the beginning of the financial year and on any given day), taking into account hedging instruments					
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	Article18(3a)	≥100.0%	≥110.0%	118.1%	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 the issuance of mortgage covered bonds	first sentence of Article23(1)	≤10.0%	≤9.0%	2.6%	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 the issuance of mortgage covered bonds	second sentence of Article23(1)	≤10.0%	≤9.0%	0.0%	0.0%

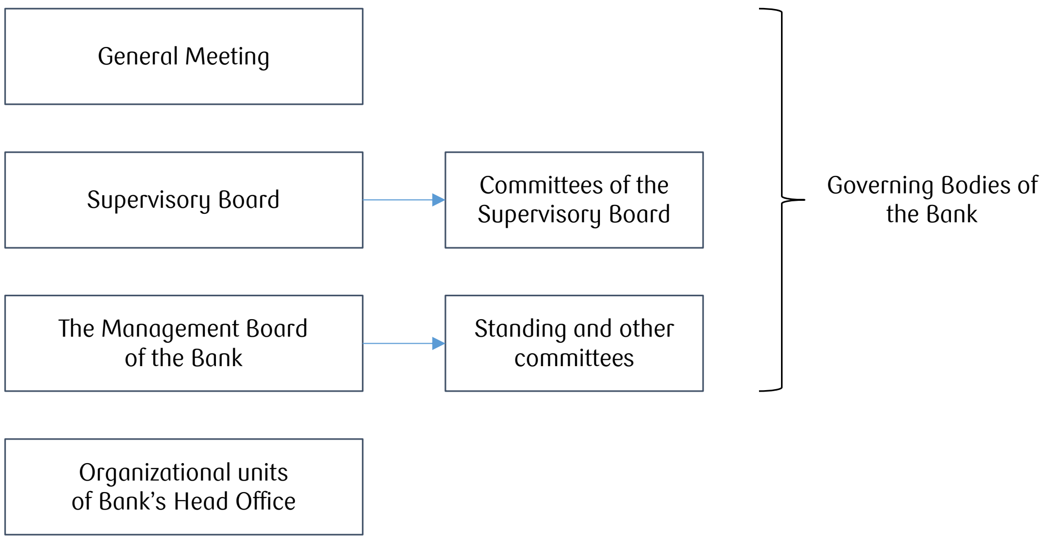
PKO Bank Hipoteczny SA did not breach any of these limits during the entire period covered by this Report.

The Bank achieved positive results on the coverage test and liquidity test performed at the end of December 2017.

6. STRUCTURE AND GOVERNING BODIES OF PKO BANK HIPOTECZNY SA

Organisational structure of PKO Bank Hipoteczny SA

The management of PKO Bank Hipoteczny SA is carried out on the basis of the organisational 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,



Powers of the governing bodies and committees of PKO Bank Hipoteczny SA

The competences of the General Meeting of the Bank include in particular:

- appointing and dismissing members of the Supervisory Board,
- adopting resolutions on settlement of claims for damages caused at the establishment of the bank, or by the exercise of management or supervision,
- establishing the procedure for redemption of shares and the level of compensation for the redemption of shares and the expression of consent to the acquisition of the Bank's own shares for the purpose of redemption,
- creation and dissolution of special funds created from net profit,
- adopting resolutions on the issuance of 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 organised part of the Bank's enterprises, and establishing limited property rights over them.

The competences 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 principles for the prudent and stable management of the Bank and the risk management strategy, including the Bank's general level of risk, the information policy in the area of capital adequacy, management of operational risk, estimating internal capital, capital management and planning, the functioning of the management system, the rules for management of models, the risk measurement models, including the assessment of creditworthiness, the model for measurement

of lost value, the internal capital adequacy assessment process (ICAAP) and acceptance of periodic reports in this area,
- approving the Bank's product, pricing and discount policy
- approving the annual internal audit plans,
- approving and periodically reviewing the general principles of the policy on variable components of remuneration of persons holding managerial positions,
- 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 organisational structure of the Bank, adjusted to the scale and profile of the risk taken on by the Bank,
- approving and reviewing 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
- assessing the Directors' report on the Bank's activities and the financial statements for the previous financial year in terms of their consistence 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 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 Meeting,
- assessing the application by the Bank of the Principles of Corporate Governance for Supervised Institutions.

In 2017, the following Supervisory Board committees operated:
- Audit and Finance Committee,
- Risk Committee,
- the Remuneration and Nomination Committee,
- the Commercial Committee.

The Audit and Finance Committee and the Risk Committee were established by the Resolution of the Supervisory Board of 13 December 2016 and replaced the Audit, Finance and Risk Committee. They began to operate on 16 January 2017, when the amendments to the Bank's Articles of Association regarding the establishment of new committees were entered into the Register of Entrepreneurs of the National Court Register.

The powers of the Audit and Finance Committee of the Bank's Supervisory Board include, in particular:
- 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 authorised 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.

The powers of the Risk Committee of the Bank's Supervisory Board include, in particular:
- 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 the 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 utilisation 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,

The competences of the Bank's Remuneration and Nomination Committee include in particular:
- 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 Management of Conflicts of Interest,
- preparing opinions on requests concerning 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 a potential support from external, independent entities, the programme for raising qualifications of members of the Supervisory Board.

The powers of the Commercial Committee of the Bank's Supervisory Board include in particular:

- 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 competences 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 principles of prudent and stable management of the Bank,
- setting the general level of risk acceptable for the Bank,
- setting the annual financial plan, including the conditions for its execution,
- adopting the Organisational Regulations of the Bank and the rules for division of competences,
- 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 usage of special funds created from net income,
- setting the dividend pay-out date within the period set by the General Meeting,
- adopting the rules for the functioning of the internal control system and the annual internal audit plan,
- establishing, restructuring and closing down branches and other organisational 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:

- the Asset and Liability Committee
- the Credit Committee
- the Data Quality Committee,
- the Strategy and Business Initiatives Committee.

The Asset and Liability Committee and the Credit Committee were established by resolutions of the Bank's Management Board of 13 January 2015, and the Data Quality Committee was established by resolution of the Bank's Management Board of 28 January 2015. On 7 November 2017, the Bank's Management Board adopted new Rules of Procedure of Standing Committees, changed the composition of the committees and established the Strategy and Business Initiatives Committee.

The competences of the Asset and Liability Committee include in particular:

- 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 competences.

The competences of the Credit Committee include, in particular:

- 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 competences.

The competences of the Data Quality Committee include, in particular:
- determining the strategic directions of operations in the area of managing the quality of data and data architecture in the Bank, in the contest of the Data Management System (DMS),
- oversight over the functioning of the DMS, including evaluation of its efficiency and the operations of particular organisational units of the Head Office.

The competences of the Strategy and Business Initiatives Committee include in particular:
- 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 competences.

The Management Board of PKO Bank Hipoteczny SA

In the period from 1 January to 31 December 2017, the composition of the Management Board of PKO Bank Hipoteczny SA was as follows:

No.	Name & surname	Position	Date of appointment	Date of resignation/ dismissal
1	Rafał Kozłowski	President	06/10/2014	31/12/2017
2	Jakub Niesłuchowski	Vice President	01/04/2015	-
3	Marek Szcześniak	Vice President	01/06/2015	-

The Supervisory Board of PKO Bank Hipoteczny SA, in connection with the resignation of Mr Rafał Kozłowski on 28 December 2017 appointed Ms Agnieszka Krawczyk as the Vice-President of the Management Board, as from 1 January 2018, and entrusted Mr Jakub Niesłuchowski with the performance of the organizational and procedural duties of the President of the Company's Management Board, as from 1 January 2018, until the appointment of the President of the Management Board.

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 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 competences within the Bank's Management Board, which was in force for the whole 2017:

1) supervision of compliance risk and internal audit management was performed by Mr Rafał Kozłowski, President of the Management Board,
2) supervision of risk management (other than compliance risk) was performed by Mr Marek Szcześniak, Vice-President of the Management Board,
3) supervision of accounting and financial reporting matters, including financial controls, was performed by Mr Jakub Niesłuchowski, Vice-President of the Management Board.

During the reporting period, Mr Marek Szcześniak was also served as the Deputy Chairperson of the Supervisory Board in Kredobank SA in Ukraine. During the whole reporting period, Mr Rafał Kozłowski served as a member of the Supervisory Board of PKO Leasing SA with registered office in Łódź, until 28 April 2017 he served as a member of the Supervisory Board of Raiffeisen-Leasing Polska SA with registered office in Warsaw and from 1 April 2017 to 31 December 2017 he served as a member of the Supervisory Board of PKO Faktoring SA with registered office in Warsaw. During the reporting period Mr Jakub Niesłuchowski did not hold any other directorial positions.

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 22 November 2012 in the matter of evaluating the qualifications 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 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 to 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 21 March 2017, by resolutions of the ordinary general meeting, all members of the Bank Management Board were granted a vote of approval for the period ended 31 December 2016.

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.

Compensation of Management Board Members

Within the meaning of § 2 clause 1 item 30a of the of the Regulation of the Minister of Finance of 19 February 2009 on current and periodic information submitted by issuers of securities and the conditions for recognizing information required by law of a non-member state as equivalent information (Journal of Laws No 33, item 259, as amended), members of the Management Board are persons managing the Bank.

The compensation of Management Board members comprises:

1) monthly compensation, whose level is set by the Bank's Supervisory Board,
2) benefits to which Bank Employees are entitled:
    a. on the basis of the generally applicable provisions of the law,
    b. on the basis of the Bank's internal regulations, which may be standardised or exceptional, and whose basis for awarding is not an evaluation of the effects of the work of a Bank Management Board member or the result of the area of the Bank they supervise,
3) variable remuneration components for the results of work, in particular bonuses, awards for particular achievements at work, whose specific principles for awarding and payment are described in the Rules on variable remuneration components for members of the PKO Bank Hipoteczny SA Management Board, adopted by a resolution of the Bank's Supervisory Board.

The rules for setting the variable remuneration components are described in the chapter on Human Resources Management.

PKO Bank Hipoteczny SA has concluded the following agreements with members of the Management Board, which include compensation in the case of resignation or dismissal from their positions:

1) work contracts, providing for severance pay in the case of termination for reasons other than breach of the basic duties arising from the employment relationship, in an amount not to exceed the value of three times the monthly remuneration, the level of which should reflect the Supervisory Board's assessment of the work of the Management Board member in the Company during the previous three years, unless the employment period was shorter,
2) an agreement on non-competition, which calls for compensation for respecting the ban on competition, lasting for six months from the date employment in the Company ends.

Benefits for members of the Management Board of PKO Bank Hipoteczny SA in 2017 are described in notes 34.3 and 34.4 to the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2017.

The Supervisory Board of PKO Bank Hipoteczny SA

In the period from 1 January to 31 December 2017, the composition of the Supervisory Board of PKO Bank Hipoteczny SA was as follows:

No.	Name	Function on the supervisory board	Date of appointment	Date of resignation / dismissal	qualifications in finance	Independent member*	the knowledge and skills in the field of accounting or audit of financial statements	Audit and Finance Committee	Risk Committee	the Remuneration and Nomination Committee	the Commercial Committee
1	Jakub Papierski	Chairperson	06/10/2014		✓					Ch	Ch
2	Piotr Mazur	Deputy Chairperson	06/10/2014		✓				Ch		DCh
3	Justyna	Board Member	28/10/2016		✓				CM		

	Borkiewicz										
4	Mieczysław Król	Board Member	28/10/2016		✓				DCh	DCh	
5	Adam Marciniak	Board Member	28/10/2016	17/10/2017	✓						
6	Artur Osytek	Board Member	06/10/2014	17/10/2017	✓		✓				
7	Barbara Soares da Silva	Board Member	06/10/2014	17/10/2017	✓		✓				
8	Bartosz Drabikowski	Board Member	18/10/2017	15/01/2018	✓		✓	DCh			CM
9	Artur Kluczny	Board Member	18/10/2017		✓	✓		Ch			
10	Piotr Kwiecień	Board Member	18/10/2017		✓	✓		CM			
11	Jan Emeryk Rościszewski	Board Member	18/10/2017		✓						CM

Ch – Committee Chairperson, DCh – Committee Deputy Chairperson, CM- Committee Member

*) *in accordance with the definition of the Act of 11 May 2017 on statutory auditors, audit firms and public supervision*

The Composition of the Committees is presented as at 31 December 2017.

In accordance with Article 395 § 2(3) of the Code of Commercial Companies and Partnerships, each year the ordinary general meeting of shareholders grants to each individual member of the Supervisory Board a vote of approval. The granting of this vote of approval constitutes an evaluation of the Supervisory Board members, independent of the approval by the general meeting of shareholders of the Supervisory Board's report on the Bank's operations. On 21 March 2017, by resolutions of the ordinary general meeting, all members of the Bank's Supervisory Board received a vote of approval for the period ended 31 December 2016.

The above constitutes a confirmation of the Supervisory Board members' proper performance of their duties, based on adequate knowledge, abilities and experience, in accordance with the requirements of art. 22aa of the Banking Law.

On 18 October 2017, the General Meeting of shareholders adopted the 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 appointment and in the course of exercising the functions and regulates the course of the evaluation process. On 18 October 2017, the General Meeting of shareholders evaluated the qualifications of candidates for members of the Supervisory Board in accordance with the Policy mentioned above.

Remuneration of members of the Supervisory Board

Pursuant to the Rules of Remunerating Members of the Company's Supervisory Board, as adopted by the General Meeting of Shareholders on 18 October 2017, members of the Supervisory Board of PKO Bank Hipoteczny SA do not receive any remuneration in connection with their functions, excluding independent members of the Supervisory Board, who receive a monthly remuneration equal to the average monthly remuneration in the enterprise sector, excluding payment of profit bonus in the fourth quarter of the previous year, as announced by the President of the Central Statistical Office. The remuneration is increased by 10% if the independent member of the Supervisory Board participates in at least one standing committee of the Supervisory Board.

Benefits for members of the Supervisory Board of PKO Bank Hipoteczny SA in 2017 are described in note 34.3 to the financial statements of PKO Bank Hipoteczny SA for the year ended 31 December 2017.

Human resource management

Employment

As at 31 December 2017, 69 people were employed in PKO Bank Hipoteczny SA. This means that the headcount was the same as in the previous year.

Remuneration policy

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

- base salary,
- bonuses and awards for special achievements in their professional work,
- additional remuneration for working overtime and at night.

Base salaries and additional benefits granted to employees are determined on the basis analysis of market remuneration in the banking sector. The remuneration policy in PKO Bank Hipoteczny SA is consistent with the principles of appropriate and effective risk management. In the reporting period, there were no significant changes in the Bank's remuneration policy.

Variable remuneration components

A bonus scheme is in place in PKO Bank Hipoteczny SA, under which the degree of meeting objectives determines the level of variable remuneration. The scheme functions based on the Management by Objectives (MbO) formula. The system focuses on describing the tasks that determine the direction of the growth of the entire organisation, and then are cascaded down into goals of particular organisational units and individual employees. Each objective is set in accordance with the SMART framework (Specific, Measurable, Ambitious, Realistic, Time-Related). Because individual compensation is linked to the level and quality of performance of specified tasks, the role of the variable portion of compensation is strengthened, constituting an additional monetary incentives.

Independent of 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 effects for the Bank are achieved.

Variable remuneration components for members of the Management Board and Material Risk Takers (MRT)

In accordance with the requirements of CRD IV, 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 a detailed method of estimating internal capital in banks, the following rules laying down the principles of determining variable remuneration components are in force in the Bank:

- The rules on variable remuneration components for members of the Management Board of PKO Bank Hipoteczny SA, adopted by a resolution of the Supervisory Board,
- A list of the positions of employees whose professional activities have a significant impact on the institution's risk profile and who are covered by the Rules on variable remuneration components for individuals holding managerial positions at the Bank, adopted by a resolution of the Management Board,

- The Rules on variable remuneration components for persons holding managerial positions in the Bank, adopted by an order of the President of the Bank's Management Board.

List of Material Risk Takers (MRT) in PKO Bank Hipoteczny SA

The rules of the policy on variable remuneration components for members of the Management Board and MRTs as at 31 December 2017 covered 3 members of the Management Board and 16 positions included in the List, i.e. the same number of positions as as at 31 December 2016.

The List of MRTs was determined by the Bank's Management Board based on qualitative and quantitative criteria for setting the categories of employees whose professional activities have a significant influence on the risk profile, as mentioned in Commission Delegated Regulation (EU) 604/2014 of 4 March 2014. On the basis of these criteria, the following were designated as MRTs:

1) senior management,
2) positions accountable to the management body for the operations of the independent risk management function, compliance function or internal audit function,
3) managerial positions responsible for legal matters, finance, HR, IT, economic analysis and launching new products,
4) positions in which the employees received total remuneration that exceeds the relevant level defined by regulations (as long as such employees actually have a significant influence on the risk profile),
5) positions in which employees fit into the same remuneration range as senior management and individuals taking on operational risk (as long as they have a significant influence on the risk profile).

The Rules of variable remuneration components describe the method of awarding, to members of the Management Board and MRTs, variable remuneration components related to their performance and the effects of their work. The basis for awarding variable remuneration components is primarily the meeting of bonus objectives assigned as part of the Management by Objectives (MbO) system. Once it has been verified whether the bonus objectives have been met, variable remuneration components for a given assessment period (calendar year) are awarded. The maximum amount of variable remuneration cannot exceed 100% of the fixed remuneration for a given assessment period. The maximum amount of variable remuneration may be increased to a maximum of 200% of the fixed remuneration on the condition of approval by the General Meeting.

Variable remuneration is awarded and paid in the following forms:

- in non-deferred form – in the amount of 60% of the variable remuneration (in the first year after the assessment period),
- in deferred form – in the amount of 40% of the 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 form of financial instrument that is phantom shares that are converted into cash after the retention period and in case of deferred remuneration – after deferment). In the event that the amount of variable remuneration for the year has exceeded PLN 1 million, PLN 400 thousand plus 60% of the excess over the amount of PLN 1 million is subject to deferral.

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 legal regulations or customer service standards,
- inadequate performance of assigned professional duties,
- violation of the principles of community life in relation to other employees.

For members of the Management Board, granting and payment of variable remuneration is subject to approval of the financial statements for the assessment period. The bonus amount for a member of the Management Board may be adjusted downwards or upwards by a specified rate, 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 suffered a material deterioration,
- it is found that there has been a material negative change in the Bank's equity,
- there is a violation by a member of the Management Board or by an MRT of the provisions of law, rules, procedures or duties arising from the employment relationship of a person holding a managerial position, or if such person makes significant errors,
- the performance and the degree of performance 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 due variable remuneration.

If a severance pay related to the dismissal from the office is awarded to a member of the Management Board, which is coupled with the termination of employment, other than a severance pay resulting from generally applicable provisions of law, the amount of the severance pay shall reflect the assessment of performance over the last three years of employment, provided that the Bank's policies determine the maximum level of severance pay. The Company's Supervisory Board decides on the level and payment of the 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 the employment with the Bank.

In 2017, none of the employees at PKO Bank Hipoteczny SA received a total remuneration of at least EUR 1 million.

The policy of variable remuneration components for members of the Management Board and key managers with a high influence on the Bank's risk profile is subject to annual review 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, 7 meetings of the Remuneration and Nomination Committee of the Supervisory Board of PKO Bank Hipoteczny SA were held.

Non-salary benefits available to employees of PKO Bank Hipoteczny SA

Medical care

Apart from the occupational medicine benefits (resulting from the Labour Code provisions), the Bank provides its employees with additional medical care to which they are entitled under different benefit packages dedicated to specific groups of positions.

Company Social Benefits Fund

As part of the Company Social Benefits Fund, the Bank provides its employees with special assistance grants in extraordinary circumstances, as well as access to the MyBenefit cafeteria plan, through which every Bank employee can use an online platform to independently spend the funds provided to them from the Company Social Benefits Fund. The platform offers a broad range of benefits for the employees to choose from. The amount of funds received to be spent at the cafeteria is dependent on the amount of gross income per person in a given family.

7. CORPORATE GOVERNANCE AND INFORMATION FOR INVESTORS

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 Meeting of 22 December 2015 – in relation to the powers reserved for the General Meeting.

Under, and to the extent arising from, the aforementioned decisions, the Bank opts 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 in view of the Bank having 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, provided that 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 as 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 2017 the Supervisory Board performed an evaluation of the application of the Principles in the Bank in 2016. 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 special character of the mortgage bank.

The text of the Principles is available at 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

Main characteristics of the internal control system in relation to the process of preparing the financial statements

The control system includes the process of preparing financial statements. In accordance with the rules adopted in 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 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 financial reporting. On the other hand, the internal audit, in accordance with the confirmed audit plans, reviews and independently evaluates the adequacy and effectiveness of control over the financial reporting processes and evaluates risk management in this process. No issues that would cast doubt on the reliability of the financial reporting have been observed so far in 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 based on them

No.	Name	Registration date	No. of shares	Series	Share Numbers	Nominal value per share	No. of votes at General Meeting	Amount paid in for shares	No. of privileged shares, type of privilege
1	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	24 October 2014	300,000,000	A	from 1 to 300,000,000	PLN 1	300,000,000	PLN 300,000,000,00	None
2	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	22 April 2016	200,000,000	B	from 1 to 200,000,000	PLN 1	200,000,000	PLN 200,000,000.00	None
3	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	28 July 2016	200,000,000	C	from 1 to 200,000,000	PLN 1	200,000,000	PLN 200,000,000.00	None
4	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	1 December 2016	100,000,000	D	from 1 to 100,000,000	PLN 1	100,000,000	PLN 100,000,000.00	None
5	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	12 April 2017	150,000,000	E	from 1 to 150,000,000	PLN 1	150,000,000	PLN 150,000,000.00	None
6	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	11 September 2017	150,000,000	F	from 1 to 150,000,000	PLN 1	150,000,000	PLN 150,000,000.00	None
7	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	16 November 2017	100,000,000	G	from 1 to 100,000,000	PLN 1	100,000,000	PLN 100,000,000.00	None

Description of the rules for appointing and dismissing managers

Members of the Management Board are appointed and dismissed by a 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 Meeting approves the financial statements for the last full financial year during which the member served, at the latest. Additionally, the term of a Management Board member also expires as a result of their death, resignation or dismissal from the Management Board, as of the date of the event causing the expiration, unless the resolution on dismissal calls for a different date of expiration. Management Board members may be dismissed before the completion of their term at any time.

The Supervisory Board advises 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 advises 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 risk management and the internal audit unit. The Supervisory Board advises 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, and the Supervisory Board does so immediately after the relevant item is placed on the agenda of the Supervisory Board meeting.

Additional information on the authorisations of managers is found in Section 6, Structure and Governing Bodies of PKO Bank Hipoteczny SA.

Description of authorisations to decide on share issues or buybacks

The powers of the General 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 all 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

The rules for amending the Articles of Association of PKO Bank Hipoteczny SA are consistent with the provisions of the Code of Commercial Companies and Partnerships, and with the Banking Law Act. Amendments to the Bank's Articles of Association require a resolution of the General Meeting and an entry into the register of entrepreneurs of the National Court Register. Within the scope 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 that took place in the last financial year, and description of the operations of, management, supervisory and administrative bodies of the issuer and their committees

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

The General Meeting and relations with shareholders

The method of operation of the General Meeting and its basic powers as well as a description of shareholder rights and the method of their execution arise directly from 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 be the sole shareholder, i.e. PKO Bank Polski SA, the resolutions of the General Meeting are adopted without formally convening a General Meeting, in accordance with the principles arising from Article 405 of the Polish Code of Commercial Companies and Partnerships

Entity authorised to audit financial statements

On 3 March 2017 the Supervisory Board of PKO Bank Hipoteczny SA selected the company KPMG Audyt Spółka z ograniczoną odpowiedzialnością sp.k. as the entity authorised to audit and review the Bank's financial statements for the years 2017-2019.

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 authorised to audit financial statements which is maintained by the National Board of Statutory Auditors, with number 3546. The Bank's Supervisory Board appointed the auditor authorised 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 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 fee of the entity authorised to audit financial statements was as follows:

The fee of KPMG, excluding VAT ('000 PLN)	**2017**	**2016**
Audit of financial statements	110.0	40.0
Review of financial statements as well as audit and review of group packages	100.0	65.0
Other assurance services - comfort letters	340.1	375.4
Translation of financial statements	10.0	20.0

Other information

1. *Shareholders holding directly or indirectly through their subsidiaries at least 5% of the total number of votes at the General Meeting*

Powszechna Kasa Oszczędności Bank Polski SA holds 100 per cent of the shares in PKO Bank Hipoteczny SA.

The Bank's share capital amounts to PLN 1,200,000,000 (one billion two hundred million złoty) and is divided into 1,200,000,000 (one billion two hundred million) ordinary registered series A, B, C, D, E, F and G shares, with a nominal value of PLN 1 (one) each.

The shares issued by PKO Bank Hipoteczny are not preferred and have been fully paid up.

2. *Changes in holding shares and rights to shares in PKO Bank Hipoteczny SA by individuals in management and supervisory roles*

In the period from 1 January to 31 December 2017, there were no changes in holding shares and rights to shares in PKO Bank Hipoteczny SA by individuals in management and supervisory roles.

3. *Evaluation of PKO Bank Hipoteczny SA's financial credibility*

On 27 March 2015, the Bank commissioned the ratings agency Moody's Investors Service ("Moody's") with assigning a rating for the Bank and for the covered bonds issued by PKO Bank Hipoteczny SA.

On 7 September 2015, Moody's assigned long- and short-term issuer ratings for PKO Bank Hipoteczny SA at the level of Baa1/P-2, 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 provisional rating for PLN-denominated covered bonds of PKO Bank Hipoteczny SA at the level of Aa3. 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 zloty-denominated covered bonds so far by PKO Bank Hipoteczny SA.

On 29 September 2016, Moody's assigned a long-term (P) rating (a provisional rating) for PKO Bank Hipoteczny SA's EUR-denominated covered bonds at the level of Aa3. 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 so far by 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 *country ceiling* for debt instruments, which currently is at the level of Aa3.

4. *Significant and material agreements with the central bank or supervisory bodies*

In 2017, PKO Bank Hipoteczny SA did not conclude any significant or material agreements with the central bank or supervisory bodies.

5. *Financial liabilities and guarantee obligations granted*

In 2017, PKO Bank Hipoteczny SA did not issue any guarantees.

Financial liabilities under loans granted and not disbursed as at 31 December 2017 stood at PLN 682.9 million, up by PLN 71.1 million compared to 31 December 2016.

6. *Off-balance-sheet liabilities to related parties*

In 2017, PKO Bank Hipoteczny SA did not grant any off-balance sheet obligations to related parties.

7. *Loans taken out and loan and guarantee agreements unrelated to the Bank's operations*

In 2017, Bank Hipoteczny SA did not take out any loans or enter into any loan or guarantee agreements unrelated to the Bank's operations.

8. *Underwriting agreements and guarantees granted to subsidiaries*

On 30 August 2017, PKO Bank Hipoteczny SA concluded with PKO Bank Polski SA, acting also through Dom Maklerski PKO Banku Polskiego in Warsaw, its branch, an agreement amending and consolidating the program agreement of 9 November 2015, by which it appointed Dom Maklerski PKO Banku Polskiego as the underwriter (until that time, covered bonds could only be offered in an ordinary issue).

9. *Indication of pending proceedings before courts, arbitration bodies or public-administration authorities*

As at 31 December 2017, no proceedings were under way before courts, arbitration bodies or public-administration bodies concerning liabilities or receivables whose value constitutes at least 10% of PKO Bank Hipoteczny SA's equity.

10. *Factors that will influence future financial performance over at least the next quarter*

Among the significant factors and threats that could affect the Bank's results over the following quarter, there must be included:

- the development of the residential market in Poland,
- the development of the residential loans market in Poland,
- the possibility and timing of further transfers to the Bank of a portion of the portfolio of mortgage loans granted by PKO Bank Polski SA,
- the situation on the domestic and international covered bonds markets, in particular demand from investors for the covered bonds issued by the Bank.

11. *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 2017, PKO Bank Hipoteczny SA did not grant any loan or credit guarantees to a single entity or subsidiary of that entity whose total value would constitute the equivalent of at least 10% of the Bank's equity.

12. *Information on loan and credit agreements entered into and withdrawn from during a given financial year*

On 2 February 2017 PKO Bank Hipoteczny SA and PKO Bank Polski SA concluded an Agreement on the Revolving Working Capital Overdraft for an amount of up to PLN 1,500 million for a three-year period, to be disbursed in tranches.

On 5 June 2017, PKO Bank Hipoteczny SA concluded a medium-term working capital agreement up to a limit of PLN 100 million for 1 year and 1 day, with an external financial institution.

On 19 December 2017, PKO Bank Hipoteczny SA concluded, with an external financial institution, an amendment to the medium-term working-capital loan agreement of 5 June 2017, increasing the limit amount by PLN 50 million.

Additionally, as at 31 December 2017 the Bank had liabilities arising from acquired receivables in the amount of PLN 2,497.9 million, which resulted from the acquisition, from PKO Bank Polski SA, of residential mortgage loan receivable portfolios, as described in Note 23 of the Financial Statement. The payment date of the liability on account of the acquisition of receivables is agreed from time to time by the parties to the Receivables Sale Agreement. For receivables acquired in 2017, the parties agreed that payment will be made within 12 months from the transfer date at the latest. In the case of lack of payment for the liability within 1 month from the transfer date, the price is increased by interest.

13. *Information on transaction or a number of transactions concluded by the issuer or its subsidiary with related parties, if they are significant and were concluded not on arm's length*

In 2017 PKO Bank Hipoteczny SA did not conclude any significant transactions with related parties on terms other than arm's length.

14. *Events that occurred subsequent to the date of the report*

During the period from 1 January 2018 to the date of signing of this report, i.e. 20 February 2018, PKO Bank Hipoteczny SA conducted issues of unsecured bonds of the total nominal value of PLN 734 million, while at the same time unsecured bonds of the total nominal value of PLN 552.3 million matured and were redeemed.

The unsecured bonds issues were conducted under the Bond Issue Programme established by PKO Bank Hipoteczny SA on 30 September 2015 for the issuance of bonds of up to PLN 3,000 million. The issued bonds mature for redemption between 13 March 2018 and 8 February 2019.

On 15 January 2018, Mr Bartosz Drabikowski submitted his resignation from the position of a member of the Bank's Supervisory Board effective 15 January 2018.

On 9 February 2018, the Extraordinary General Meeting of the Company appointed Mr Rafał Kozłowski as member of the Company's Supervisory Board effective 9 February 2018. On 14 February 2018, the Company's Supervisory Board appointed Mr Rafał Kozłowski as member of the Audit and Finance Committee and the Commercial Committee.

On 14 February 2018, the Supervisory Board adopted the Rules of Appointing and Remunerating Members of the Management Board of PKO Bank Hipoteczny SA, which replaced the currently binding Rules on Variable Remuneration Components for Members of the Management Board of PKO Bank Hipoteczny SA. The adopted policies are compliant with the requirements of CRD IV, 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, 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 a detailed method of estimating internal capital in banks, and the Act of 9 June 2016 on the rules of setting remuneration of persons managing certain companies. The main changes in the remuneration policy in relation to those in force in 2017 include changing the form of employment of members of the Company's Management Board from an employment contract to the contract for the provision of services.

15. Information on changes in the basic principles of managing the Bank's enterprise and its capital group

In 2017, in PKO Bank Hipoteczny SA there were no changes in the basic principles of managing the Bank's enterprise.

16. 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.

17. Deposits and issued guarantees and suretyships

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

Statement by the Management Board of PKO Bank Hipoteczny SA

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

- the financial statements for the year ended 31 December 2017 have been prepared in accordance with binding accounting principles and give a true and fair view of the financial position of PKO Bank Hipoteczny SA and of its financial performance,
- the Directors' Report for the year ended 31 December 2017 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 basic risks and threats.

The Management Board of PKO Bank Hipoteczny SA declares that the entity authorised to audit the financial statements which conducted the audit of financial statements for the year ended 31 December 2017 had been selected in compliance with applicable laws and that both the entity as well as the statutory auditor who conducted the audit fulfilled all criteria for providing an unbiased and independent audit opinion in compliance with applicable laws and professional norms.

This Directors' Report on the activities of PKO Bank Hipoteczny SA for the year ended 31 December 2017 comprises 50 sequentially numbered pages.

Signatures of all Management Board members

20 February 2018	Jakub Niesłuchowski	acting President of the Management Board Vice President	*Signed on the Polish original* .... (signature)
20 February 2018	Marek Szcześniak	Vice President	*Signed on the Polish original* .... (signature)
20 February 2018	Agnieszka Krawczyk	Vice President	*Signed on the Polish original* .... (signature)