Bank Hipoteczny

PKO Bank Hipoteczny SA
Directors' Report
for the period from 1 January 2016 to 31 December 2016

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1. INTRODUCTION

The company PKO Bank Hipoteczny SA was established on 6 October 2014. PKO Bank Hipoteczny SA began its operations on 1 April 2015, after receiving a license from the Financial Supervision Authority.

PKO Bank Hipoteczny SA specialises in granting residential mortgage loans for individual clients. It also acquires receivables on such loans from PKO Bank Polski SA. The Bank acquires loans for its portfolio based on its strategic cooperation with PKO Bank Polski SA.

In December 2016 the Management Board of PKO Bank Hipoteczny SA adopted, and the Supervisory Board of PKO Bank Hipoteczny SA confirmed, 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 loans 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 January 2017 show that Poland's GDP grew in 2016 by 2.8% year on year. According to analysts' expectations, in the following quarters the pace of GDP growth should accelerate. The European Commission forecast published in February 2017 assumes that Poland's GDP will grow by 3.2% in 2017, and by another 3.1% in 2018. The rapid pace of GDP growth may have a positive influence on the employment level and on consumers' earnings. As a result, it may contribute to generating demand for bank loans 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 December 2016 stood at 1,335.2 thousand people, down by 228.1 thousand people, or 14.6%, from a year earlier. The unemployment rate at the end of December 2016 stood at 8.3%, compared with 9.7% a year earlier. The number of people employed at the end of September 2016 stood at 16,266 thousand, up 0.2% on the year, according to GUS's Research on the Population's Economic Activity (BAEL). Also, the average monthly wage in the enterprise sector in December 2016 stood at PLN 4,635.77, up 3.8% 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. Deflation and a low inflation rate have a positive effect on banking clients' creditworthiness, which in turn translates into the granting of housing loans. According to data published by GUS, the consumer price index for December 2016 was 0.8% year on year.
- *Interest rates:* Low interest rates translate into a decline in credit costs and an increase in consumer creditworthiness. As of 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 timeliness of borrowers' meeting of payment obligations.

The residential real estate market

- The situation on the housing market in 2016 remained good. Growing demand for residential space was accompanied by increased supply. Growth in prices of flats during the period was moderate.
- According to preliminary data from GUS, in 2016 162,727 dwellings were completed, or 10.2% more than in 2015. During the year permits were issued, or building plans were submitted, for 211,565 residential units, or 12% more than in 2015. The number of units on which construction began also increased, by 3.3%, to 173,932.
- According to data on the developer market from REAS, 2016 was the best ever in terms of sales and the number of dwellings that entered the market. On the six markets with the highest turnover (Warsaw, Kraków, Wrocław, the Gdańsk-Gdynia-Sopot tricity, Poznań and Łódź) in 2016 more than 65.0 thousand units came onto the market (in comparison with 51.9 thousand in 2015), and more than 62.0 thousand were purchased (compared with 51.8 thousand in 2015). The number of completed dwellings that remained in developers' inventory at the end of 2016 grew by 4% from the end of 2015, reaching 52,700. The last quarter of 2016 saw a record level of sales (18.1 thousand units) and number of dwellings entering the market (19.0 thousand).

- According to National Bank of Poland data, in the first three quarters of 2016 the housing availability index in large cities was stable. The average for seven cities (Warsaw, Wrocław, Gdańsk, Gdynia, Kraków, Łódź, Poznań) stood at 0.86 square meter for the average monthly wage in the enterprise sector, i.e. it was higher by 0.03 sq. metre than in the third quarter of 2015.
- The situation on the residential real estate market is stable in terms of prices. Despite a recovery, prices per square metre of residences on the primary market were stable. On the secondary market, too, transaction prices have remained stable. Only on the Warsaw market a decline was noted in the third quarter of 2016. This was due to the sale of a higher number of flats with weaker quality or location, i.e. with a lower price per square metre.
- On 30 April 2016 the Act on halting sales of real estate from the State Treasury Agricultural Property Fund and on amending certain other acts entered into force. On the basis of the act, the group of people qualified to purchase agricultural land was restricted. In response to banks' limitations on loans for construction of houses on agricultural land, on 16 August 2016 an amendment entered into force, which limited the scope of the act to plots with an area exceeding 0.3 hectare Over the longer term, the limitations arising from the act may affect the operations of developers by limiting the supply of land for residential construction, though in 2016 such an effect was not noted.
- On 27 September 2016 the Council of Ministers adopted a resolution accepting the National Housing Programme, which sets three policy directions for improving access to housing with the support of public funds:
  i. Developing the segment of flats for rent at affordable rates, with the opportunity to purchase over the longer term. The flats would be built with the participation of a National Housing Operator, using real estate held by the State Treasury.
  ii. Support for social construction via financing of 35-55% of the costs of council flats built by local governments, and support for the construction of social rental housing built by housing associations, Social Construction Associations (TBSes) or other entities (e.g. developers). Additionally, municipally owned companies, housing associations and TBSes will be able to apply for preferential loans at the bank BGK for the construction of rental social housing.
  iii. Support for savings for housing purposes (purchase, construction, down payment, renovation) through Individual Housing Accounts: exemption from income tax on capital gains and support for certain goals with bonuses paid from the state budget.

  At the moment it is not possible to estimate the effect of the National Housing Programme on the real estate market. There have only been letters of intent between BGK Nieruchomości and local governments, and the pilot construction phase is to begin in 2018. The first flats are to be handed over to residents in 2019.

The residential lending market

- According to NBP data, banks' receivables on housing loans in Poland as of 31 December 2016 stood at PLN 393.8 billion, up almost 5% year on year. Of that amount, 59% was denominated in Polish złoty.
- The total value 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 2015 data was close to 50%. 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 2016 stood at PLN 29.7 billion, up 3.4% year on year.
- In 2016 the Flats for Young People (MdM) programme enjoyed great interest, and accelerated purchase decisions. The funds for the entire year were used up already in March, and by mid-year some of the funds for 2017 as well. Because the programme will be expiring (according to the act,

MdM is to remain in force until 30 September 2018), its influence on the real estate market in further periods will be insignificant.

The covered-bond market

- The Polish covered-bond market is relatively small, and characterised by moderate liquidity. At the end of December 2016, the total value of mortgage covered bonds outstanding issued by Polish banks stood at about PLN 9.8 billion, or PLN 4.4 billion higher than at the end of 2015. Still, that accounts for barely 2.4% of the value of mortgage loans granted by banks. By comparison, in Germany this ratio was around 15% in 2015; in the Czech Republic about 36%.
- As of the date of this Report, three mortgage banks were operating in Poland: PKO Bank Hipoteczny SA, mBank Hipoteczny SA and Pekao Bank Hipoteczny SA.
- On 1 January 2016 amendments to the Act on Covered Bonds and Mortgage Banks and other regulations took effect. The changes in the regulations removed barriers to investment in Polish covered bonds for both domestic and foreign investors. The amendments also introduced mechanisms and requirements concerning covered bonds and mortgage banks which from the investor's point of view increase the safety of covered bonds. The amendments allowed banks to refinance a higher proportion of residential mortgage loans with covered bonds than they could before. The changes in the law 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 RESULTS

Basic financial indicators for PKO Bank Hipoteczny SA

	31.12.2016	31.12.2015
Total assets (mln PLN)	8,610.4	791.5
ROA[1]	0.30%	(3.34%)
ROE[2]	2.49%	(3.82%)
Capital adequacy ratio	17.1%	47.8%
Leverage ratio	8.8%	29.9%

PKO Bank Hipoteczny SA Balance Sheet

mln PLN	31.12.2016	31.12.2015
Cash and balances with the central bank	16.0	0.0
Amounts due from banks	13.0	14.8
Financial derivative instruments	27.8	0.0
Net loans and advances to customers	8,247.9	722.7
Securities	283.0	40.5
Other assets	22.7	13.5
TOTAL ASSETS	**8,610.4**	**791.5**
Credit facility	393.8	39.8
Amounts due to PKO Bank Polski SA for acquired receivables	3,038.0	429.5
Mortgage covered bonds issued	3,232.1	29.9
Unsecured bonds issued	1,151.2	0.0
Financial derivative instruments	0.1	0.0
Other liabilities	13.9	6.3
Equity	781.3	286.0
TOTAL LIABILITIES AND EQUITY	**8,610.4**	**791.5**

PKO Bank Hipoteczny SA's balance sheet total as of 31 December 2016 stood at PLN 8,610.4 million, more than 10-fold growth from the end of 2015.

[1] Ratio calculated by dividing the net result (for 2015, the annualised figure) by the average level of assets at the beginning and the end of the reporting period and intermediate monthly periods
[2] Ratio calculated by dividing the net result (for 2015, the annualised figure) by the average level of equity at the beginning and the end of the reporting period and intermediate monthly periods

The key item on the assets side of the Bank's balance sheet was mortgage loans. Their value as of 31 December 2016, taking into account impairment write-downs, stood at PLN 8,247.9 million, of which PLN 2,318.9 million constituted new loans granted by the bank, while PLN 5,929.0 million was loans acquired from PKO Bank Polski SA.

On the liabilities side, the share of covered bonds rose significantly. In 2016, PKO Bank Hipoteczny SA carried out two benchmark issues of złoty-denominated covered bonds, with a total value of PLN 1 billion, and one benchmark issue of euro-denominated covered bonds with a value of EUR 500 million. That brought the value of covered bonds on the balance sheet at the end of 2016 to PLN 3,232.1 million.

At the end of 2016, financial obligations towards PKO Bank Polski SA, in the form of a revolving line of credit on the current account and obligations arising from the acquisition of credit receivables from PKO Bank Polski SA, constituted a significant item in the Bank's liabilities. The total value of these obligations at the end of December 2016 stood at PLN 3,431,8 million.

Another significant item on the Bank's liabilities side at the end of 2016 was the short-term bonds issued by the bank. Their total value as of 31 December 2016 stood at PLN 1,151.2 million.

In 2016, PKO Bank Polski SA acquired a total of PLN 500 million worth of new shares in PKO Bank Hipoteczny. As a result of this capital increase, the value of PKO Bank Hipoteczny SA's equity at the end of 2016 grew to PLN 781.3 million.

PKO Bank Hipoteczny SA statement of profit or loss

mln PLN	01.01.2016 - 31.12.2016	01.01.2015 – 31.12.2015
Net interest income	63.6	6.3
Net fees and commissions	(3.6)	(1.5)
Income from financial instruments measured at fair value	0.0	0.0
Foreign exchange result	(0.8)	0.0
Other operating income and expenses	0.0	0.1
Impairment allowance and write-downs	(1.6)	(0.2)
General administrative expenses	(39.3)	(20.2)
Operating result	**18.3**	**(15.5)**
Profit / (Loss) before income tax	18.3	(15.5)
Income tax expense	(5.1)	2.9
Net profit / (loss)	**13.2**	**(12.6)**

PKO Bank Hipoteczny SA ended 2016 with net income of PLN 13.2 million. 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 143.0 million, comprising primarily PLN 140.5 million of revenue from mortgage loans, and revenue from securities. During this time, the Bank had an interest expense of PLN 79.4 million, mainly from the revolving line of credit on the current account, and obligations arising from the acquisition of receivables from PKO Bank Polski SA. The interest expense for these two sources of financing totalled PLN 45.9 million. The Bank also had interest expenses on issued covered bonds in the amount of PLN 24.5 million (including costs of CIRS hedging transactions), and on issued unsecured bonds in the amount of PLN 9 million.

In 2016, the Bank achieved net fees and commissions of negative PLN 3.6 million. This position comprised mainly costs of expert valuations of the mortgage lending value of property, in the amount of negative PLN 7.2 million, and revenue from clients for valuations of real estate performed by the Bank in the amount of PLN 4.1 million.

During the analysed period, the Bank had administrative expenses of PLN 39.3 million. A significant part was costs of employee benefits, whose value during the reporting period reached PLN 13.8 million. A significant position in the structure of administrative costs was accounted for by costs of materials in the amount of PLN 17.2 million, including costs related to services provided by PKO Bank Polski SA in the amount of PLN 7.6 million.

The growth in administrative expenses by PLN 19.1 million in comparison to 2015 was caused mainly by growth of costs of services provided by PKO Bank Polski SA (PLN 4.3 million), which resulted from the significant increase in the value of the loan portfolio on the bank's balance sheet. The higher administrative costs are also an effect of higher contributions to the Bank Guarantee Fund (PLN 4 million), costs of the tax on civil code transactions, related to the Bank's capital increase (PLN 2.5 million) and higher HR costs (PLN 1.2 million). In 2016 the Bank also incurred PLN 4.3 million in costs of the tax on selected financial institutions.

In light of revenue growth that exceeded cost growth, the Bank noted an improvement in the C/I ratio, which stood at 59.1% in 2016, a decline of 313.7 percentage points in comparison to 2015.

The Bank's net impairment allowance and write-downs in 2016 stood at negative PLN 1.6 million (entirely IBNR), or 0.02% of total loans at the end of 2016.

4. PKO BANK HIPOTECZNY SA'S OPERATIONS AND EXPANSION PLANS

Sale of residential mortgages in the agency model

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

In 2016 the Bank granted mortgage loans with a total value of PLN 2,497.2 million, which constitutes growth of 440% from 2015.

PKO Bank Hipoteczny SA does not take deposits or issue guarantees.

In accordance with Recommendation S of the Polish Financial Supervision Authority, in 2016 the Bank only granted loans whose value did not exceed 90% of the market value of the real estate, of which the portion of the loan exceeding 80% of this value was subject to insurance.

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

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

Criterion	Agency model
Loan value / market value of the real estate	max. 90%
Loan value / mortgage lending value of the real estate	max. 100%
Legal form of the real estate	Ownership or perpetual usufruct
Loan collateral	Mortgage recorded in Position No. 1 in section IV of the Land and Mortgage Registry
Currency	PLN
Designation	Residential purposes

Acquisition of receivables on 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 framework agreement with PKO Bank Polski SA on the sale of receivables. Under this agreement, in 2016 PKO Bank Hipoteczny SA acquired from PKO Bank Polski SA a portfolio of receivables on residential loans secured by mortgages with a total value of PLN 5.764 billion. 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	max. 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 registry
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 mortgage loans on PKO Bank Hipoteczny SA's balance sheet according to the LtV ratio at market value[3] and LtV at the mortgage lending value of property is presented in the following tables.

Gross loans by LtV at market value	31.12.2016	31.12.2015
< 50%	31%	24%
51% - 60%	17%	23%
61% - 70%	19%	24%
71% - 80%	23%	16%
80% - 90%	10%	13%
> 90%	0%	0%
Total	**100%**	**100%**

Gross loans by LtV at MLV	31.12.2016	31.12.2015
< 50%	18%	10%
51% - 60%	12%	14%
61% - 70%	14%	20%
71% - 80%	16%	21%
80% - 90%	19%	18%
Total	**100%**	**100%**

Average LtV	31.12.2016	31.12.2015
Average LtV based on market valuation	60,0%	63,5%
Average LtV based on MLV	71,3%	73,6%

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 27 April 2016 PKO Bank Hipoteczny SA issued its Series 2 covered bonds, on the basis of the Base Prospectus approved on 12 November 2015 by the Financial Supervision Authority. This was Poland's first benchmark issue of covered bonds based exclusively on zloty-denominated housing loans. Its value was PLN 500 million. The maturity was set at five years plus one day, and the maturity date at 28 April 2021. The spread over 3-month WIBOR was 65 basis points.

As part of the book-building process, 37 investors, including the European Bank for Reconstruction and Development, expressed interest in purchasing a total of PLN 1.24 billion of covered bonds. That means demand for PKO Bank Hipoteczny's covered bonds exceeded the value of the issue by almost 2.5 times.

[3] 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.

Chart: Purchasers of PKO Bank Hipoteczny SA's Series 2 covered bonds

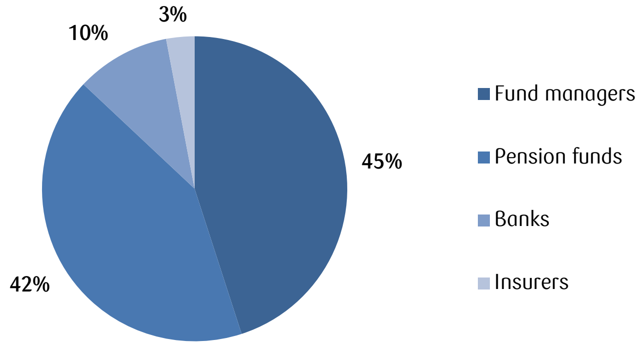
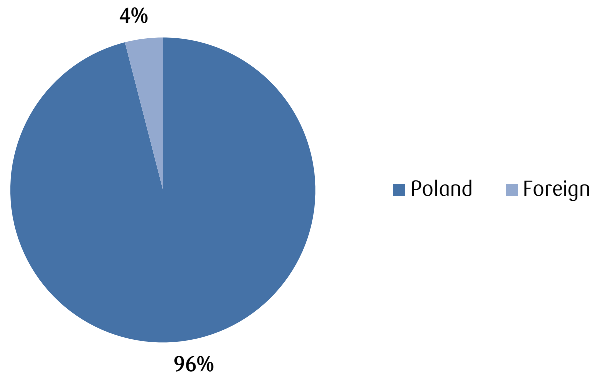


Chart: Purchasers of PKO Bank Hipoteczny SA's Series 2 covered bonds by country of origin



The covered bonds in PKO Bank Hipoteczny SA's first benchmark issue were introduced to trading on the Warsaw Stock Exchange's parallel market and on the off-exchange market Bondspot on 11 May 2016. Since 6 June 2016 they have also been accepted in repo transactions with the National Bank of Poland.

On 17 June 2016, PKO Bank Hipoteczny SA carried out its second benchmark issue of covered bonds, Series 3. The bank offered PLN 500 million of securities to institutional investors. During the book-building process, the spread on the Series 3 covered bonds was set at 59 basis points above 3-month WIBOR. During the process, investors expressed interest in purchasing a total of PLN 681.5 million of the bonds. The maturity was set at five years plus one day, and the maturity date at 18 June 2021.

Chart: Purchasers of PKO Bank Hipoteczny SA's Series 3 covered bonds

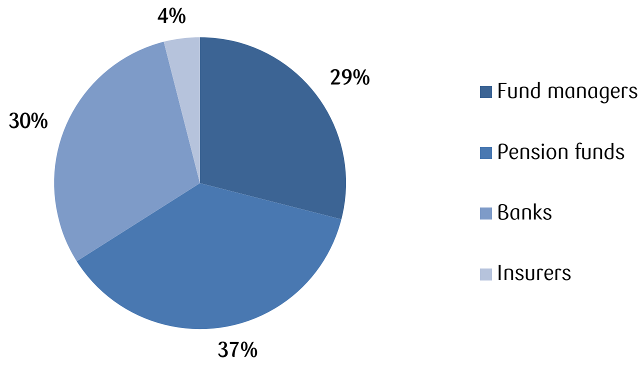
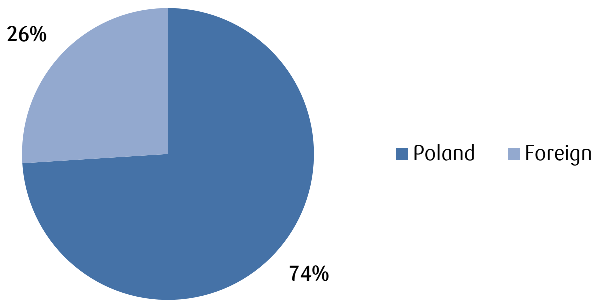


Chart: Purchasers of PKO Bank Hipoteczny SA's Series 3 covered bonds by country of origin



The covered bonds in PKO Bank Hipoteczny SA's second benchmark issue were admitted to trading on the Warsaw Stock Exchange's parallel market and on the off-exchange market Bondspot on 29 June 2016. Since 11 July 2016 they have also been accepted in repo transactions with the National Bank of Poland.

On 29 June 2016, the Series 1 covered bonds, issued by the bank in December 2015, also began trading on the WSE's parallel market. Earlier, these bonds were only noted on the off-exchange market Bondspot.

International issuance of covered bonds

On 24 October 2016 PKO Bank Hipoteczny SA conducted Poland's first ever benchmark issue of Euro-denominated covered bonds. The issue was conducted on the basis of the Covered Bonds Programme approved by the Commission de Surveillance du Secteur Financier (CSSF) on 28 September 2016. 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 institutional investors securities worth EUR 500 million based on a fixed interest rate. During the book-building process, the interest rate on the Euro-denominated covered bonds was set at 0.178 percent. During the process, investors expressed interest in purchasing a total of EUR 1.5 billion of the bonds. The maturity was set at five years and eight months, and the maturity date at 24 June 2022.

PKO Bank Hipoteczny SA's Euro-denominated covered bonds were admitted to trading on the Luxembourg Stock Exchange and the Warsaw Stock Exchange on 24 October and 12 December 2016, respectively. Since 4 November 2016 they have also been accepted in repo transactions with the European Central Bank.

Chart: Purchasers of PKO Bank Hipoteczny SA's Euro-denominated covered bonds

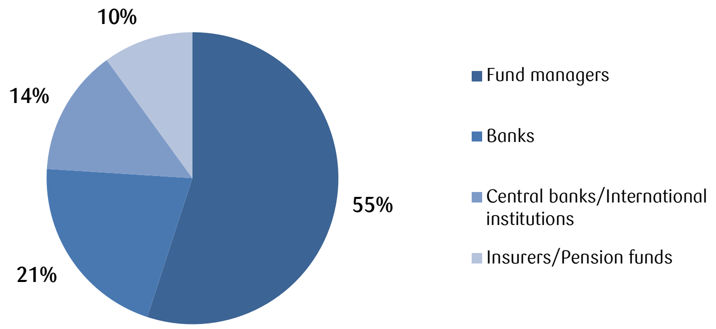


Chart: Purchasers of PKO Bank Hipoteczny SA's Euro-denominated covered bonds by region of origin

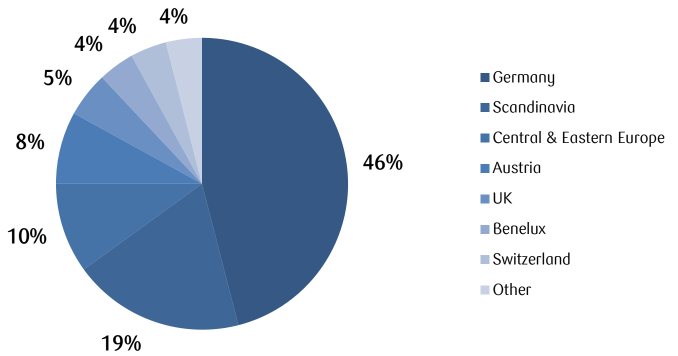


Table: PKO Bank Hipoteczny SA's PLN-denominated issues of covered bonds conducted through 31 December 2016

Series	ISIN code	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

Table: PKO Bank Hipoteczny SA's EUR-denominated issues of covered bonds conducted through 31 December 2016

Series	ISIN code	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, Bondspot, WSE

parallel market

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.

Ratings of the bank and its covered bonds

As of the date of this report, Moody's had assigned the following ratings to PKO Bank Hipoteczny SA and the covered bonds issued by the bank:

Rating type	Rating	Outlook
Long-term covered bond rating (PLN & EUR)	Aa3	n/a
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

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

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

The rating assigned to PKO Bank Hipoteczny SA's covered bonds is the highest possible for Polish securities, which is capped by Poland's "country ceiling" rating for debt instruments, currently at Aa3.

Short-term bonds

On 30 September 2015, PKO Bank Hipoteczny established a non-public short-term bond issuance programme. As part of the programme, in February 2016 the Bank conducted its first issue of bonds directed to qualified investors. As of 31 December 2016 the Bank had issued bonds with a total value of PLN 2,136 million. The outstanding amount of issued bonds as of 31 December 2016 was PLN 1,151.2 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 on PKO Bank Hipoteczny SA the obligation to limit the risk related to changes in currency rates and interest rates.

For the purpose of financing operations related to the issuance of mortgage loans and the acquisition of receivables on mortgage loans granted by PKO Bank Polski SA, PKO Bank Hipoteczny SA issues covered bonds and unsecured short-term bonds, and takes out lines of credit and obligations related to acquired receivables. Still, in accordance with the Act on Covered Bonds and Mortgage Banks, the level of obligations arising from taking out loans and credits (including obligations on 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 of 31 December 2016 there were no factors that could indicate a risk of delay in payment of the obligations undertaken by the Bank. During 2016, the Bank did not breach any liquidity limits. Detailed information on the levels of the Bank's liquidity standards was provided in note 39 of the Financial Statement.

For the purpose of hedging interest-rate risk and currency risk, PKO Bank Hipoteczny has engaged in Cross-Currency Interest Rate Swap (CIRS) transactions, in which the Bank pays a coupon based on a variable złoty rate, and receives a coupon based on a fixed rate for a foreign currency. If a court declares PKO Bank Hipoteczny bankrupt, the CIRS transactions would automatically be extended by 12 months on the terms set on the transaction date. 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 Euro-denominated covered bonds.

PKO Bank Hipoteczny plans to be 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 bring with them the conclusion of transactions mitigating financial risks on the interbank market.

PKO Bank Hipoteczny SA's expansion plans:

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'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 2016 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 contains obligations on PKO Bank Polski SA to properly perform the functions entrusted to it, as well as broad reporting and controlling obligations on behalf of PKO Bank Hipoteczny SA.

On 17 November 2015 the Framework Agreement on the Sale of Receivables was signed with PKO Bank Polski. Acquisitions of portfolios of receivables on residential mortgage loans have been made on this basis since December 2015.

PKO Bank Polski SA, as part of the Financial Supervision Authority regulatory approval process for creating a mortgage bank, undertook that in the case of need, 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 ensure the immediate provision to PKO Bank Hipoteczny SA of the necessary financial support.

The internal control system

The internal control system in PKO Bank Hipoteczny SA is one of the elements of managing the bank. It supports decision-making processes by seeking to ensure the efficiency and effectiveness of business operations, the credibility of financial reporting, compliance with the principles of risk management and compliance of the Bank's operations with the law, the internal regulations and market standards.

The internal control system in PKO Bank Hipoteczny SA functions on three independent levels.

The first level is the control function, which covers all organisational units of the bank and the positions responsible for executing the tasks assigned to this function. Its mission is to ensure that in all banking processes, effective control mechanisms have been established and are applied.

The second level of the internal control system comprises the organisational units designated for risk management independent of the control function, including the compliance unit. Their mission is to identify, evaluate, audit and monitor types of risk designated as significant, within the scope of their responsibility.

The third level is the independent internal audit unit, which independently and objectively analyses and evaluates the adequacy and effectiveness of the risk management system and the internal control system, with the exception of the internal audit unit.

The Bank's Management Board ensures the continuity of the internal control system's operations and the proper cooperation of all employees within the framework of the functioning internal control system. Irregularities identified by the internal control system are mitigated by remedial actions.

Reporting within the internal control system during 2016 and remedial actions indicated that the internal control system in PKO Bank Hipoteczny SA was effective and adequate to the scale of the Bank's operations.

Oversight of the internal control system in PKO Bank Hipoteczny SA in 2016 was conducted by the Supervisory Board's Audit, Finance and Risk Committee. The Committee monitored matters related to the internal control system, including internal and external audit.

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 framework of 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 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 significance, scale and complexity of a given risk,
- 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 supports the execution of the Bank's strategy, while maintaining compliance with the risk management strategy, in particular in the area of the risk tolerance level,
- 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 as a result of a client's failure to meet obligations toward the bank due to a worsening of the client's ability to service obligations, or the risk of a decline in the economic value of the Bank's receivables (including negative changes in real estate prices); this field includes **residual risk**, arising from lower than assumed effectiveness in applying techniques for reducing credit risk.	constant
Liquidity risk: the risk of inability to fulfil obligations in a timely manner as a result of a lack of liquid funds; this field includes **financing risk**, which is the risk of loss of financing sources and the inability to roll over maturing financing sources or loss of access to new sources of financing.	constant
Operational risk: the 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 organs of public administration); operational risk does not include reputation risk or business risk.	constant
Business risk: the risk of losses resulting 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**.	constant
Macroeconomic risk: risk of a worsening of the Bank's financial situation as a result of the unfavourable influence of changing macroeconomic conditions.	constant
Modelling risk: the risk of losses as a result of erroneous business decisions on the basis of the models in operation.	constant
Compliance risk: the risk of imposition of legal sanctions, the emergence of financial losses or the loss of reputation as a result of failure by the Bank, Bank employees or entities operating on its behalf to follow the law, the Bank's internal regulations or the market standards adopted by the bank.	constant
Capital risk: the risk of failure to ensure the proper level and structure of own funds in relation to the scale of the Bank's operations and risk exposure, and thus own funds being insufficient to absorb unexpected losses, taking into consideration growth plans and extreme situations; capital risk includes **excess leverage risk**, the 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 sale of assets that may bring losses or cause the need for a correction of the valuation of the remaining assets.	constant
Interest rate risk: the risk of losses on balance-sheet positions and off-balance-sheet items that are sensitive to changes in interest rates, as a result of changes in market interest rates.	potential
Currency risk: the risk of losses on changes in currency rates, generated by maintaining open positions in particular foreign currencies.	potential
Concentration risk: the threat arising from excessive concentration in terms of: - exposure to particular clients, - exposure to groups of related clients, - exposure 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.	potential
Reputation risk: the risk of a worsening 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.	potential

Risks of constant significance are subject to active management.

The Bank performs a separate estimation of internal capital for the following types of risk designated as significant:

- credit risk,
- liquidity risk,
- operational risk,
- business risk.

Macroeconomic, capital, modelling and compliance risks are reflected in the estimations of internal capital covering credit, operational, liquidity and business risk.

In the case of potentially significant risks, PKO Bank Hipoteczny SA performs periodic monitoring of whether they should be designated as significant. The Bank has defined significance criteria; when they are met, a risk will be recognised as significant. In 2016 none of these limits was exceeded.

In 2016, as a result of an ICAAP review, the Bank defined two additional types of risk subject to management, i.e. capital risk and reputation risk. Additionally, as part of the execution of the provisions of the amended Recommendation C, the Bank separated out and defined concentration risk, which thus far was managed as part of credit risk.

In its Risk Management Strategy, the Bank defined a range of strategic limits defining the appetite for particular types of risk. The bank will continuously monitor these limits. In 2016 none of them was exceeded.

A detailed description of the purposes and methods of risk management in the Bank is found in the PKO Bank Hipoteczny SA Financial Statement for 2016, in the chapter titled Objectives and principles of risk management related to financial instruments (Notes 35-42). It also includes important information on the level of financial risk in the Bank's operations and a description of the risk management objectives and methods adopted by the unit, together with the methods of hedging significant types of planned transactions for which hedge accounting is applied.

Valuation of collateral on mortgage loans

PKO Bank Hipoteczny SA's policy concerning loan collateral and its valuation is based on the provisions of the acts:

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

Additionally, the question of loan collateral is addressed by:

- the recommendations of the Financial Supervision Authority, including recommendations F, S and J,
- the bank's internal regulations.

The Bank possesses and applies Regulations for setting the mortgage lending value of real estate (MLV), approved by the Financial Supervision Authority on 26 February 2015. The Regulations take into account the provisions of Recommendation F concerning the basic criteria applied by the Financial Supervision Authority in approving regulations for setting the mortgage lending value of real estate issued by mortgage banks.

The MLV 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 an entity securing a loan. The MLV is used to determine the maximum value of a loan that can be secured by a mortgage on a given property, and for decisions on whether a receivable secured by a particular property can be acquired by the Bank.

PKO Bank Hipoteczny SA sets the MLV based on an MLV expert opinion, 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 possessor of the property. In the expert opinion, prepared as of a specific date, the assumptions and parameters of the analysis are documented, as is the process of setting the MLV and the proposed MLV 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	Valuer 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 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 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	Valuer 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 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 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 five 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 of 31 December 2016 stood at PLN 4,650,411 thousand. The nominal value of the over-collateralisation in the form of securities issued by the State Treasury stood at PLN 85,000 thousand. As of 31 December 2015 these figures were respectively PLN 82,071 thousand and PLN 0. The cover pool also takes into account CIRS transactions hedging currency risk and the interest rate on EUR-denominated covered bonds.

In 2015-16 the cover pool did not include asset-backed securities that do not meet the requirements described in paragraph 1 art. 80 of Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60) (recast).

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

- the Act of 29 August 1997 on covered bonds and mortgage banks (Dz. U. Journal of Laws 2003, No. 99, pos. 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 the cover pool as of 31 December 2016.

Total cover pool, including:	**PLN 4,735.4 mln**
loans secured by mortgages	*PLN 4,650.4 mln*
other assets (art. 18 points 3 and 4 of the Act on Covered Bonds and Mortgage Banks)	*PLN 85.0 mln*
Liquidity buffer (art. 18 point 3a of the Act on Covered Bonds and Mortgage Banks)	PLN 16.1 mln
Nominal value of hedging transactions	PLN 2,205.4 mln*
Number of loans	25,179
Average loan value	PLN 184,700
Average weighted time since loan issuance (seasoning)	38.7 months
Average weighted maturity	256.5 months
Average weighted LtMLV	68.72%
Over-collateralisation	46.06%

*The nominal value of the hedging transaction corresponds to the issue price of the covered bond

PKO Bank Hipoteczny SA regularly publishes detailed data on the cover pool and the receivables it contains, in the Disclosure 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 Financial Supervision Authority, upon the request of a mortgage 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	Role	Date of appointment	Date of dismissal/resignation
1	Tadeusz Swat	Monitor	06.03.2015	
2	Grzegorz Kędzia	Deputy Monitor	06.03.2015	

Statutory limits

Acting within the framework of 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 the mortgage bank.

The statutory limits and the level to which they have been met as of 31 December 2016 were as follows:

Limit	Legal basis	Limit level		Actual level	
		statutory	internal	31.12.2016	31.12.2015
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	art. 13 section 1	≤30.00%	≤28.00%	16.89%	15.54%
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	art. 14	≤100.00%	≤90.00%	72.14%	29.07%
Total value of acquired shares in other entities, in proportion to the Bank's own funds	art. 15 section 1 point 5	≤10.00%	0.00%	0.00%	0.00%
Total value of term deposits accepted, credits and loans taken out and bonds issued, in proportion to the Bank's own funds	art. 15 section 2	≤1000.00%	≤900.00%	586.46%	165.94%
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	art. 15 section 3	≤100.00%	≤95.00%	55.61%	65.25%
Total nominal value of covered bonds outstanding, in proportion to the Bank's own funds and general risk provision	art. 17	≤4000.00%	≤3600.00%	415.67%	10.61%
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 mortgage covered bonds outstanding (taking into account hedging instruments)	art. 18 section 1	≥110.00%	≥115.00%	147.62%	n/d
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	art. 18 section 1	≥85.00%	≥90.00%	143.44%	n/d
Interest costs on mortgage covered bonds outstanding (cumulative from the beginning of the financial year and on any given day), in proportion to interest revenue on receivables	art. 18 section 2	≤100.00%	≤90.00%	23.65%	6.78%

secured by mortgages and rights and additional 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 art. 18 section 3a over the nominal value of interest on mortgage bonds outstanding due in the following 6 months	art. 18 section 3a	≥100.00%	≥110.00%	118.08%	n/d
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	art. 23 section 1 sentence 1	≤10.00%	≤9.00%	2.62%	5.38%
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	art. 23 section 1 sentence 2	≤10.00%	≤9.00%	0.00%	0.00%

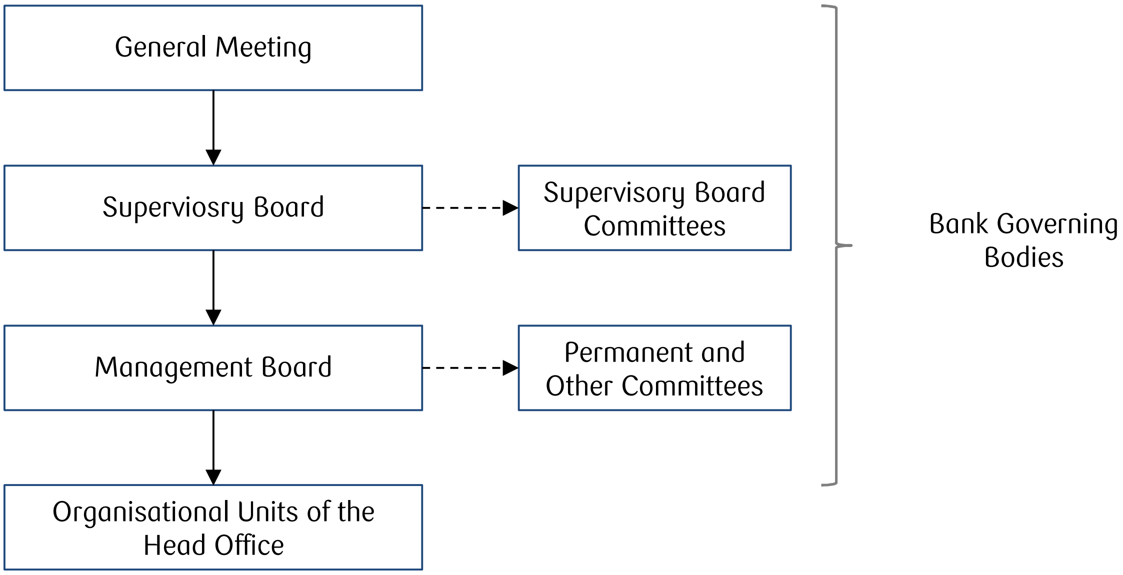
PKO Bank Hipoteczny SA did not breach any of these limits during the entire period covered by this Report.

The Bank achieved positive results on the coverage test and liquidity test performed at the end of 2016.

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,



Competences of PKO Bank Hipoteczny SA governing bodies and committees

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 internal control 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 Management Board's report on the Bank's operations and the financial report for the previous financial year in terms of their agreement with the books and documents and the requests of the Management Board concerning the division of profit or covering losses and presenting to the General Meeting a written annual report on the results of these assessments,
- applying to the 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 entities 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 2016, the following Supervisory Board committees operated:

- the Remuneration and Nomination Committee,
- the Audit, Finance and Risk Committee,
- the Commercial Committee.

The competences of the Bank's Remuneration and Nomination Committee included in particular:

- preparing opinions on and conducting periodic reviews of nominations for key management positions in the Bank,
- presenting to the Supervisory Board proposals concerning the appropriate forms of agreements with members of the 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,
- preparing opinions and performing periodic reviews, subject to the approval of the Supervisory Board, of the general principles for the policy on variable components of the compensation of individuals holding management positions,

- preparing and carrying out, with the potential support of external, independent entities, of an annual summary of its evaluation of the responsibilities of the Management Board, as well the programme for raising the qualifications of members of the Supervisory Board.

The competences of the Audit, Finance and Risk Committee of the Bank's Supervisory Board included, in particular:

- monitoring the process of financial reporting, including reviewing the Bank's periodic and annual financial reports,
- monitoring and periodically evaluating the effectiveness of internal control systems, the principles of prudent and stable management of the bank, including the principles of corporate governance for supervised institutions, internal audit and risk management, using information gained from the Bank by an independent auditor and other sources,
- monitoring financial audit proceedings and the independence of the statutory auditor and the entity authorised to audit the financial statements,
- monitoring the compliance of the Bank's policy in the area of taking on risk with the Bank's strategy and financial plan,
- providing opinions on the strategic direction and tasks in the area of banking risk in the context of the Bank's strategy and the conditions arising from the macroeconomic situation and the regulatory environment, in particular in the area of risk management strategy, including the acceptable general level of risk,
- analysing periodic reports related to banking risk and preparing guidelines on this basis, as well as accepting the strategy for managing banking risk and reviewing it periodically,
- providing opinions on the principles for managing models, the model for measuring risk, the principles of evaluating creditworthiness, the model of measuring impairment, the principles of risk management, the ICAAP process and the acceptance of periodic reports,
- providing opinions on the principles of the information policy in the area of capital adequacy, the policy in the area of managing the risk of non-compliance, managing operational risk, estimating internal capital, capital management and planning, the functioning of the internal control system,
- providing opinions on the draft regulations for setting the Mortgage Lending Value of Real Estate,
- monitoring and supervision concerning the outsourcing of external processes.

The competences of the Commercial Committee of the Bank's Supervisory Board included in particular:

- reviewing cooperation agreements 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 abolishing permanent Committees of the Bank and defining their properties,
- 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 abolishing branches and other organisational units of the Bank within the country and abroad,
- taking decisions on issues of covered bonds.

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

- the Asset and Liability Committee
- the Credit Committee
- the Data Quality Committee

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

- taking decisions on limits and threshold values for particular types of risk, questions related to the setting of transfer prices, and portfolio parameters and models used to determine write-offs and provisions, as well as other significant models of financial and business risk and their parameters,
- issuing recommendations for the Management Board, including in the area of shaping the structure of the Bank's assets and liabilities, the management of particular types of risk, capital and the price policy.

The competences of the Credit Committee include, in particular:

- taking credit decisions in relation to individual credit engagements that are significant in terms of their value, or issuing recommendations for the Management Board in this area,
- accepting transactions within the framework of acquisitions of receivables,
- issuing recommendations and taking decisions in the area of management of difficult receivables.

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 Offi ce.

The PKO Bank Hipoteczny SA Management Board

In 2016 the composition of the PKO Bank Hipoteczny SA Management Board, appointed to a term that ends upon approval of the financial reports for the year ending 31 December 2017, was as follows:

No.	Name & Surname	Position	Date of appointment	Date of resignation
1	Rafał Kozłowski	President	06.10.2014	
2	Jakub Niesłuchowski	Vice President	01.04.2015	
3	Marek Szcześniak	Vice President	01.06.2015	

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

1) supervision over management of compliance risk and internal audit is performed by Mr Rafał Kozłowski, president of the Management Board,
2) supervision over management of significant risks to which the Bank is exposed (other than compliance risk) is performed by Mr Marek Szcześniak, vice president of the Management Board,
3) supervision over matters of accounting and financial reporting, including financial controls, is performed by Mr Jakub Niesłuchowski, vice president of the Management Board.

During the reporting period, Mr Marek Szcześniak also performed the function of member of the Supervisory Board (from 1 January 2016 to 16 May 2016) and deputy chairman of the Supervisory Board (from 17 May 2016 to 31 December 2016) in Kredobank SA in Ukraine. Mr Rafał Kozłowski in the period from 1 December

2016 to 31 December 2016 performed the function of member of the Supervisory Board in Raiffeisen-Leasing Polska S.A. with its registered office in Warsaw and in PKO Leasing SA with its registered office in Łódź. 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 Management Board members in PKO Bank Hipoteczny SA is carried out by the Remuneration and Nominations 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). 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.

Management Board members are subject to continuous evaluation by the Supervisory Board's Remuneration and Nominations Committee, beginning from the moment of recruitment and continuing through their entire term. Additionally, in accordance with art. 395 § 2 point 3 of the Commercial Companies Code, the ordinary general meeting of shareholders once a year grants to each individual member a certification of performance of their duties. The granting of this certification 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 14 March 2016, by resolutions of the ordinary general meeting, all members of the Bank Management Board received certifications of the performance of their duties for the period ending 31 December 2015.

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 understanding of the provisions of § 2 para. 1 point 30a of the resolution of the Finance Minister dated 19 February 2009 on current and periodic information transmitted by issuers of securities and the conditions of deeming as equivalent information required by the provisions of the laws of a non-member state (Journal of Laws Dz.U. No. 33, position 259, as amended), the people managing the Bank are the members of the Management Board.

The compensation of Management Board members comprises:

- monthly compensation, whose level is set by the Bank's Supervisory Board,
- benefits to which Bank Employees are entitled:
    - on the basis of the generally applicable provisions of the law,
    - 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,
- variable components of compensation for the results of work, in particular bonuses, awards for particular achievements at work, whose specific principles for awarding and pay-out are described

in the Regulations on variable components of compensation 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 components of compensation 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:

- work contracts, calling for severance in the case of cancellation for reasons other than violation of the basic obligations arising from the employment relationship, in an amount not to exceed the value of three times the monthly compensation, 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,
- 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 and the Supervisory Board of PKO Bank Hipoteczny SA in 2016 are the subject of notes 32.3 and 32.4 of the PKO Bank Hipoteczny SA Financial Statement for the period from 1 January 2016 to 31 December 2016.

The PKO Bank Hipoteczny SA Supervisory Board

In 2016 the composition of PKO Bank Hipoteczny SA's Supervisory Board was as follows:

No.	Name & surname	Function on the supervisory board	Date of appointment	Date of resignation/ dismissal	Qualifications in accounting and financial review, and conditions of independence[1]	Audit, Finance and Risk Committee	Remuneration and Nominations Committee	Commercial Committee
1	Jakub Papierski	Chairman	06.10.2014				✓	✓
2	Jacek Obłękowski[2]	Deputy Chairman	06.10.2014	08.04.2016			✓	✓
3	Piotr Alicki[3]	Board Member	06.10.2014	31.10.2016			✓	✓
4	Piotr Mazur	Board Member/ Deputy Chairman (from 14.04.2016)	06.10.2014			✓		✓
5	Barbara Soares da Silva	Board Member	06.10.2014		✓	✓		
6	Artur Osytek	Board Member	06.10.2014		✓	✓		
7	Justyna Borkiewicz[4]	Board Member	28.10.2016					✓
8	Mieczysław Król[5]	Board Member	28.10.2016				✓	
9	Adam Marciniak[6]	Board Member	28.10.2016					✓

1 - meeting the criteria of independence in accordance with art. 86 para. 5 of the act on auditors

2 - Mr Jacek Obłękowski performed the function of Deputy Chairman of the Remuneration and Nominations Committee and member of the Commercial Committee until 8 April 2016

3 - Mr Piotr Alicki performed the function of Deputy Chairman of the Remuneration and Nominations Committee from 14 April 2016 to 31 October 2016 and a member of the Commercial Committee until 31 October 2016.

4 - Ms Justyna Borkiewicz performed the function of member of the Commercial Committee beginning 13 December 2016.

5 - Mr Mieczysław Król performed the function of Deputy Chairman of the Remuneration and Nominations Committee beginning 13 December 2016

6 - Mr Adam Marciniak performed the function of member of the Commercial Committee beginning 13 December 2016.

In accordance with art. 395 § 2 point 3 of the Commercial Companies Code, the ordinary general meeting of shareholders each year grants to each individual member of the Supervisory Board a certification of performance of their duties. The granting of this certification 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 14 March 2016, by resolutions of the ordinary general meeting, all members of the Bank's Supervisory Board received certifications of the performance of their duties for the period ending 31 December 2015.

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.

Human resources management

Employment

As of 31 December 2016, 69 people (69 full-time positions) were employed in PKO Bank Hipoteczny SA. That constitutes growth in relation to the end of 2015 by 13 people (13.25 full-time positions). The average employee age was 39.2 years, and 94% of employees had completed higher education. Women made up 59% of all employees.

Remuneration policy

The basic internal regulation in the area of Remuneration Policy is the PKO Bank Hipoteczny SA Compensation Regulations, introduced by an Ordinance of the Management Board President. In accordance with this ordinance, Bank employees are entitled to the following components of their compensation:

- base compensation,
- bonuses and awards for particular achievements in professional work,
- additional pay for overtime work and work during night hours.

The basic compensation and the additional benefits provided to employees are set based on analysis of market compensation in the banking sector. The compensation policy in PKO Bank Hipoteczny SA is cohesive with the principles of appropriate and effective risk management. In 2016 there were no significant changes in the Bank's compensation policy.

Variable components of compensation

A bonus system is in effect in PKO Bank Hipoteczny SA, under which the degree of achievement of basic goals determines the level of variable remuneration. The system works 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 components of compensation for members of the Management Board and key managers with high influence on the bank's risk profile (Material Risk Takers - MRT)

In accordance with the requirements of CRD IV, Commission Delegated Regulation (EU) 604/2014 and 2016/861 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 following regulations determining the principles for setting the variable components of compensation are in effect in the Bank:

- Regulations on variable components of compensation for Management Board members of PKO Bank Hipoteczny SA, adopted by a Resolution of the Supervisory Board,
- A list of the positions whose professional activities has a significant effect on the risk profile of the institution and who are covered by the Regulations on variable components of compensation for individuals holding management positions, adopted by a Resolution of the Management Board,
- The Regulations on variable components of compensation for persons holding management positions in the Bank, adopted by a Directive of the Bank's Management Board President.

List of Material Risk Takers – MRT in PKO Bank Hipoteczny SA

The rules of the policy on variable components of compensation for members of the Management Board and MRTs at the end of 2016 covered three members of the Management Board and 16 positions included in the List.

The List of MRTs was set by the Bank's Management Board based on qualitative and quantitative criteria for setting the categories of employees whose professional activities has a significant influence on the risk profile, 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) the high-level management team responsible for significant business units, for managing particular categories of risk and for control functions,
2) positions responsible for ensuring internal support who have decisive significance for the conduct of operations, exposing the Bank to significant operational risk and other types of risk,
3) positions generating credit risk and market risk, selected using criteria based on authorisation limits,
4) positions in which the employees received total compensation that exceeds the corresponding level defined by the provisions (insofar as the employees in fact have significant influence on the risk profile),
5) positions in which the employees fit into the same compensation category as the high-level management team and the individuals taking on operational risk (insofar as they have a significant influence on the risk profile).

As of 31 December 2016 the List of MRTs covered 16 positions, i.e. two positions more than on 31 December 2015.

The regulations of variable components of compensation describe the method of awarding to Management Board members and MRTs variable components of compensation related to the results and effects of their work. The basis for awarding variable components of compensation is primarily the achievement of the bonus goals assigned as part of the MbO system. Variable components of compensation for a given evaluation period (the calendar year) are awarded after evaluation of bonus goals. The maximum value of variable compensation cannot exceed 100% of the fixed compensation for a given evaluation period. The maximum value of variable compensation may be increased to a maximum of 200% of the fixed compensation on condition of approval by the General Meeting.

Variable compensation is awarded and paid out in the following forms:

- immediate – 60% of the variable compensation (in the first year after the evaluation period)
- deferred – 40% of the variable compensation (in equal tranches in the following three years after the first year following the evaluation period)

Meanwhile both the immediate and the deferred compensation are awarded in equal parts in cash and financial instruments (so-called phantom shares), whose conversion into cash is performed after the a retention period, and in the case of the deferred compensation – after the deferral period. If the value of variable compensation for a given year exceeds PLN 1 million, the sum of PLN 400,000 plus 60% of the excess amount over PLN 1 million is subject to deferral.

Each of the calculated components of deferred compensation may be reduced as a result of:

- violation of employee obligations,
- significant shortcomings in adherence to the provisions of the law or standards of client service,
- improper performance of assigned duties,
- behaviour toward other employees that violates the principles of social co-existence.

In the case of Management Board members a condition of awarding and paying out variable compensation is the approval of the financial report for a given evaluation period. The value of a Management Board member's bonus may be adjusted upward or downward according to a defined ratio depending on the results achieved ty the Bank described in the annual Bank Note (a set of key management indicators defined for a given calendar year).

In the case of:

- a significant worsening of the Bank's results,
- a determination that a significant negative change in the Bank's equity has taken place,
- a violation by a Management Board member or an MRT of the provisions of the law, the regulations, procedures or duties resulting from the employment relationship of a person holding a management position or the commission by them of significant errors,
- the correction of the execution and degree of execution of results of coals of a Management Board member or MRT,
- a worsening of the results of structures supervised or overseen by such individuals,
- the awarding of variable compensation on the basis of incorrect or misleading information or as a result of fraud by a Management Board member or an MRT

it is possible for the Supervisory Board or the Management board, respectively, to apply a malus type solution reducing the level of the variable compensation due.

In the case of an award of severance pay to a Management Board member related to dismissal from performance of duties related to the dissolution of the employment relationship, other than one resulting from the generally applicable provisions of the law, its level shall reflect the assessment of work during the last three years of employment, while the Bank's regulations define the maximum level of the severance payment. The Company's Supervisory Board shall determine the level and disbursement of the severance payment.

Members of the Management Board and selected MRTs are covered by agreements on non-competition, which call for compensation for refraining from employment in a competing company after being employed in the Bank.

The policy of variable components of remuneration for Management Board members and key managers with a high influence on the Bank's risk profile is subject to annual review by the Internal Audit Office, the

Committee on Remuneration and Nominations of the Bank's Supervisory Board and the Supervisory Board of PKO Bank Hipoteczny SA.

In 2016 there were four meetings of the Committee on Remuneration and Nominations of the Supervisory Board of PKO Bank Hipoteczny SA.

Non-financial benefits to which employees of PKO Bank Hipoteczny SA are entitled

Medical care

The Bank provides to its employees supplementary medical care, in addition to occupational medicine benefits (required by the Labour Code), to which employees are entitled under various benefit packages corresponding to particular groups of positions.

The Employer Social Benefit Fund

As part of the statutory Employer Social Benefit Fund, the Bank provides employees with 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 Employer Social Benefit Fund. The platform ensures a broad palette of benefits for employees to choose from. The level of funds received depends on the level of gross income per family member.

7. CORPORATE GOVERNANCE AND INFORMATION FOR INVESTORS

Statement of application of corporate governance

The *Principles of Corporate Governance for Supervised Institutions* are issued by the Financial Supervision Authority.

The Bank has adopted the *Principles of Corporate Governance for Supervised Institutions* on the basis of decisions by the Bank's governing bodies:

- a Resolution of the Bank's Management Board dated 15 December 2014 concerning the competences and duties of the Management Board, i.e. the conduct of the Bank's affairs and representation of the bank, in accordance with the generally applicable law and the Bank's Articles of Association,
- a Supervisory Board Resolution dated 18 December 2014 concerning the competences and duties of the Supervisory board, i.e. supervision of the conduct of the Bank's affairs, in accordance with the generally applicable law and the Bank's Articles of Association,
- a resolution of the General Meeting dated 22 December 2015, concerning the competences which are reserved for the General Meeting.

On the basis of the aforementioned decisions, and in the areas they concern, the Bank declines to apply 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 section 4, § 9 sections 1 and 6, § 10 section 3, § 11 section 3 and § 31 section 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 section 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 entities: the Bank does not apply this principle in light of the fact that the sole shareholder ensures effective and efficient performance of supervision by the Supervisory Board members through the appointment of two members of the Supervisory Board who meet the requirements of art. 86 section 4 of the Act on Statutory Auditors and Their Self-Governing Organisation, Entities Entitled to Audit Financial Statements and Public Oversight and through professionalism including adequate knowledge and experience on the part of the other Supervisory Board members.

In accordance with the requirement arising from § 27 of the *Principles of Corporate Governance for Supervised Institutions*, on 20 May 2016 the Supervisory Board performed an evaluation of the application of the Principles in the Bank in 2015. The Supervisory Board found that the Bank took adequate action to implement the provisions of the Principles in the area of declaring that they are to be applied by particular bodies of the Bank, and also by actions introducing the provisions of the Principles to the internal regulations and ensuring their application in the Bank's continuing operations.

The English-language text of the Principles can be found on the website of the Financial Supervision Authority at: https://www.knf.gov.pl/en/Images/principles_of_corporate_governance_tcm81-39736.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 reports. In accordance with the rules adopted in the Bank, one of the purposes of the internal control system is to assist decision-making processes, contributing to ensuring the credibility and accuracy of financial reporting, accounting procedures and reliable internal and external reporting.

Ensuring compliance with the control mechanisms in financial reporting is the responsibility of the Director of the Finance and Accounting Office, while internal audit, within the framework of confirmed audit plans, performs duties including checking and independently evaluating the adequacy and effectiveness of control over the financial reporting processes and evaluating risk management in this process. Thus far, in internal audit operations no issues that would cast doubt on the credibility of financial reporting have been observed.

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	6 Oct. 2014	300 mln	A	1 to 300,000,000	PLN 1	300 mln	PLN 300 mln	None
2	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	22 April 2016	200 mln	B	1 to 200,000,000	PLN 1	200 mln	PLN 200 mln	None
3	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	22 July 2016	200 mln	C	1 to 200,000,000	PLN 1	200 mln	PLN 200 mln	None
4	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	1 Dec. 2016	100 mln	D	1 to 100,000,000	PLN 1	100 mln	PLN 100 mln	None

Description of the rules for appointing and dismissing managers

Management Board members 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 Management Board members, including the President and the member responsible for risk, requires the consent of the Financial Supervision Authority. The terms of office of the Management Board members expire at the latest on the date of the General Meeting approving the financial report for the last full financial year during which the member serves. 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 informs the Financial Supervisory Committee of the composition of the Management Board and of changes in its composition immediately after its appointment or after changes are made to its composition. The Supervisory Board also informs the Financial Supervisory Commission of the Management Board members who as part of the division of competences are in charge of risk management or the internal audit unit, immediately after the point on this matter 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 competencies of the General Meeting include adoption of resolutions on setting the method of cancelling shares, the level of compensation for cancelled shares and approving the acquisition of the bank's own shares for the purpose of cancellation, the issuance of bonds convertible into shares or other instruments giving the right to acquire 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.

Rules for changes to the Bank's statute

The rules for changing the Statute of PKO bank Hipoteczny SA are compliant with the provisions of the Commercial Companies Code and the Banking Law. Changes to the Bank's Statute require a resolution of the General Meeting and a record in the Krajowy Rejestr Sądowy business register. Within the scope defined by art. 34 para. 2 of the Banking Law, a change in the Statute requires the consent of the 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 are presented in Section 6, Structure and Governing Bodies of PKO Bank Hipoteczny SA.

The General Meeting and relations with shareholders

The method by which the General Meeting operates and its basic rights and a description of the rights of shareholders and the method of their execution arise directly from the provisions of the law in force and of the Bank's Statute. In consideration of the fact that all shares in the Bank's equity capital are the property of a single shareholder, i.e. PKO Bank Polski SA, the resolutions of the General Meeting are adopted without the formal calling of a General Meeting, in accordance with the principles arising from art. 405 of the Commercial Companies Code.

Entity authorised to audit reports

On 14 May 2015 the PKO Bank Hipoteczny SA Supervisory Board selected the company KPMG Audyt Spółka z ograniczoną odpowiedzialnością sp. k. as the entity authorised to audit the Bank's financial statements for 2015-2016.

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 that is maintained by the National Council of Statutory Auditors, with the number 3546. The selection of the entity authorised to audit and review the financial statements was made by the Bank's Supervisory Board in accordance with the applicable law and professional standards, on the basis of par. 18 section 1 point 4 of the Bank's Articles of Association.

On 8 June 2015 an agreement was signed between PKO Bank Hipoteczny SA and KPMG on the performance of an audit of the financial statements for the years ending 31 December 2015 and 31 December 2016, and the review of the financial statements for the periods ending 30 June 2015 and 30 June 2016. An annex to the agreement was signed expanding the scope of the audit and review of financial statements.

KPMG's compensation(PLN thousand)	2016	2015[4]
Audit of financial statements	49.2	94.7
Review of financial statements and audit and review of group packages	80.0	36.9
Other services - *comfort letters*	461.8	-
Translation of financial statements	24.6	12.3

Other information

1. *Shareholders possessing directly or indirectly through subsidiary entities at least 5% of the total number of votes at the General Meeting*

Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna owns 100 percent of the shares of PKO Bank Hipoteczny SA.

The Bank's share capital amounts to PLN 800,000,000 (eight hundred million złoty) and is divided into 800,000,000 (eight hundred million) ordinary registered series A, B, C and D shares, with a nominal value of PLN 1 (1 złoty) each.

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

2. *Changes in the ownership of shares in PKO Bank Hipoteczny SA, and rights to them, by individuals in management and supervisory roles*

In 2016 there were no changes in the ownership of shares of PKO Bank Hipoteczny SA or rights to them held by managers and supervisors.

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

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

On 7 September 2015 Moody's issued long- and short-term issuer ratings for PKO Bank Hipoteczny at the level of Baa1/P-2, with a stable outlook.

On 8 September 2015 Moody's assigned a long-term provisional rating for PKO Bank Hipoteczny SA's PLN-denominated covered bonds 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 applies to all issues of PLN-denominated covered bonds thus far by PKO Bank Hipoteczny SA.

On 29 September 2016 Moody's issued 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 Euro-denominated covered bonds.

The rating assigned to PKO Bank Hipoteczny SA's covered bonds is the highest possible for Polish securities, which is capped by Poland's "country ceiling" rating for debt instruments, currently at Aa3.

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

In 2016 PKO Bank Hipoteczny SA did not conclude any significant agreements with the central bank or supervisory bodies.

5. *Financial and guarantee obligations granted*

[4] In 2015 the half-year financial statement was subject to the audit procedure

In 2016 PKO Bank Hipoteczny SA did not issue any guarantees. Financial obligations from credits granted and not paid out as of 31 December 2016 stood at PLN 611,793 thousand, meaning growth compared with 31 December 2015 of PLN 438,314 thousand.

6. Off-balance-sheet obligations granted to related entities

In 2016 PKO Bank Hipoteczny SA did not grant any off-balance sheet obligations to related entities.

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

In 2016 PKO Bank Hipoteczny SA did not take out loans or enter into loan or guarantee agreements unrelated to the Bank's operations.

8. Underwriting agreements and guarantees granted to subsidiaries

In 2016 PKO Bank Hipoteczny SA did not conclude any agreements on underwriting or guarantees.

9. Indication of proceedings under way before courts, arbitration bodies or public-administration authorities

In 2016 no proceedings were under way before courts, arbitration bodies or public-administration bodies concerning obligations or receivables whose value constitutes at least 10% of PKO Bank Hipoteczny SA's equity capital.

10. Factors that will influence future financial results 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:

1. the development of the residential market in Poland,
2. the development of the residential loans market in Poland,
3. 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,
4. the situation on the domestic and international covered bonds markets, in particular demand from investors for the covered bonds issued by the Bank.
5. the entry into force of the act on mortgage loans and other regulatory changes.

11. Information on the granting by the Bank or by a subsidiary of loan guarantees – in total to a single subsidiary unit or entity, if the total value of existing guarantees constitutes the equivalent of at least 10% of the issuer's equity capital.

In 2016 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 capital.

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

On 29 October 2015 PKO Bank Hipoteczny SA and PKO Bank Polski SA concluded an Agreement on a revolving line of credit on the current account for an amount of up to PLN 900 million for a period of three years, which is activated in tranches. The annual interest rate was set at the level of 3-month WIBOR plus 70 basis points, and the unused amount of an activated tranche is subject to a commission of 0.1% per annum. The value of credit used as of 31 December 2016 stood at PLN 393,739 thousand.

Additionally, as of 31 December 2016 the Bank had obligations for acquired receivables in the amount of PLN 3,038 million, which results from the transaction of acquisition from PKO Bank Polski SA of a portfolio of receivables on residential loans secured by mortgages described in Note 16 of the Financial Statement. The payment date of the obligation for the acquisition of the receivables is agreed each time between the parties in the Receivables Sale Agreement. For receivables acquired in 2016, the parties agreed that payment will be made at the latest from eight to twelve months from the transfer date. In the case of lack of payment for the obligation one month from the transfer date, the price is increased by interest.

13. *Information on the conclusion by the issuer or a subsidiary unit of one or more transactions with related entities on non-market conditions*

In 2016 PKO Bank Hipoteczny SA did not conclude significant transactions with related entities on non-market conditions.

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

From 1 January 2017 to 28 February 2017 PKO Bank Hipoteczny acquired, under the Framework Agreement with PKO Bank Polski SA on the sale of receivables, a portfolio of receivables on residential mortgage loans in the amount of PLN 552.1 million.

From 1 January 2017 to 28 February 2017 PKO Bank Hipoteczny issued bonds with a total nominal value of PLN 1,182.7 million, while bonds with a total nominal value of PLN 664 million matured and were redeemed. The issues were conducted within the bond issuance programme established by PKO Bank Hipoteczny on 30 September 2015.

ON 16 January 2017 the District Court for Gdańsk-Północ in Gdańsk registered changes in the Statue of the Bank in the area of § 19 para. 1, consisting of the replacement of the earlier Audit, Finance and Risk Committee of the Supervisory Board with two Supervisory Board Committees: the Audit and Finance Committee and the Risk Committee. Mieczysław Król, Artur Osytek and Justyna Borkiewicz joined the Audit and Finance Committee. Piotr Mazur, Barbara Soares da Silva and Adam Marciniak joined the Supervisory Board Risk Committee.

On 2 February 2017 the Bank issued Euro-denominated covered bonds worth EUR 25 million and a maturity period set at seven years from the issue date. These bonds were purchased as part of a private placement. The covered bonds are listed on the Luxembourg Stock Exchange.

On 2 February 2017 the Bank signed with PKO Bank Polski an Agreement for a renewable revolving line of credit on the current account, up to a limit of PLN 1.5 billion, which will be made available in tranches. The line of credit was extended for the period until 2 February 2020. On 28 February 2017 the amount of PLN 1 billion was made available.

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

In 2016 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 entities.

Statement by the PKO Bank Hipoteczny SA Management Board

The PKO Bank Hipoteczny SA Management Board certifies that, to the best of its knowledge:

- the financial report for the period from 1 January 2016 to 31 December 2016 was prepared in accordance with the accounting principles in force and reflects in a true, honest and clear manner the assets and financial situation of PKO Bank Hipoteczny SA and its financial result,
- the Directors Report for the period from 1 January 2016 to 31 December 2016 contains a true picture of the development, achievements and standing of PKO Bank Hipoteczny SA, including the description of the basic risks and threats.

The PKO Bank Hipoteczny SA Management Board certifies that the entity authorised to audit the financial statements, conducting its review of the condensed interim financial statements for the period from 1 January 2016 to 31 December 2016 was selected in accordance with the law and that this entity and the statutory auditor conducting the audit met the conditions for issuing an impartial and independent report on the annual financial statement, in accordance with the appropriate regulations and professional norms.

This PKO Bank Hipoteczny SA Directors' Report for the period from 1 January 2016 to 31 December 2016 comprises 42 numbered pages.

Signatures of all Management Board members

28 February 2017	Rafał Kozłowski	President of the Management Board	*Signed on the Polish original* .... (signature)
28 February 2017	Jakub Niesłuchowski	Vice-President of the Management Board	*Signed on the Polish original* .... (signature)
28 February 2017	Marek Szcześniak	Vice-President of the Management Board	*Signed on the Polish original* .... (signature)