



Bank Hipoteczny

PKO Bank Hipoteczny SA  
Directors' Report  
for the six-month period ended  
30 June 2017

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## 1. INTRODUCTION

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

PKO Bank Hipoteczny SA achieved a leading position in the Polish mortgage banks market by total assets and volume of mortgage loans. The Bank is also the largest regular issuer of covered bonds in Poland, operating on both Polish and foreign markets. The outstanding mortgage covered bonds issued by the Bank exceeds the half of the total market volume.

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

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

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

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

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

## 2. EXTERNAL OPERATING CONDITIONS

### 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 May 2017 show that Poland's GDP grew in Q1 2017 by 4.2% year on year. The European Commission forecast published in May 2017 assumes that Poland's GDP will grow by 3.5% in 2017, and by another 3.2% 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 increased 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 Q1 2017 stood at 1,324.2 thousand people, down by 276.3 thousand people, or 17.3%, from a year earlier. The unemployment rate at the end of March 2017 stood at 8.1%, compared with 9.9% a year earlier. The number of people employed at the end of March 2017 stood at 16,281 thousand, up 1.7% year on year, according to GUS's Research on the Population's Economic Activity (BAEL). Also, the average monthly wage in the enterprise sector in June 2017 stood at PLN 4,508.08, up 5.7% 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 June 2017 was 1.5% 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.

### Residential real estate market

- Good climate on the housing market in Q2 2017 was maintained. On the market of flats offered by development companies, despite the high demand the price growth in the analysed period was less than 3% year on year because of the adequately matched supply of flats. The situation on the residential real estate market is stable in terms of prices. On the secondary market, like on the primary market, the transaction prices of sq. meter of flats were stable despite the observed revival.
- According to the data published by GUS, more flats were completed during the first six months of 2017 than in the corresponding period of the previous year. The number of residential units for which permits were issued, or building plans were submitted, and the number of residential units on which construction began also increased. In H1 2017, 78,276 dwellings were completed, or 6.1% more year on year. During the first six months of 2017 permits were issued, or building plans were submitted, for 130,687 residential units, or 33.2% more year on year. The number of units on which construction began increased, by 22.9% year on year, to 106,036.
- According to data provided by REAS on the development companies' market, 17.5 thousand flats were sold in Q2 2017 on the six markets with the highest turnover (Warsaw, Kraków, Wrocław, Tricity, Poznań and Łódź), (compared to 17.7 thousand in Q2 2016), and 17.6 thousand flats were

bought (compared to 15.1 thousand in Q2 2016). The number of completed dwellings that remained in development companies' inventory in Q2 2017 stood at 50.0 thousand.

- According to data published by the National Bank of Poland, in Q1 2017 the availability of flats in big cities improved slightly. As a result of an increase in wages, the average availability ratio of flats in Q1 2017 reached 0.88 sq. m. buyable for an average monthly salary in the enterprise sector and was by 0.04 sq. m. higher than Q4 2016.
- The demand for flats generated by the Flats for Young People (MdM) scheme is maintained. Despite the fact that the funds planned for payments in 2017 have been exhausted and the limit for 2018 has been used up in 50%, the demand for flats is supported by the disbursements from credit agreements that have already been concluded or are in the process of being concluded. In 2018, the number of MdM agreements that will be signed can be estimated at around 19,000, which will translate into PLN 5.5-5.9 billion in loans granted to finance purchases of residential units.
- According to data published by the National Bank of Poland, the estimated share of cash purchases of flats in the primary market in 7 largest cities was 67% in Q1 2017 and increased by 5 p.p. year on year.

### Residential lending market

- According to NBP data, banks' receivables from housing loans in Poland as at 30 June 2017 stood at PLN 391.1 billion, up almost by 1.1% year on year. Of that amount, loans denominated in PLN accounted for 63% (a 4 p.p. increase compared to 31 December 2016).
- 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 Q1 2017 stood at PLN 11.0 billion, up by 16.7% year on year.

### Covered bond market

- As at the date of this Report, three mortgage banks were operating in Poland, namely PKO Bank Hipoteczny SA, mBank Hipoteczny SA and Pekao Bank Hipoteczny SA.
- The Polish covered bond market is relatively small, and characterised by moderate liquidity. At the end of June 2017, the total value of outstanding covered bonds issued by Polish mortgage banks stood at about PLN 11.6 billion, up by PLN 1.8 billion compared to the end of 2016. Still, that accounts for barely 3.2% 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%.
- In the reporting period PKO Bank Hipoteczny SA was the largest issuer of mortgage covered bonds in Poland. As at 30 June 2017, the value of outstanding mortgage covered bonds issued by PKO Bank Hipoteczny SA stood at PLN 6.1 billion, which accounted for approx. 53% of the total value of outstanding covered bonds issued by Polish mortgage banks. For mBank Hipoteczny SA and Pekao Bank Hipoteczny SA, this amount was PLN 4.2 billion and PLN 1.3 billion, respectively.
- On 1 January 2016, an amendment to the Polish Covered Bonds Act and other regulations became effective. The changes in the regulations removed barriers to investment in Polish covered bonds for both domestic and foreign investors. The amendments also introduced mechanisms and requirements concerning covered bonds and mortgage banks, which increase the safety of covered bonds from the investor's point of view. The amendments allowed banks to achieve a higher proportion of residential mortgage loans refinanced with covered bonds than before. The changes in the laws regulating the covered-bond market and the operations of mortgage banks had a positive influence on the size and liquidity of Poland's covered-bond market.

### 3. FINANCIAL PERFORMANCE

#### Basic financial indicators for PKO Bank Hipoteczny SA

|                            | 30/06/2017 | 31/12/2016 | 30/06/2016 |
|----------------------------|------------|------------|------------|
| Total assets (PLN million) | 12,134.5   | 8,610.4    | 4,352.6    |
| ROA <sup>1</sup>           | 0.49%      | 0.30%      | 0.02%      |
| ROE <sup>2</sup>           | 5.85%      | 2.49%      | 0.13%      |
| Capital adequacy ratio     | 16.7%      | 17.1%      | 17.9%      |
| Leverage ratio             | 7.6%       | 8.8%       | 10.6%      |

#### The balance sheet of PKO Bank Hipoteczny SA

| PLN million   | 30/06/2017      | 31/12/2016     | 30/06/2016     |
|---|-----------------|----------------|----------------|
| Cash and balances with the central bank                     | 0.0             | 16.0           | 0.7            |
| Amounts due from banks                                      | 7.6             | 13.0           | 0.7            |
| Financial derivative instruments                            | 0.2             | 27.8           | 0.0            |
| Net loans and advances to customers                         | 11,538.6        | 8,247.9        | 4,181.0        |
| Securities  | 563.1           | 283.0          | 151.6          |
| Other assets  | 25.0            | 22.7           | 18.6           |
| <b>TOTAL ASSETS</b>   | <b>12,134.5</b> | <b>8,610.4</b> | <b>4,352.6</b> |
| Line of credit liabilities                                  | 1,244.8         | 393.8          | 201.2          |
| Amounts due to PKO Bank Polski SA for purchased receivables | 1,786.5         | 3,038.0        | 2,376.6        |
| Mortgage covered bonds issued                               | 6,116.8         | 3,232.1        | 1,030.2        |
| Unsecured bonds issued                                      | 1,912.5         | 1,151.2        | 246.3          |
| Financial derivative instruments                            | 103.6           | 0.1            | 0.0            |
| Other liabilities   | 21.8            | 13.9           | 12.0           |
| Equity  | 948.5           | 781.3          | 486.3          |
| <b>TOTAL LIABILITIES AND EQUITY</b>                         | <b>12,134.5</b> | <b>8,610.4</b> | <b>4,352.6</b> |

Total assets of PKO Bank Hipoteczny SA as at 30 June 2017 stood at PLN 12,134.5 million, up by 41% compared to the end of 2016. Mortgage loans were the key item on the assets side of the Bank's balance sheet. Their carrying amount, taking into account impairment write-downs as at 30 June 2017, was

<sup>1</sup> Ratio expressed as the quotient of profit (loss) for the year and the average level of assets at the beginning and at the end of the reporting period and intermediate monthly periods, annualized

<sup>2</sup> Ratio calculated by dividing the profit (loss) after tax by the average level of equity at the beginning and at the end of the reporting period and intermediate monthly periods, annualized

PLN 11,538.6 million, of which new loans amounted to PLN 3,682.6 million, whereas loans purchased from PKO Bank Polski SA amounted to 7,856.0 million.

On the equity and liabilities side, the share of covered bonds rose significantly and reached 50% of total assets at the end of June 2017. In H1 2017, PKO Bank Hipoteczny SA carried out:

- a) an issue of EUR-denominated covered bonds, by way of a private placement, worth EUR 25 million,
- b) a benchmark issue of EUR-denominated covered bonds, worth EUR 500 million,
- c) a benchmark issue of PLN-denominated covered bonds with floating rate, worth PLN 500 million,
- d) an issue of PLN-denominated covered bonds with fixed rate, worth PLN 265 million,

That brought the carrying amount of covered bonds at the end of June 2017 to PLN 6,116.8 million.

Financial liabilities to PKO Bank Polski SA, in the form of a revolving line of credit and liabilities arising from the acquisition of credit receivables from PKO Bank Polski SA, constituted a significant item in the Bank's equity and liabilities as at 30 June 2017. The total amount of these liabilities was PLN 2,931.3 million. Short-term bonds issued by the Bank were also a significant source of funding the Bank's operations. Their total amount as at 30 June 2017 stood at PLN 1,912.5 million.

In the period from 1 January to 30 June 2017, PKO Bank Polski SA subscribed for a total of PLN 150 million worth of new shares in PKO Bank Hipoteczny SA. As a result of this capital increase, PKO Bank Hipoteczny SA's equity reached PLN 948.5 million.

#### Profit and loss account of PKO Bank Hipoteczny SA

| PLN million  | 01/01/2017  | 01/01/2016 |
|--|-------------|------------|
|  | 30/06/2017  | 30/06/2016 |
| Net interest income  | 62.2        | 19.4       |
| Net fee and commission income                                | (2.1)       | (2.3)      |
| Net income from financial instruments measured at fair value | (0.2)       | 0.0        |
| Net foreign exchange gains                                   | 6.5         | (0.0)      |
| Other operating income and expenses                          | 0.0         | 0.0        |
| Impairment allowance and write-downs                         | (1.5)       | (0.8)      |
| General administrative expenses                              | (30.9)      | (15.7)     |
| <b>Operating result</b>                                      | <b>34.0</b> | <b>0.6</b> |
| Profit / (Loss) before income tax                            | 34.0        | 0.6        |
| Income tax expense   | (8.9)       | (0.4)      |
| <b>Net profit / (loss)</b>                                   | <b>25.1</b> | <b>0.2</b> |

PKO Bank Hipoteczny SA ended H1 2017 with a profit of PLN 25.1 million, an increase of PLN 24.9 million year on year. The most significant driver of the positive financial result was the improvement in net interest income as a result of the significant expansion in the scale of the Bank's operations, coupled with limited growth in the cost base.

In the analysed period, the Bank generated interest income of PLN 165.5 million, comprising primarily income from mortgage loans in the amount of PLN 161.2 million, and income from securities. During this

time, the Bank incurred interest expense of PLN 103.3 million. Interest expense resulted mainly from issued covered bonds (including costs of IRS and CIRS hedging transactions). The related interest expenses amounted to PLN 54.0 million. The Bank also incurred interest expense of PLN 31.9 million on account of the revolving working capital overdraft and the liability from the purchase of receivables from PKO Bank Polski SA, and of PLN 17.2 million on account of bonds issued.

In the period from 1 January to 30 June 2017, the Bank achieved net fee and commission income of PLN -2.1 million. This item comprised of mainly costs of expert valuations of the mortgage lending value of real estate (MLV), as prepared by real estate appraisers, in the amount of PLN -3.9 million, as well as income from clients for real estate valuations performed by the Bank, in the amount of PLN 2.5 million.

In the period from 1 January to 30 June 2017, the Bank incurred general administrative expenses of PLN 30.9 million. The cost of tax on certain financial institutions, which amounted to PLN 11.3 million in the reporting period, accounted for a significant portion of general and administrative expenses. The costs of materials in the amount of PLN 8,8 million, including costs related to services rendered by PKO Bank Polski SA in the amount of PLN 5.8 million, were a significant item in the structure of administrative expenses. Costs of employee benefits, whose amount during the reporting period reached PLN 7.9 million, were another significant item in the structure of administrative expenses.

An increase of PLN 15.2 million year on year in administrative expenses was mainly due to tax on certain financial institutions (+ PLN 11.3 million) and due to an increase in the costs of services rendered by PKO Bank Polski SA (+ PLN 2.5 million), which resulted from a 176,0% increase in the value of the loan portfolio in the Bank's balance sheet.

In light of the growth of income that exceeded the growth of costs, the Bank reported an improvement in the annualized C/I ratio, which amounted to 35.8% (excluding the cost of tax on certain financial institutions) for the period from 1 July 2016 to 30 June 2017.

The Bank's net impairment write-down and provision income In the period from 1 January 2017 to 30 June 2017 stood at PLN -1.5 million, including a provision for incurred but not reported credit risk (IBNR) in the amount of PLN -1.3 million.



#### 4. OPERATIONS AND DEVELOPMENT PLANS OF PKO BANK HIPOTECZNY SA

##### Sale of residential mortgages under the agency model

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

In H1 2017, the Bank originated mortgage loans with a total amount of PLN 1,557.7 million, which constitutes a 47.4% increase compared to H1 2016.

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

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

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

| Criterion  | Agency model   |
|--|--|
| Loan value / market value of the real estate           | max. 80% <sup>3</sup>  |
| 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 register |
| Currency   | PLN  |
| Designation  | Residential purposes   |

##### Acquisition of receivables under residential mortgage loans

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

On 17 November 2015, PKO Bank Hipoteczny SA signed a receivables sale framework agreement with PKO Bank Polski SA. Under this agreement, in H1 2017 PKO Bank Hipoteczny SA purchased from PKO Bank Polski SA a portfolio of receivables under residential mortgage loans with a total amount of PLN 2,230.4 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 register |

<sup>3</sup> Where a low down payment insurance policy is used, the Bank may grant a loan for which this ratio is not higher than 90%.

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

### Structure of the residential mortgage loan portfolio

The structure of the portfolio of gross loans on PKO Bank Hipoteczny SA's balance sheet according to the LTV ratio at market value<sup>4</sup> and LTV at the mortgage lending value of property is presented in the following tables.

| Gross loans by LTV at market value    | 30/06/2017  | 31/12/2016  | 30/06/2016  |
|---------------------------------------|-------------|-------------|-------------|
| < 50%                                 | 29%         | 31%         | 28%         |
| 51% - 60%                             | 16%         | 17%         | 19%         |
| 61% - 70%                             | 18%         | 19%         | 21%         |
| 71% - 80%                             | 23%         | 23%         | 22%         |
| 80% - 90%                             | 14%         | 10%         | 10%         |
| > 90%                                 | 0%          | 0%          | 0%          |
| <b>Total</b>                          | <b>100%</b> | <b>100%</b> | <b>100%</b> |
| Average LTV based on market valuation | 60.9%       | 60.0%       | 60.9%       |

| Gross loans by LTV at MLV | 30/06/2017  | 31/12/2016  | 30/06/2016  |
|---------------------------|-------------|-------------|-------------|
| < 50%                     | 16%         | 18%         | 14%         |
| 51% - 60%                 | 10%         | 12%         | 12%         |
| 61% - 70%                 | 13%         | 14%         | 15%         |
| 71% - 80%                 | 17%         | 16%         | 18%         |
| 80% - 90%                 | 21%         | 19%         | 21%         |
| > 90%                     | 23%         | 21%         | 20%         |
| <b>Total</b>              | <b>100%</b> | <b>100%</b> | <b>100%</b> |
| Average LTV based on MLV  | 72.2%       | 71.3%       | 72.5%       |

### Covered bonds

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

#### *Domestic issuance of covered bonds*

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

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

On 22 June 2017, PKO Bank Hipoteczny carried out its pilot issue of PLN-denominated fixed rate mortgage covered bonds. The Bank offered PLN 265 million of securities to institutional investors. At the time of book-

<sup>4</sup> 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.

building, the interest rate on covered bonds was set at 2.69%. The period from the date of issue to redemption of covered bonds was set at 4 years plus 3 months, and the maturity date was set at 10 September 2021.

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

Chart: Purchasers of PKO Bank Hipoteczny SA's domestic issuance of covered bonds (2015 - 2017)

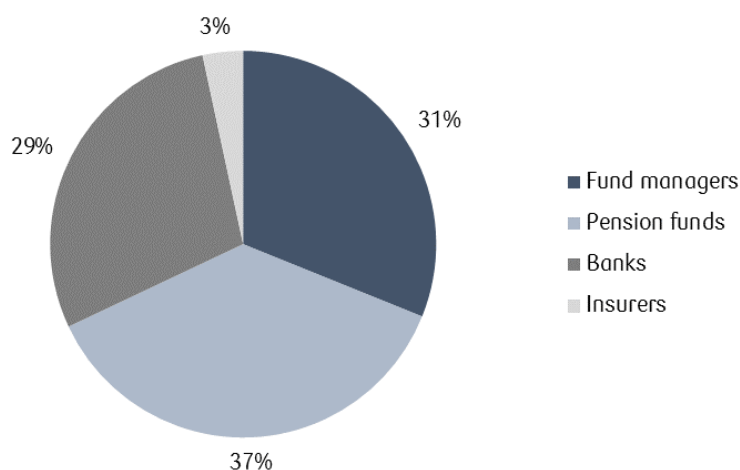


Chart: Purchasers of PKO Bank Hipoteczny SA's domestic issuance of covered bonds by country of origin (2015 - 2017)

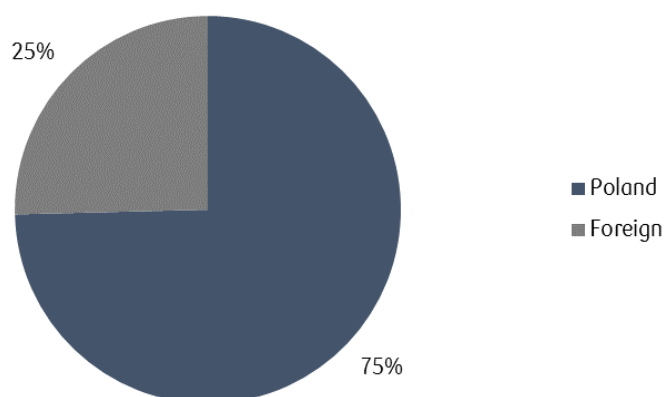


Table: Polish zloty-denominated issues of mortgage covered bonds by PKO Bank Hipoteczny SA by 30 June 2017

| Series | Covered bond number (ISIN) | Issuance date | Maturity date | Value (PLN) | Interest       | Currency | Rating | Listing                       |
|--------|----------------------------|---------------|---------------|-------------|----------------|----------|--------|-------------------------------|
| 1      | PLPKOHP00017               | 11/12/2015    | 11/12/2020    | 30,000,000  | WIBOR3M +0.75% | PLN      | Aa3    | Bondspot, WSE parallel market |
| 2      | PLPKOHP00025               | 27/04/2016    | 28/04/2021    | 500,000,000 | WIBOR3M +0.65% | PLN      | Aa3    | Bondspot, WSE parallel market |

|     |              |            |            |             |                   |     |     |  |
|-----|--------------|------------|------------|-------------|-------------------|-----|-----|--|
| 3   | PLPKOHP00033 | 17/06/2016 | 18/06/2021 | 500,000,000 | WIBOR3M<br>+0.59% | PLN | Aa3 | Bondspot,<br>parallel market<br>Warsaw Stock<br>Exchange |
| 4.  | PLPKOHP00041 | 28/04/2017 | 18/05/2022 | 500,000,000 | WIBOR3M<br>+0.69% | PLN | Aa3 | Bondspot,<br>parallel market<br>Warsaw Stock<br>Exchange |
| 5.. | PLPKOHP00058 | 22/06/2017 | 10/09/2021 | 265,000,000 | 2.69%             | PLN | Aa3 | Bondspot,<br>parallel market<br>Warsaw Stock<br>Exchange |

### *International issuance of covered bonds*

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

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

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

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

Chart: Purchasers of PKO Bank Hipoteczny SA's EUR-denominated covered bonds (2016 - 2017)

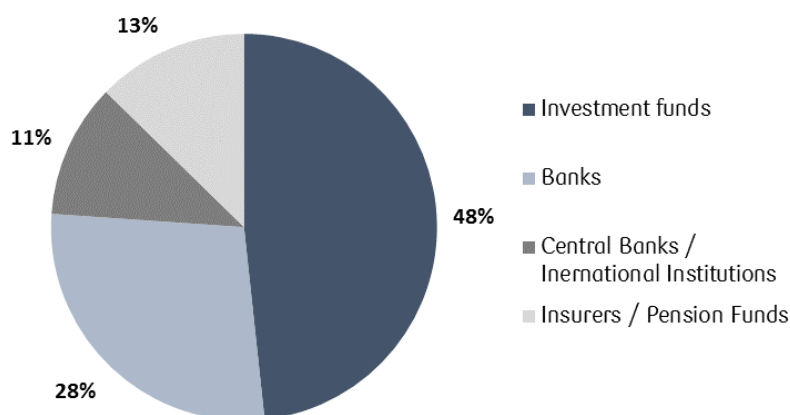


Chart: Purchasers of PKO Bank Hipoteczny SA's EUR-denominated covered bonds by country of origin (2016 - 2017)

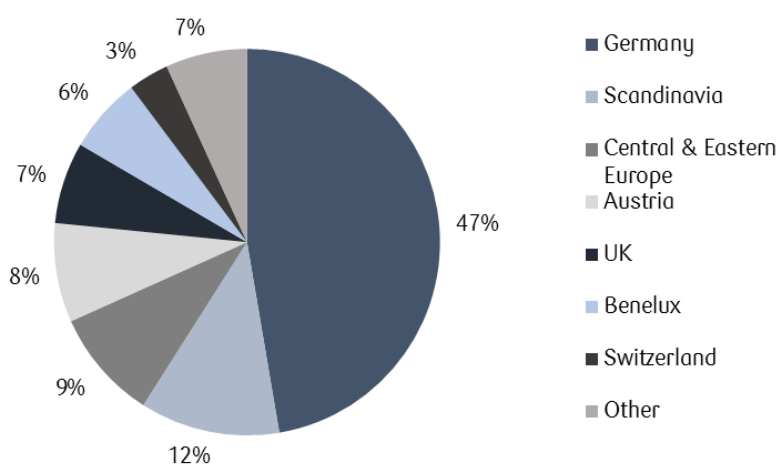


Table: EUR-denominated issues of mortgage covered bonds by PKO Bank Hipoteczny SA by 30 June 2017

| Series | Covered bond number (ISIN) | Issuance date | Maturity date | Value (EUR) | Coupon | Price   | Currency | Rating | Listing                    |
|--------|----------------------------|---------------|---------------|-------------|--------|---------|----------|--------|----------------------------|
| 1      | XS1508351357               | 24/10/2016    | 24/06/2022    | 500,000,000 | 0.125% | 99.702% | EUR      | Aa3    | LuxSE, WSE parallel market |
| 2      | XS1559882821               | 02/02/2017    | 02/02/2024    | 25,000,000  | 0.82%  | 100.00% | EUR      | Aa3    | LuxSE                      |
| 3      | XS1588411188               | 30/03/2017    | 24/01/2023    | 500,000,000 | 0.625% | 99.972% | EUR      | Aa3    | LuxSE, WSE parallel market |

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 purchase 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 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 has been maintained for all issues of PLN-denominated covered bonds so far by PKO Bank Hipoteczny SA.

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

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

### **Short-term bonds**

On 30 September 2015, PKO Bank Hipoteczny SA established a non-public short-term bond issuance programme. In the period from 1 January to 30 June 2017, the Bank issued bonds worth a total of PLN 2,627.6 million under that scheme. The carrying amount of issued bonds as at 30 June 2017 was PLN 1,912.5 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 Polish Covered Bonds Act imposes an obligation on PKO Bank Hipoteczny SA to mitigate the risk related to fluctuations in currency rates and interest rates.

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

In the Management Board's opinion, as at 30 June 2017 there were no factors that could indicate a risk of delay in payment of liabilities incurred by the Bank. In the period from 1 January to 30 June 2017, the Bank did not breach any of the liquidity limits. Detailed information on the levels of the Bank's liquidity limits is provided in Note 37 to the Financial Statements.

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

When issuing fixed interest bonds in PLN, the Bank entered into IRS transactions to hedge interest rate risk. In the IRS transaction, the bank pays a coupon based on a floating PLN rate, and receives a coupon based on a fixed PLN rate.

PKO Bank Hipoteczny SA is a regular issuer of covered bonds on both the domestic and the international markets. The Bank also intends to continue seeking short-term financing in the form of short-term bond issues. Potential issues of covered bonds in convertible currencies will involve conclusion of financial risk mitigating transactions on the interbank market.

**PKO Bank Hipoteczny SA's development directions:**

The strategy adopted by PKO Bank Hipoteczny SA calls for:

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

## 5. INTERNAL OPERATING CONDITIONS

### Qualified leadership

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

### The lending process and the relationship with PKO Bank Polski SA

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

- the agency model,
- the pooling model.

The relationship with PKO Bank Polski SA is regulated in detail by an outsourcing agreement concluded 16 January 2015 between the two entities. The agreement regulates the scope of the relationship and describes in detail the method of performing the outsourced functions, first and foremost in the area of offering and administering mortgage loans and performing functions supporting PKO Bank Hipoteczny SA. Additionally, the agreement imposes obligations on PKO Bank Polski SA to properly perform the functions entrusted to it, as well as broad reporting and controlling obligations for the benefit of PKO Bank Hipoteczny SA.

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

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

### Internal control system

The internal control system in PKO Bank Hipoteczny SA is one of the elements of managing the Bank. It supports decision-making processes by ensuring:

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

The internal control system in PKO Bank Hipoteczny SA includes:

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



- the compliance unit, which, in cooperation with the Bank's other units, is responsible for identification, assessment, control and monitoring of the Bank's compliance risk with generally applicable laws as well as the Bank's internal regulations and market standards adopted by the Bank, taking into account regulatory recommendations, and for the submission of the relevant reports,
- an independent internal audit unit to evaluate and assess, independently and objectively, the adequacy and effectiveness of the risk management system and the internal control system, except for the aspects relating to the internal audit unit itself.

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

- the first level consists of organizational structures that manage risk in the Bank's operating activities,
- the second level consists of specialized posts or organizational units that manage the Bank's significant risks, and the activities of the compliance unit,
- the third level consists 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 organisational units under the implemented internal control system. The Management Board also identifies the corrective actions to be taken to remedy any irregularities identified by the internal control system, including specific corrective and disciplinary measures. The criteria adopted by the Bank for distinguishing the relevant processes take into account the management strategy, the business model and the impact on the Bank's financial performance and capital adequacy, as well as risk appetite. The processes confirmed as significant are related to the objectives and targets of the internal control system.

In H1 2017, the reporting under the internal control system and the remedial actions taken indicated that the internal control system in PKO Bank Hipoteczny SA was effective and adequate to the scale of the Bank's operations.

Oversight of the internal control system in PKO Bank Hipoteczny SA is conducted by the Supervisory Board supported by the Supervisory Board's Audit and Finance Committee. The Audit and Finance Committee monitors the effectiveness of the internal control system based on the reports obtained from the compliance unit, the internal audit unit, and the control function's matrix coordinator.

## **Risk management**

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

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

- the Bank manages identified types of risk associated with its operations,
- the process of risk management is adequate to the scale of the Bank's operations and to the materiality, scale and complexity of a given risk,
- the 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         |
|---|----------------------|
| <b>Credit risk:</b> a risk of losses as a result of a client's failure to meet obligations to the Bank due to 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); credit risk includes <b>residual risk</b> , arising from lower than assumed effectiveness in applying credit risk mitigation techniques.   | material             |
| <b>Liquidity risk:</b> a risk of inability to fulfil obligations in a timely manner as a result of a lack of liquid funds; liquidity risk includes <b>financing risk</b> , which is a risk of losing financing sources, inability to roll over maturing financing sources or losing access to new sources of financing.   | material             |
| <b>Operational risk:</b> a risk of losses resulting from failure by, or faults in, internal processes, individuals or systems, or from external events, including <b>legal risk</b> (the risk of losses arising from lack of familiarity with, misunderstanding of and failure to apply legal norms and accounting standards, the inability to enforce the provisions of agreements, disadvantageous interpretations or decisions by courts or bodies of public administration); operational risk does not include reputation risk or business risk.  | material             |
| <b>Business risk:</b> a 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 <b>strategic risk</b> .   | material             |
| <b>Macroeconomic risk:</b> a risk of worsening of the Bank's financial position as a result of an unfavourable influence of changing macroeconomic conditions.  | material             |
| <b>Model risk:</b> a risk of losses as a result of erroneous business decisions on the basis of the models in operation.  | material             |
| <b>Compliance risk:</b> a risk of legal sanctions, financial losses or the loss of reputation as a result of failure by the Bank, Bank employees or entities operating on its behalf to comply with the law, the Bank's internal regulations or the market standards adopted by the Bank.   | material             |
| <b>Capital risk:</b> a risk of failure to ensure the adequate 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 stressed situations; capital risk includes <b>risk of excessive leverage</b> – a risk arising from susceptibility to the threat arising from financial leverage or conditional financial leverage, which may require unplanned actions to correct business plans, including emergency sale of assets that may bring losses or cause the need for a correction of the valuation of the remaining assets. | material             |
| <b>Interest rate risk:</b> a risk of losses on balance-sheet items and off-balance-sheet items that are sensitive to fluctuations in interest rates, as a result of fluctuations in market interest rates.  | potentially material |
| <b>Currency risk:</b> a risk of losses on fluctuations in currency rates, generated by maintaining open positions in certain foreign currencies.  | potentially material |
| <b>Concentration risk:</b> a threat arising from excessive concentration in terms of:<br>- exposure to particular clients,<br>- exposure to groups of related clients,<br>- exposure subject to joint or correlated risk factors<br>characterised by the potential to generate losses large enough to threaten the financial condition of the Bank or the ability to conduct basic operations or to lead to a significant change in the Bank's risk profile.  | potentially material |
| <b>Reputation risk:</b> a risk of deterioration of the Bank's reputation among clients, counterparties, investors, supervisory and control bodies and the public, as a result of business decisions by the Bank, operational events, cases of non-compliance or other events.   | potentially material |

Material risks 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.

For potentially material risks, PKO Bank Hipoteczny SA performs periodic monitoring of whether they should be designated as material. The Bank has defined significance criteria; when they are met, a risk will be recognised as significant. In the period from 1 January to 30 June 2017, 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 monitors these limits on an ongoing basis. In the period from 1 January to 30 June 2017, none of them was exceeded.

A detailed description of the Bank's risk management objectives and methods is provided in the Condensed interim financial statements of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2017 in the chapter "*Objectives and principles of management of financial instruments-related risk*" (Notes 33-41). It also includes important information on the level of financial risk in the Bank's operations and a description of the adopted risk management objectives and methods, together with the methods of hedging significant types of planned transactions for which hedge accounting is applied.

### **Measurement of mortgage loan collaterals**

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

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

Additionally, the question of loan collaterals is addressed by:

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

The Bank has in place and applies the Rules for setting the mortgage lending value of real estate, as approved by the Polish Financial Supervision Authority on 26 February 2015. The Rules take into account the provisions of Recommendation F concerning the basic criteria applied by the Polish Financial Supervision Authority in approving rules for setting the mortgage lending value of real estate issued by mortgage banks.

The mortgage lending value of real estate is the value determined by the mortgage bank which, in the Bank's opinion, reflects the level of risk associated with the real estate as the loan collateral. The mortgage lending value of real estate is used to determine the maximum amount of a loan that can be secured by a mortgage

on a given property, and to make a decision on whether a receivable secured by a particular property can be purchased by the Bank.

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

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

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

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

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

| No. | Stage   | Implementation   |
|-----|---|--|
| 1   | Confirmation of the property's legal status   | PKO Bank Polski SA, under the Outsourcing Agreement  |
| 2   | Preparation of an inspection protocol of the property, together with market research          | Appraiser with appropriate experience and the ability to estimate bank risk in the area of securing mortgage loans |
| 3   | Preparation of the MLV expert opinion   | A dedicated organisational unit of the Bank: the Collateral Valuation 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 at 30 June 2017 stood at PLN 8,156.5 million. The nominal value of the over-collateralisation in the form of securities issued by the State Treasury stood at PLN 134 million. As at 31 December 2016, these figures were PLN 4,650.4 million and PLN 85 million respectively. The cover pool also takes into account CIRS transactions hedging currency risk and the interest rate on EUR-denominated covered bonds. FX-Forward transactions hedging the currency risk of issued EUR-denominated covered bond and an IRS transaction hedging the interest rate risk of Polish zloty-denominated covered bonds issued on a fixed-rate basis.

In 2016-2017, the cover pool did not include asset-backed securities that do not meet the requirements described in paragraph 1 art. 80 of Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60) (recast).

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

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

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

The following table presents basic data on the cover pool as at 30 June 2017

|   | 30/06/2017                 | 31/12/2016                 |
|---|----------------------------|----------------------------|
| <b>Total cover pool, including:</b>                                 | <b>PLN 8,290.5 million</b> | <b>PLN 4,735.4 million</b> |
| <i>loans secured by mortgages</i>                                   | <i>PLN 8,156.5 million</i> | <i>PLN 4,650.4 million</i> |
| <i>other assets (Article 18(3) of the Polish Covered Bonds Act)</i> | <i>PLN 134.0 million</i>   | <i>PLN 85.0 million</i>    |
| Liquidity buffer (Article 18(3a) of the Polish Covered Bonds Act)   | PLN 27.4 million           | PLN 16.1 million           |
| Nominal value of hedging transactions <sup>5</sup>                  | PLN 4,595.9 million        | PLN 2,205.4 million        |
| Number of loans   | 44,983                     | 25,179                     |
| Average loan value  | PLN 181,300                | PLN 184,700                |
| Average weighted time since loan issuance (seasoning)               | 38.4 months                | 38.7 months                |
| Average weighted maturity   | 259.7 months               | 256.5 months               |
| Average LtV   | 57.5%                      | 55.9%                      |
| Average weighted loan to mortgage lending value of real estate      | 70.2%                      | 68.7%                      |
| Over-collateralisation <sup>6</sup>                                 | 34.2%                      | 47.6%                      |

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

### The Cover Pool Monitor

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

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

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

<sup>5</sup> The nominal value of the hedging transaction corresponds to the issue price of the covered bond

<sup>6</sup> Including the net value of hedging transactions

## Statutory limits

Acting under the Polish Covered Bonds Act, PKO Bank Hipoteczny SA is obliged to monitor and comply with designated limits related to the operations of a mortgage bank.

The statutory limits and the levels of their utilisation as at 30 June 2017 were as follows:

| Limit   | Legal basis      | Limit level |          | Actual level |            |
|---|------------------|-------------|----------|--------------|------------|
|   |                  | statutory   | internal | 30.06.2017   | 31.12.2016 |
| Total value of receivables on loans secured by mortgages, and receivables on such loans purchased from other banks, in which the value exceeds 60% of the mortgage lending value, in proportion to the total value of receivables secured by mortgages  | Article 13(1)    | ≤30.0%      | ≤28.0%   | 17.9%        | 16.9%      |
| Value of funds received from issuance of mortgage bonds designated for refinancing of loans secured by mortgages or receivables on such loans purchased from other banks, in proportion to 80% of the mortgage lending value of particular residential properties that constitute the collateral  | Article 14       | ≤100.0%     | ≤90.0%   | 78.3%        | 72.1%      |
| Total value of acquired shares in other entities, in proportion to the Bank's own funds   | Article 15(1)(5) | ≤10.0%      | 0.0%     | 0.0%         | 0.0%       |
| Total value of term deposits accepted, credits and loans taken out and bonds issued, in proportion to the Bank's own funds  | Article 15(2)    | ≤1000.0%    | ≤900.0%  | 523.6%       | 586.5%     |
| Total value of term deposits accepted, credits and loans taken out and bonds issued, in proportion to the amount designated for refinancing of activities described in art. 12 of the Act, i.e. issuance of loans secured and unsecured by mortgages, receivables purchased from other banks on loans granted by them and secured or unsecured by mortgages | Article 15(3)    | ≤100.0%     | ≤95.0%   | 43.0%        | 55.6%      |
| Total nominal value of covered bonds outstanding, in proportion to the Bank's own funds and general risk provision  | Article 17       | ≤4000.0%    | ≤3600.0% | 649.0%       | 415.7%     |
| Total nominal value of receivables secured by mortgages and value of rights and additional funds constituting the basis for issuance of mortgage covered bonds, in proportion to the total value of outstanding mortgage covered bonds (taking into account hedging instruments)  | Article 18(1)    | ≥110.0%     | ≥115.0%  | 134.2%       | 147.6%     |
| 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   | Article 18(1)    | ≥85.0%      | ≥90.0%   | 133.1%       | 143.4%     |
| Interest expense on mortgage covered bonds outstanding (cumulative from the beginning of the financial year and on any given day), in proportion to interest income on receivables secured by mortgages and rights and additional funds constituting the basis for the issuance of mortgage covered bonds (cumulative from the                              | Article 18(2)    | ≤100.0%     | ≤90.0%   | 28.5%        | 23.7%      |



beginning of the financial year and on any given day), taking into account hedging instruments

|  |                                  |         |         |        |        |
|--|----------------------------------|---------|---------|--------|--------|
| Bank funds constituting the excess described in Article 18(3a) over the nominal value of interest on mortgage bonds outstanding due in the following 6 months  | Article 18(3a)                   | ≥100.0% | ≥110.0% | 138.1% | 118.1% |
| Value of receivables secured by mortgages established during the course of construction investments, in proportion to the total value of receivables secured by mortgages that constitute the basis for the issuance of mortgage covered bonds   | first sentence of Article 23(1)  | ≤10.0%  | ≤9.0%   | 7.0%   | 2.6%   |
| Value of receivables secured by mortgages established on land designated for construction in accordance with development plans, in proportion to the value of receivable secured by mortgages established during the course of construction investments that constitute the basis for the issuance of mortgage covered bonds | second sentence of Article 23(1) | ≤10.0%  | ≤9.0%   | 0.0%   | 0.0%   |

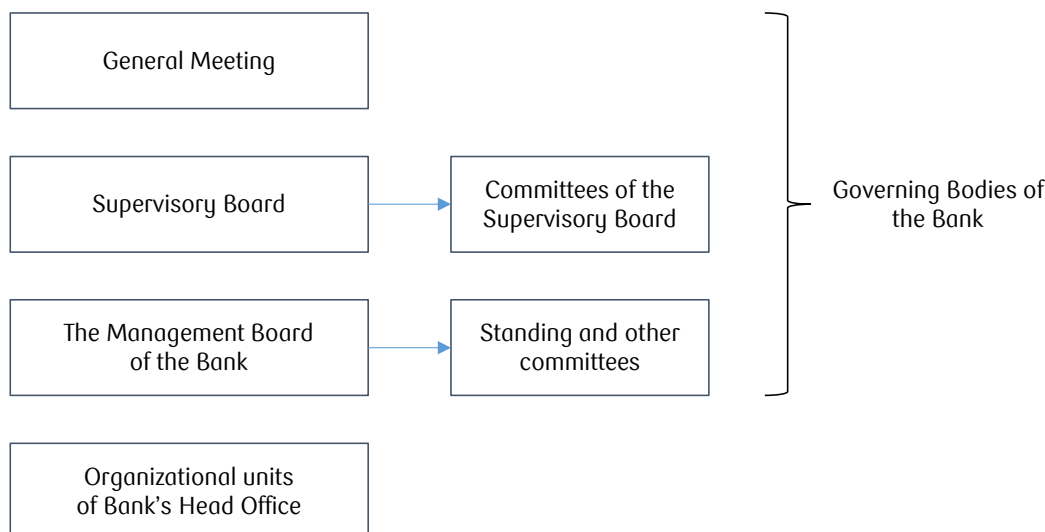
PKO Bank Hipoteczny SA did not breach any of these limits during the entire period covered by this Report.

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

## 6. STRUCTURE AND GOVERNING BODIES OF PKO BANK HIPOTECZNY SA

### Organisational structure of PKO Bank Hipoteczny SA

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



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

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

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

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

- approving the Bank's annual financial plan and long-term development plans (in particular the Bank's strategy),
- Approving the foundations of the Bank's policy in the area of compliance risk,
- approving the principles for the prudent and stable management of the Bank and the risk management strategy, including the Bank's general level of risk, the information policy in the area of capital adequacy, management of operational risk, estimating internal capital, capital management and planning, the functioning of the management system, the rules for management of models, the risk measurement models, including the assessment of creditworthiness, the model for measurement of lost value, the internal capital adequacy assessment process (ICAAP) and acceptance of periodic reports in this area,
- approving the Bank's product, pricing and discount policy

- approving the annual internal audit plans,
- approving and periodically reviewing the general principles of the policy on variable components of remuneration of persons holding managerial positions,
- approving the Management Board regulations,
- approving the Regulations for Setting the Mortgage Lending Value of Property, which take effect after the approval by the Financial Supervision Authority,
- affirming the Code of Ethics and the Rules for Management of Conflicts of Interest
- approving the framework organisational structure of the Bank, adjusted to the scale and profile of the risk taken on by the Bank,
- approving and reviewing agreements with PKO Bank Polski SA,
- adopting the Supervisory Board By-laws,
- appointing and dismissing, by secret ballot, individual members of the Management Board,
- representing the bank in agreements with members of the Management Board
- assessing the Directors' report on the Bank's activities and the financial statements for the previous financial year in terms of their consistence with the books of accounts and documents and the proposals of the Management Board concerning the distribution of profit or the financing of losses and presenting, to the General Meeting, a written annual report on the results of these assessments,
- applying to the Polish Financial Supervision Authority for consent to the appointment of two members of the Management Board, including the President and for the appointment of a Bank cover pool monitor and deputy cover pool monitor,
- granting prior approval for actions that meet designated criteria, including acquiring or disposing of Bank assets, concluding agreements that exceed the normal scope of the Bank's operations, concluding transactions between the Bank and its shareholders or related 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 2017, the following Supervisory Board committees operated:

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

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

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

- monitoring and expressing periodic opinions on the adequacy and effectiveness of the internal control system, the adequacy and effectiveness of the risk management system, the effectiveness of the Bank's compliance risk management, the application of the Corporate Governance Principles for Supervised Institutions, the principles of operation of internal audit and compliance functions, the adequacy and effectiveness of the whistleblowing policy and the ethical procedures and standards in force at the Bank,
- monitoring the process of financial reporting, including reviewing the Bank's periodic and annual financial statements,

- monitoring financial audit proceedings and the independence of the statutory auditor and the entity authorised to audit the financial statements,
- reviewing the principles of operation of the internal control system and of the compliance risk management policy.

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

- reviewing the Bank's overall current and future risk appetite, strategic risk directions and tasks in the context of the Bank's strategy and the conditions resulting from the macroeconomic situation and the regulatory environment, and, in particular, the risk management strategy developed by the Management Board and the Bank's acceptable overall risk level,
- monitoring the compliance of the Bank's policy in the area of taking on risk with the strategy and financial plan,
- analysing periodic risk-related reports, including the utilisation of strategic risk tolerance limits, and developing appropriate guidelines on the basis thereof, as well as reviewing periodically the implementation of the risk management strategy,
- giving opinions on capital adequacy, creditworthiness evaluation principles, the risk measurement model, the impairment measurement model,
- giving opinions on the principles of the information policy in the area of capital adequacy, managing capital adequacy, managing liquidity, operational and model risk and impairment measurement,
- providing opinions on the draft Rules on setting the mortgage lending value of real estate,

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

- evaluating and conducting periodic reviews of nominations for key managerial positions in the Bank,
- submitting, to the Supervisory Board, proposals relating to appropriate forms of contracts with members of the Bank's Management Board,
- preparing opinions on the Code of Ethics and the Principles for Management of Conflicts of Interest,
- preparing opinions on requests concerning consent for a member of the Management Board to engage in competitive activities or to participate in a competing company as a shareholder of a civil-law company, a sole proprietorship or as a member of a governing body of a capital company, or to participate in another competing legal person as a member of a governing body,
- evaluating and performing periodic reviews, subject to the approval of the Supervisory Board, of the general principles for the policy on variable remuneration components of individuals holding managerial positions,
- evaluating and monitoring the variable remuneration components of individuals whose activities have a significant impact on the Bank's risk profile, second-level risk management, the compliance unit manager and the internal audit unit manager,
- 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 powers of the Commercial Committee of the Bank's Supervisory Board include 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.
- monitoring and supervision concerning the outsourcing of internal processes.

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

- defining PKO Bank Hipoteczny SA's strategy, taking into account the risk of the operations it conducts and the principles of prudent and stable management of the Bank,

- setting the general level of risk acceptable for the Bank,
- setting the annual financial plan, including the conditions for its execution,
- adopting the Organisational Regulations of the Bank and the rules for division of competences,
- establishing and closing down standing Committees of the Bank and defining their powers,
- adopting the Management Board by-laws,
- adopting the Regulations for setting the mortgage lending value of property,
- adopting the regulations for the usage of special funds created from net income,
- setting the dividend pay-out date within the period set by the General Meeting,
- adopting the rules for the functioning of the internal control system and the annual internal audit plan,
- establishing, restructuring and closing down branches and other organisational units of the Bank in Poland and abroad,
- taking decisions on issues of covered bonds.

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

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

The 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 or terms of transactions as part of acquisition 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 context of the Data Management System (DMS),
- oversight over the functioning of the DMS, including evaluation of its efficiency and the operations of particular organisational units of the Head Office.

## The Management Board of PKO Bank Hipoteczny SA

In the period from 1 January to 30 June 2017 the composition of the PKO Bank Hipoteczny SA Management Board was as follows:

| No. | Name & surname      | Position                               | Date of appointment | Date of resignation/<br>dismissal |
|-----|---------------------|--|---------------------|-----------------------------------|
| 1   | Rafał Kozłowski     | President of the Management Board      | 06/10/2014          |                                   |
| 2   | Jakub Niesłuchowski | Vice-President of the Management Board | 01/04/2015          |                                   |
| 3   | Marek Szcześniak    | Vice-President of the Management Board | 01/06/2015          |                                   |

The mandates of the members of the Bank's Management Board appointed for four years joint term of office shall expire, at the latest, on the day of the General Meeting approving the financial statements for the financial year ended 31 December 2018.

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

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

During the reporting period, Mr Marek Szcześniak served also as the Deputy Chairperson of the Supervisory Board in Kredobank SA in Ukraine. During the whole reporting period, Mr Rafał Kozłowski served as a member of the Supervisory Board of PKO Leasing SA with registered office in Łódź, until 28 April 2017 he served as a member of the Supervisory Board of Raiffeisen-Leasing Polska SA with registered office in Warsaw and from 1 April 2017 to 30 June 2017 he served as a member of the Supervisory Board of PKO Faktoring SA with registered office in Warsaw. During the reporting period Mr Jakub Niesłuchowski did not hold any other directorial positions.

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

The process of selecting and evaluating candidates for members of the Management Board in PKO Bank Hipoteczny SA is carried out by the Remuneration and Nomination Committee of the Bank's Supervisory Board. The Committee takes into consideration the guidelines of the European Banking Authority dated 22 November 2012 in the matter of evaluating the qualifications of members of a management body and persons performing key functions (the EBA guidelines) and the Regulation of the Minister of Development and Finance of 10 March 2017 on information and documents concerning the founders and the management board of the bank to be submitted to the Polish Financial Supervision Authority. During the candidate selection process, the Committee takes into account PKO Bank Hipoteczny SA's profile, area and scale of operations. During the evaluation of a candidate, the Committee also verifies that the candidate's experience and knowledge will strengthen the abilities possessed by the other members of the Bank's Management Board, and complement them, so as to ensure the coverage of all areas managed in the Bank. The examination of this criterion has as its purpose ensuring variety in the selection of members of the managing body, its purposes, tasks and area of operation.

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

Members of the Management Board are subject to continuous evaluation by the Supervisory Board's Remuneration and Nomination Committee, beginning from the moment of recruitment and continuing through their entire term of office. In addition, in accordance with Article 395 § 2(3) of the Code of Commercial Companies and Partnerships, each year the ordinary general meeting of shareholders grants to each individual member of the Management Board a vote of approval. The granting of this vote of approval constitutes an evaluation of the Management Board members, independent of the approval by the general meeting of shareholders of the Management Board's report on the Bank's operations. On 21 March 2017, by resolutions of the ordinary general meeting, all members of the Bank Management Board were granted a vote of approval for the period ended 31 December 2016.

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

#### *Compensation of Management Board Members*

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

The compensation of Management Board members comprises:

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

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

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

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

Benefits for members of the Management Board and the Supervisory Board of PKO Bank Hipoteczny SA in 2017 are the subject matter of Notes 30.3 and 30.4 to the condensed interim financial statements of PKO Bank Hipoteczny SA for the period of six months ended 30 June 2017.

## The Supervisory Board of PKO Bank Hipoteczny SA

In the period from 1 January to 30 June 2017, 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 finance | Qualifications in accounting and financial review, and conditions of independence | Audit and Finance Committee | Risk Committee | Remuneration and Nomination Committee | Commercial Committee |
|-----|-------------------------|-----------------------------------|---------------------|-------------------------------|---------------------------|---|-----------------------------|----------------|---------------------------------------|----------------------|
| 1   | Jakub Papierski         | Chairperson                       | 06/10/2014          |                               | ✓                         |   |                             |                | Ch                                    | Ch                   |
| 2   | Piotr Mazur             | Deputy Chairperson                | 06/10/2014          |                               | ✓                         |   |                             | Ch             |                                       | DCh                  |
| 3   | Justyna Borkiewicz      | Board Member                      | 28/10/2016          |                               | ✓                         |   | CM                          |                |                                       | CM                   |
| 4   | Mieczysław Król         | Board Member                      | 28/10/2016          |                               | ✓                         |   | Ch                          |                | DCh                                   |                      |
| 5   | Adam Marciniak          | Board Member                      | 28/10/2016          |                               | ✓                         |   |                             | CM             |                                       | CM                   |
| 6   | Artur Osytek            | Board Member                      | 06/10/2014          |                               | ✓                         | ✓   | DCh                         |                |                                       |                      |
| 7   | Barbara Soares da Silva | Board Member                      | 06/10/2014          |                               | ✓                         | ✓   |                             | DCh            |                                       |                      |

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

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

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

### Human resource management

#### *Employment*

As at 30 June 2017, 70 people were employed in PKO Bank Hipoteczny SA. This means that employment increased by 1 person compared to the end of 2016.

#### *Remuneration policy*

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

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



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

#### *Variable remuneration components*

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

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

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

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

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

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

The rules of the policy on variable remuneration components for members of the Management Board and MRTs as at 30 June 2017 covered 3 members of the Management Board and 17 positions included in the List, i.e. 1 position more than as at 31 December 2016.

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

- 1) senior management,
- 2) positions accountable to the management body for the operations of the independent risk management function, compliance function or internal audit function,

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

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

Variable remuneration is awarded and paid in the following forms:

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

Both, non-deferred and deferred remuneration is granted in equal parts in cash and in form of financial instrument that is phantom shares that are converted into cash after the retention period and in case of deferred remuneration – after deferment).

In the event that the amount of variable remuneration for the year has exceeded PLN 1 million, PLN 400 thousand plus 60% of the excess over the amount of PLN 1 million is subject to deferral.

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

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

For members of the Management Board, granting and payment of variable remuneration is subject to approval of the financial statements for the assessment period. The bonus amount for a member of the Management Board may be adjusted downwards or upwards by a specified rate, depending on the financial performance of the Bank, as specified in the annual Note of the Bank (a set of key management indicators specified for the calendar year),

If:

- the Bank's financial performance suffered a material deterioration,
- it is found that there has been a material negative change in the Bank's equity,
- there is a violation by a member of the Management Board or by an MRT of the provisions of law, rules, procedures or duties arising from the employment relationship of a person holding a managerial position, or if such person makes significant errors,
- the performance and the degree of performance of a Management Board member's or an MRT's outcomes or objectives has been adjusted,

- the performance of the structures supervised or managed by the above-mentioned persons has deteriorated,
- variable remuneration has been granted on the basis of incorrect or misleading information or as a result of fraud by a member of the Management Board or an MRT

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

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

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

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

In the reporting period, there were 3 meetings of the Remuneration and Nomination Committee of the Supervisory Board of PKO Bank Hipoteczny SA.

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

##### *Medical care*

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

##### *Company Social Benefits Fund*

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

## 7. CORPORATE GOVERNANCE AND INFORMATION FOR INVESTORS

### Representation on compliance with the rules for corporate governance

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

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

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

- the provisions referring to the principles of cooperation and rights of multiple shareholders (§ 8(4), § 9(1) and (6), § 10(3), § 11(3) and § 31(3)), which are not applied in view of the Bank having a single shareholder,
- chapter 9, concerning the management of assets at the client's risk, because the Bank does not conduct operations in this area,
- the principle described in § 22(1), concerning the independence of Supervisory Board members, manifesting itself primarily in the lack of direct and indirect ties to the supervised institution, members of the management and supervisory bodies, significant shareholders and related 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 Article 86(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 17 May 2017 the Supervisory Board performed an evaluation of the application of the Principles in the Bank in 2016. In the Supervisory Board's opinion, the Bank ensured that the Principles, to the extent adopted by the Bank's bodies, were applied adequately to the scale, nature of operations and special character of the mortgage bank.

The full text of the Principles is available on the Bank's website at:

<http://www.pkobh.pl/bank-hipoteczny-en/about-us/corporate-governance/>

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

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

The Director of the Finance and Accounting Office is responsible for ensuring compliance with the control mechanisms in financial reporting. On the other hand, the internal audit, in accordance with the confirmed

audit plans, reviews and independently evaluates the adequacy and effectiveness of control over the financial reporting processes and evaluates risk management in this process. No issues that would cast doubt on the reliability of the financial reporting have been observed so far in internal audit operations.

*List of direct or indirect holders of significant blocks of shares with an indication of the number of shares held and the number of votes based on them*

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

*Description of the rules for appointing and dismissing managers*

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

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

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

*Description of authorisations to decide on share issues or buybacks*

The Bank issues shares in accordance with the provisions of the Polish Code of Commercial Companies and Partnerships. The powers of the General Meeting include adopting resolutions on establishing the share redemption method and the level of compensation for redeemed shares, and approving the acquisition of the Bank's treasury shares for the purpose of redemption. The General Meeting also adopts resolutions on the issuance of bonds convertible into shares or other instruments entitling the holder to acquire or take up shares in the Bank.

*Indication of all limitations on the transfer of ownership rights to the issuer's securities*

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

*Principles for amending the Bank's Articles of Association*

The rules for amending the Articles of Association of PKO Bank Hipoteczny SA are consistent with the provisions of the Code of Commercial Companies and Partnerships, and with the Banking Law Act. Amendments to the Bank's Articles of Association require a resolution of the General Meeting and an entry into the register of entrepreneurs of the National Court Register. Within the scope defined by Article 34(2) of the Banking Law, an amendment to the Articles of Association requires the consent of the Polish Financial Supervision Authority.

*Composition and changes that took place in the last financial year, and description of the operations of, management, supervisory and administrative bodies of the issuer and their committees*

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

*The General Meeting and relations with shareholders*

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

**Entity authorised to audit financial statements**

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

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

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

## Other information

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

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

The Bank's share capital amounts to PLN 950,000,000 (nine hundred fifty million złoty) and is divided into 950,000,000 (nine hundred fifty million) ordinary registered series A, B, C, D and E shares, with a nominal value of PLN 1 (one złoty) each.

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

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

In the period from 1 January 2017 to 30 June 2017, there were no changes in holding shares and rights to shares in PKO Bank Hipoteczny SA by individuals in management and supervisory roles.

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

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

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

On 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 has been maintained for all issues of PLN-denominated covered bonds so far by PKO Bank Hipoteczny SA.

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

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

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

In the period from 1 January to 30 June 2017, PKO Bank Hipoteczny SA did not conclude any significant or material agreements with the central bank or supervisory bodies.

### 5. Financial liabilities and guarantee obligations granted

In the period from 1 January to 30 June 2017, PKO Bank Hipoteczny SA did not grant any guarantees.

Financial liabilities under loans granted and not disbursed as at 30 June 2017 stood at PLN 745.6 million, up by PLN 133.8 million compared to 31 December 2016.

6. Off-balance-sheet liabilities to related entities

In the period from 1 January to 30 June 2017, PKO Bank Hipoteczny SA did not grant any off-balance sheet liabilities to related entities.

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

In the period from 1 January to 30 June 2017, Bank Hipoteczny SA did not take out any loans or enter into any loan or guarantee agreements unrelated to the Bank's operations.

8. Underwriting agreements and guarantees granted to subsidiaries

In the period from 1 January to 30 June 2017, PKO Bank Hipoteczny SA did not enter into any underwriting or guarantee agreements.

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

In the period from 1 January to 30 June 2017, no disputes were pending before courts, arbitration bodies or public-administration bodies concerning liabilities or receivables whose amount would constitute at least 10% of PKO Bank Hipoteczny SA's equity.

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

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

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.

11. Information on loan guarantees or other guarantees issued by the Bank or its subsidiary - in aggregate to a single entity or its subsidiary, if the total amount of the existing guarantees is equivalent to at least 10% of the issuer's equity

In the period from 1 January to 30 June 2017, PKO Bank Hipoteczny SA did not issue, to a single entity or its subsidiary, any loan guarantee or any other guarantee whose total amount would be equivalent to 10% of the Bank's equity.



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.

On 2 February 2017 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 1,500 million for a three-year period, which is activated in tranches.

On 5 June 2017, PKO Bank Hipoteczny SA concluded a medium-term agreement on a line of credit on the current account for an amount of up to of PLN 100 million for 1 year and 1 day, with an external financial institution.

Additionally, as at 30 June 2017 the Bank had a liability on account of purchased receivables in the amount of PLN 1,786.5 million, which results from the transaction of acquisition, from PKO Bank Polski SA, of portfolios of receivables under residential mortgage loans, as described in Note 15 to the Financial Statements. The payment date of the liability on account of the acquisition of receivables is agreed from time to time by the parties to the Receivables Sale Agreement. For receivables purchased in 2017, the parties agreed that payment will be made within 12 months from the transfer date at the latest. If the liability remains outstanding one month from the transfer date, the price is increased by interest

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

In the period from 1 January 2017 to 30 June 2017, PKO Bank Hipoteczny SA did not conclude any significant transactions with related parties not on arm's length.

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

In the period from 1 July 2017 to 18 August 2017, PKO Bank Hipoteczny SA purchased new portfolio of mortgage loans in the amount of PLN 967.6 million from PKO Bank Polski SA under the terms of the Receivables Sale Framework Agreement concerning the sale of receivables concluded on 17 November 2015.

In the period from 1 January to 18 August 2017, PKO Bank Hipoteczny SA carried out 11 bond issue with a total value amounting to PLN 772.9 million, with the simultaneous redemption of 12 bond issue with a total value amounting to PLN 658.9 million.

On 28 June 2017 the Extraordinary General Meeting adopted a resolution on increasing share capital of PKO Bank Hipoteczny SA by PLN 150,000,000, i.e. to PLN 1,100,000,000 by the issue of 150,000,000 new ordinary registered shares of F series of nominal value PLN 1 each. Till the date of Management Board approval of these statements to publication, the increase of shares has not been registered in the Register of Entrepreneurs of the National Court Register.

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

In the period from 1 January to 30 June 2017, in PKO Bank Hipoteczny SA there were no changes in the basic principles of managing the Bank's enterprise.

*16. Financial support agreements*

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

*17. Deposits and issued guarantees and suretyships*

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

### Statement by the Management Board of PKO Bank Hipoteczny SA

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

- the financial statements for the period from 1 January to 30 June 2017 have been prepared in accordance with binding accounting principles and give a true and fair view of the financial position of PKO Bank Hipoteczny SA and of its financial performance,
- the Directors' Report for the period from 1 January to 30 June 2017 gives a true view of the development and achievements as well as of the position of PKO Bank Hipoteczny SA, including a description of the basic risks and threats.

The Management Board of PKO Bank Hipoteczny SA represents that the entity authorised to audit the financial statements, which conducted the review of the financial statements for the period from 1 January to 30 June 2017, 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 review of the interim financial statements, in accordance with the applicable laws and professional standards.

This Directors' Report on the activities of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2017 comprises 43 numbered pages.

### Signatures of all Management Board members

|                |                     |  |  |
|----------------|---------------------|--|--|
| 18 August 2017 | Rafał Kozłowski     | President of the Management Board      | <i>Signed on the Polish original</i><br>.....<br>(signature) |
| 18 August 2017 | Jakub Niesłuchowski | Vice-President of the Management Board | <i>Signed on the Polish original</i><br>.....<br>(signature) |
| 18 August 2017 | Marek Szcześniak    | Vice-President of the Management Board | <i>Signed on the Polish original</i><br>.....<br>(signature) |