Supervisory Board's Assessment of ING Bank Śląski S.A. Group Operations in 2018

In 2018, the Polish economy developed even faster than in the successful 2017 – 5.1% y/y, compared to 4.8% a year earlier. It was possible despite the ongoing downturn in the Eurozone economies. The internal demand, in particular household expenses, and investments co-financed from EU funds remained the driving force of the Polish economy growth. Optimistic consumer sentiment was reflected, among others in the high growth rate of consumer and mortgage loans. Also the household deposits grew faster. Yet, according to i.a. surveys of ING Bank Śląski S.A., that was not the result of an increased propensity to save, but of shifting funds between asset classes – from bond funds to deposits, among other things.

Solid economic growth and moderate inflation prompted the Monetary Policy Council to maintain the unchanged level of interest rates in 2018. Interest rates were cut back to a record-low level for the last time in March 2015 (reference rate and lombard rate to 1.5% and 2.5%, respectively). Stable economic growth and the NBP policy were also one of the reasons for the relatively low volatility of the Polish zloty (against the background of other currencies of developing economies), despite strong geopolitical tensions in the past year related to i.a. the US trade policy.

Apart from the macroeconomic environment, the banking sector's results were also shaped by regulatory factors. Since the beginning of 2018, a new financial reporting standard has been in force – IFRS 9: Financial instruments which replaced IAS 39. It not only impacted a new classification of financial assets, but also the method of expected losses provisioning (previously impairment losses; the amount of expected losses provisioning significantly exceeded the level of impairment losses according to IAS 39). In 2018, also Directive No. 2014/65/EU of the European Parliament and of the Council on markets in financial instruments (MIFID II) went into force. It imposes the duties relating to, inter alia, investor protection and market transparency on the financial market entities (including banks). As a consequence, it also affects the way of offering investment products, including investment funds. In addition, the sector also worked very intensively on the implementation of Regulation (EU) No. 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons and on implementation of the VAT split payment mechanism.

Since January 2018, the NBP reduced reserve requirement rate (0.5%) has been in force, and since March 2018 the reduced reserve requirement rate on funds acquired for at least two years was 0%.

In 2018, the ING Bank Śląski S.A. Group posted the net profit of PLN 1,525.9 million versus PLN 1,403.1 million in 2017 (up by 9%). As in previous years, the improvement in the net result was achieved thanks to growing income. In 2018, the result on banking operations rose by PLN 463.6 million (or, 10%) to PLN 5,232.7 million compared to PLN 4,769.1 million in the previous year. It was primarily triggered by a higher net interest income (up by 11% y/y) following higher commercial volumes and improved interest margin. Net commission income rose by 9%, mainly owing to higher income on lending.

Higher result on banking operations was partially consumed by increase in the Group costs. The costs of the Bank Group went up by 9% y/y to PLN 2,326.8 million due to higher general and administrative expenses and personnel expenses; increase in the risk costs by PLN 79.7 million (or, 19%) to PLN 500.9 million due to the mandatory change of an accounting standard, relatively higher provisions in the retail segment and the growth of the entire lending portfolio. As a year ago, the provisioning balance was also impacted by the receivables sale transactions, whereby the balance was reduced by PLN 26.7 million vis-a-vis PLN 47.1 million in 2017. The balance of provisions versus the gross credit receivables portfolio settled at 0.52% in 2018 (0.50% in 2017). At the end of December 2018, loans and other receivables in Stage 3 (the most at risk ones) accounted for 2.8% of the gross receivables portfolio measured at amortized cost. The provision coverage ratio for loans and other receivables in Stage 3 was 59.6%; higher bank levy costs. In 2018, the Group paid the tax on certain financial institutions (the so-called bank levy) which was PLN 28.2 million higher than the one paid in 2017. It was due to a higher tax base which was directly related to the consistently rising commercial volumes.

The Supervisory Board exercises oversight over the Company's operations by keeping watch over the Company's adherence to the relevant regulations in the area of accounting, finance and reporting of public companies. The powers of the Supervisory Board also include supervision of the individual risk management processes at ING Bank Śląski S.A. with the support of the Risk Committee and Audit Committee. Based on the recommendations of those Committees, the Supervisory Board accepts and approves the business risk management strategy of the Bank, the key principles of the policy and the related risk appetite. Further, the Supervisory Board monitors the utilisation of internal limits vis-à-vis the current strategy of the Bank.

The Risk Committee supports the Supervisory Board in monitoring the risk management process, including operational risk, credit risk and market risk. Further, the Risk Committee supervises the risk management process as well as the assessment of internal capital, capital adequacy, and of the risk of capital-related models and other models. The Committee voices its opinion about the overall readiness of the Bank to assume risk on ongoing and long-term bases.

Monitoring of the financial reporting process is among the tasks of the Audit Committee. In this context, the Audit Committee periodically analyses the Bank financial statements and the results of their audit. Further, the Chairman of the Audit Committee – who is the Chairman of the Supervisory Board and an independent member of the Board at the same time – holds periodic meetings with the Chief Financial Officer in which the Chairman is updated on the interim financial results of the Bank prior to their publication. The Audit Committee also analyses the performance of works by the entity authorised to audit financial statements, safeguarding its independence and effectiveness. Furthermore, the Audit Committee monitors the effectiveness of internal control and internal audit systems, and also assesses the effectiveness of measures used to mitigate the compliance risk and the said risk management quality.

There was also established the Remuneration and Nomination Committee within the Supervisory Board, which monitors i.a. the situation of the labour market in the context of salaries, the employee turnover process, and also staff satisfaction survey results. The Committee regularly monitors the remuneration system of the Bank, the payroll and bonus policy included. In 2018, the Committee also assessed the collective suitability of Management Board and Supervisory Board members, based on the suitability assessment made by a third party in connection with the appointment of a new member of the Management Board and a new member of the Supervisory Board.

In the opinion of the Supervisory Board, the risk management system at the ING Bank Śląski S.A. Group covers all material risks. Moreover, to identify, measure, manage and report risks the Bank applies instruments and techniques adequate for a given risk type. In 2018, ING Bank Śląski S.A. satisfied all the requirements of sound business operations and capital adequacy, and in particular:

- pursued prudent lending policy. The lending processes and procedures applied by the Bank were compliant with the regulatory requirements and best practices on the market. In 2018, the Bank took account of the economic situation in its lending policy and applied more restrictive procedures towards sectors characterised by increased risk. The Bank's lending portfolio was diversified with a significant share of high-quality loans granted to business entities. Within the Bank Group, credit receivables in Stage 3 represented 2.8% of the total gross exposure (measured at amortised cost), which is significantly less than the average for the entire banking sector (6.4%).
- had systems and procedures in the market risk management area (for interest rate or currency risk, among others) that meet the top market standards. Throughout 2018, individual market risk categories were managed actively so that their levels were within the limits effective at the Bank. The balance sheet structure is balanced from the currency perspective; its distinctive feature is the low share of FX receivables in the total mortgage receivables, among other things,
- maintained good liquidity. As at 2018 yearend, the LtD ratio settled at 87.6%. The sound liquidity position of the Group is attributable to one of the largest among Polish banks (and still growing) stable household deposits base,
- had an adequate level of equity meeting supervisory requirements. In December 2018, the total capital ratio of the ING Bank Śląski S.A. Group was 15.6%, while the Tier 1 ratio stood at 14.8%.

Furthermore, the internal control system used by the Bank effectively secures the Bank against unexpected developments in terms of the financing granted, non-financial risk, market risk, liquidity or capital adequacy.

The slowdown in economic growth expected in 2019 (as a consequence of the lower growth rate of household spending and investments co-financed from EU funds) may contribute to the pressure on the risk cost, especially in the corporate segment. As a result, capital ratios can be pressurised and the supply of loans can be negatively impacted. This is why, the Supervisory Board is of the opinion that the Bank should continue to focus on the actions to enhance its security as well as competitiveness of products and customer experience, such as:

- adequate capital management in order to ensure safe lending growth as well as fulfilment of all present and future regulatory requirements,

- further development of the product offer and electronic distribution channels. In stiff competition, it is possible to increase revenues by expanding the customer base through acquiring new customers and increasing loyalty of the existing ones. Such an approach boosts customer balances and transactions' volumes,
- increase of lending capabilities, while being prudent when assessing clients' risk. That will foster keeping high quality of the portfolio and boost net interest income.
- maintenance of adequate stable deposits. It will ensure liquidity indispensable to develop lending,
- further improvement of cost effectiveness while maintaining high quality of processes through optimal use of existing resources and benefits resulting from the increased scale of operations.

According to the Supervisory Board, the strategy pursued by the Bank over the last few years to increase the scale of its operations proved to be successful which is reflected in the achieved financial and commercial results. The hitherto success of the strategy justifies the intention of its continuation by the Bank in 2019 while maintaining the appropriate level of capital.