

**Management Board Report
on the performance of mBank Hipoteczny S.A.
in 2018**

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1. Activity of mBank Hipoteczny S.A. in 2018

In July 2018, mBank Hipoteczny S.A. (hereinafter the "Bank") adopted new objectives for its operating strategy for 2019–2022.

The strategy for 2019–2022 responds mainly to challenges resulting from the current and expected intensive development of the covered bond market in Poland as well as the strong demand for Polish covered bonds in the European Union, supported by continued low interest rates. Simultaneously, the strategy continues the assumptions regarding the safe financial structure of mBank Group, and in the currently growing competitive pressure among mortgage banks, it stresses the importance of the cost-effectiveness of the Bank's business model.

The Bank's strategy assumes that the foundation of its operations will be to obtain long-term refinancing for mBank Capital Group (hereinafter referred to as "mBank Group"), i.e. to issue covered bonds in the most cost-effective business model possible. Such a direction requires primarily ensuring an appropriate scale of assets in the Bank's balance sheet that meet the criteria for securing covered bonds.

There are two business areas at the Bank:

- the retail area focusing on acquiring mortgage loans for natural persons;
- the commercial area financing transactions regarding commercial real estate (CRE) and lending to residential real estate projects.

In the coming years, the Bank will develop the portfolio of retail mortgage loans and CRE loans in close cooperation with mBank, i.e. assuming that the sales will be executed by the forces of mBank both in the retail area, within the already functioning cooperation model, and in the commercial area in the context of the changes to the model introduced from January 2019.

From the end of 2012 the Bank does not finance local government units or other entities with a guarantee of local government units, which results from the risk profile of this segment and inadequate credit margins. This approach has been maintained in the update of the strategy for years 2019-2022. Nevertheless, the Bank owns a historically developed portfolio of credit transactions for this segment.

In the market of finished commercial real estates the extraordinary activity of investors can still be observed. The risk of commercial projects under development has increased due to rising material and, above all, labour costs, which is the main reason behind higher activity relating to the already existing real estates.

In the area of residential construction, the growing costs have not caused a decrease in the number of project due to the fact that the projects currently entering into the market were prepared in the earlier periods. The slowdown in this segment is possible in the time horizon of 12-24 months.

1.1. Key projects

The "covered bonds" project

The project of rebuilding of the balance sheet of mBank Group on the basis of long-term source of financing in a form of covered bonds issued by mBank Hipoteczny S.A. continued to be the highest priority venture in 2018. Works on the project started in August 2012, and their purpose was preparation of a comprehensive model of cooperation between a mortgage and a universal bank in terms of sales, service and management of retail mortgage loans portfolio and then issuing of covered bonds on its basis.

The implementation of the model aims at:

- improvement of banks financing stability within the mBank Group through application of long-term and at the same time innovative solutions in relation to mortgage portfolio in the mBank Group, taking into account the liquidity needs resulting from external (new regulations - Basel III) and internal (e.g. changes within the scope of financing of subsidiary banks in the Commerzbank group) factors,
- diversification of financing sources - increasing independence of the mBank Group in terms of financing of the current portfolio of retail mortgage loans,

- improvement of long-term liquidity in the mBank Group - adaptation to the requirements of Basel III through the increase of long-term financing.

Implementation of AIRB method

There are ongoing works at the Bank – initiated with the submission of the Prevalidation Application in the second half of 2016 – focusing on obtaining the consent of the supervision authority to apply the A-IRB method to the retail portfolio obtained through the cooperation with mBank S.A., by adapting the models applied in mBank S.A. In Q4 2017, the Bank obtained an official position from the Polish (PFSA) and the European (ECB) supervision authority, which is the result of the observations from the inspection carried out in Q4 2016, as well as of the answers of the Bank to the initial evaluation results, addressed at the beginning of 2017 by the PFSA.

A substantial part of the recommendations identified during the inspection was addressed by the Bank, among others by redesigning the LGD model. However the mBank Group intends to fulfill all the expectations of the Supervision in 2019, which shall result in the submission of the final Request for the application of the statistical methods for calculating the capital requirements for credit risk for the retail portfolio acquired within the scope of the cooperation with mBank S.A. For the purpose of submitting the final request, a project team was appointed in June 2018. At present, changes in the model are in the process of approval by the supervision authorities (PFSA, ECB).

Implementation of the general Regulation on personal data protection

The works initiated in January 2017, aimed at adjusting the Bank to the *General Data Protection Regulation* (GDPR), were completed in 2018. In particular, the Bank's internal regulations were adjusted to the GDPR requirements: (including: the personal data security policy, instructions for assessing the risk of personal data processing, instructions for entrusting the processing of personal data, policy for reporting breaches of personal data protection). A number of documents (GDPR packages and information clauses) were prepared in cooperation with an external law firm, aimed at informing individuals (in particular customers, employees, counterparties) about their rights and the manner of exercising those rights by the Bank. The key GDPR packages were published on the website. In cooperation with mBank S.A., work aimed at automating the process of exercising the rights of data subjects were continued. A template agreement for entrusting personal data was also prepared, on the basis of which the process of executing annexes to agreements on entrusting personal data processing signed by the Bank was carried out; new agreements on entrusting data processing are concluded with the application of the elaborated contractual clauses. By a resolution of the Management Board, an employee was appointed to perform the function of a Data Protection Supervisor at the Bank. In addition, employees were provided with e-learning training on personal data protection.

Implementation of the Anti-money Laundering Act

The Bank continued works for the adaptation to the requirements of the Anti-Money Laundering and Anti-Terrorism Financing Act of 1 March 2018 (hereinafter: the "Act"), which implements to Polish law Directive 2015/849 of the EU Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC (the "AML IV Directive"). In particular, the necessary analyses were carried out and amendments to the internal regulations were made. According to the statutory obligation, by a resolution of the Management Board of the Bank, a Board Member responsible for the implementation of the obligations specified in the Act and the senior executives in charge for performance of the obligations relating to counteracting money laundering and terrorist financing were appointed. Relevant changes in the IT systems supporting the performance of obligations relating to counteracting money laundering and terrorist financing were introduced. Further development works on the IT systems are continued. Moreover, training was conducted for managerial staff and employees responsible for the performance of the obligations relating to the provisions of the new Act.

Implementation of Recommendation H issued by the Polish Financial Supervision Authority

The Bank continued works aimed at implementing Recommendation H on internal control systems at banks, issued on 25 April 2017 by the Polish Financial Supervision Authority. The Bank's efforts focused on introducing new regulations required by Recommendation H or making appropriate changes to the Bank's internal procedures.

Anonymous whistleblowing system

In 2018, in order to implement the Regulation of the *Minister of Development and Finance on the risk management system and the internal control system, remuneration policy and the detailed manner of assessing internal capital at banks* of 6 March 2017, a dedicated IT system was launched to enable anonymous reporting of violations, including actual or potential violations of laws on counteracting money laundering and terrorist financing, which constitutes the implementation of requirements set forth in the *Anti-Money Laundering and Anti-Terrorism Financing Act of 1 March 2018*. Besides, the internal procedure was updated regulating the manner of receiving and processing anonymous reports from employees concerning violations of laws and applicable procedures and ethical standards.

IFRS 9

Due to the fact that as of 1 January 2018, IFRS 9: "Financial Instruments" came into effect to replace the existing International Accounting Standard 39: "Financial Instruments: Recognition and Measurement", works on the implementation of the required changes in the processes and IT systems were finalised at the Bank.

Definition of Default

The Bank has started preparations to implement changes related to the entry into force of the European Commission regulation EU No 2018/171 issued pursuant to Article 178 of the Regulation No 575/2013 (CRR) on changes in the definition of default applied by banks. The works will be carried out in close cooperation with the relevant project team appointed for this purpose at mBank S.A.

1.2. Financial credibility - ratings

Financial credibility of mBank Hipoteczny S.A. and covered bonds issued by the Bank is assessed by an international rating agency - Fitch. As of the reporting date the following ratings applied:

	Rating	Outlook	Date
Long-Term Issuer Default Ratings (IDR)	BBB	Stable	30-11-2018 <i>affirming</i>
Short-Term Issuer Default Ratings (IDR)	F2	-	30-11-2018 <i>affirming</i>
National Long-Term Rating	AA-(pol)	Stable	30-11-2018 <i>affirming</i>
National Short-Term Rating	F1+(pol)	-	30-11-2018 <i>affirming</i>
Support Rating	2	-	30-11-2018 <i>affirming</i>
Mortgage Covered Bonds	A	Positive	22-06-2018 <i>affirming</i>

Fitch Ratings Ltd. assigns ratings according to the following scale (descending):

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- long-term international/domestic ratings (pol), covered bonds ratings: AAA, AA, A, BBB, BB, B, CCC, CC, C, RD, D
- short-term international/domestic ratings (pol): F1, F2, F3, B, C, RD, D
- support ratings: 1, 2, 3, 4, 5

The covered bonds issued by the Bank obtained a rating 3 level (notche) higher than a long-term rating of the Bank in foreign currency and 1 level (notch) higher than a long-term domestic rating. The rating of Poland is at the A level – stable outlook.

Besides its financial results, ratings assigned to the Bank are influenced by the assessment of mBank S.A and Commerzbank AG, including the support granted by these institutions.

The rating obtained by the Bank is a starting point for the rating assigned to the covered bonds issued by the Bank, which has an impact on the recognition of payments from covered bonds in case of the issuer's insolvency and the risk profile of the collateral of covered bonds.

1.3. Financial results

The financial statement of the Bank was prepared according to the International Financial Reporting Standards binding in the European Union (IFRS). The data presented in the Management Board Report are presented in the management view and they do not have to be consistent with the data included in the Financial Statement.

Due to the specific nature of the Bank, its assets primarily include loans secured by mortgage, and on the liabilities side - liabilities arising from the issue of covered bonds, as a main source of refinancing of credit operations.

Table 1. The dynamics of selected elements of the statement on financial situation (in PLN thousands)

Main balance sheet items	31.12.2018	31.12.2017	Dynamics
ASSETS	12,385,908	12,168,169	1.79%
Including			
Loans and advances to customers	n/a	10,766,911	n/a
Loans and advances to customers (at amortised cost)	10,930,534	n/a	n/a
Loans and advances to customers (at fair value through profit or loss)	208,181	n/a	n/a
LIABILITIES AND EQUITY	12,385,908	12,168,169	1.79%
Including			
Debt securities in issue	7,870,443	7,043,125	11.75%
Share capital	734,719	734,719	0.0%

In 2018 the Bank achieved a positive gross result in the amount of PLN 60,694 thousand. Due to a specialised activity profile in which the main source of the Bank's result is the interest income, the financial result in 2018 was greatly influenced by low interest rates and strong pressure on margins. Despite this, the Bank reported a growth in the net interest income compared to 2017 (by PLN 20,268 thousand or 12.99%).

The total value of administrative expenses decreased by 7.01% compared to 2017. The cost to income ratio fell to 36.78% from 45.99% at the end of 2017.

Due to the specialization and narrow range of the products offered, the Bank is unable to compensate the effects of the bank tax. Before the tax, the Bank's operating result amounted to PLN 88,262 thousand, as compared to 59,199 thousand in 2017, which represents an increase by 49.09%. After the tax, the gross result was still significantly higher than in the previous year (by PLN 25,921 thousand or 74.54%).

In 2018 the income of the Bank, calculated as the sum of net interest income, net fee and commission income, net trading income, other operating income and other operating expenses, amounted to PLN 174,862 thousand (in 2017: PLN 146,908 thousand). This income pertains in whole to the activity conducted within the Republic of Poland.

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Table 2. The dynamics of selected elements of profit and loss account (in PLN thousand)

Profit and loss account	Period from 01.01.2018 to 31.12.2018	Period from 01.01.2017 to 31.12.2017	Dynamics
Net interest income	176,277	156,009	12.99%
Net fee and commission income	(2,502)	(5,759)	-
Net trading income	1,210	(3,385)	-
Net impairment write-downs on loans and advances	(16,712)	(20,225)	-17.37%
Overhead costs	(59,849)	(64,361)	-7.01%
Amortisation and depreciation	(3,798)	(3,196)	18.84%
Operating result	88,262	59,199	49.09%
Tax on the Bank's balance sheet items	(27,568)	(24,426)	12.86%
Gross profit	60,694	34,773	74.54%
Income tax	(19,457)	(6,944)	180.20%
Net profit	41,237	27,829	48.18%
Weighted average number of ordinary shares / weighted average diluted number of ordinary shares	3,210,000	3,191,260	0.59%
Net profit per ordinary share / Diluted profit per ordinary share (in PLN)	12.85	8.72	47.36%

Table 3. Effectiveness ratios

PERFORMANCE INDICATORS	31.12.2018	31.12.2017
ROA net ¹⁾	0.33%	0.24%
ROA gross ¹⁾	0.49%	0.30%
ROE net ³⁾	3.97%	2.77%
ROE gross ⁴⁾	5.85%	3.46%
Cost to income ratio (C/I) ⁵⁾	36.78%	45.99%
Net interest margin ⁶⁾	1.44%	1.36%
Cost of risk ⁷⁾	0.19%	0.20%
Total Capital Ratio	16.25%	15.79%
RATINGS Fitch Ratings Ltd		
long-term international rating	BBB	BBB
short-term international rating	F2	F2
support rating	2	2
mortgage covered bonds	A	A
OTHER		
Employment	170 employees/161 FTE's	178 employees/169 FTE's
Average employment	170 employees	208 employees
Facilities	Headquarters + 4 branches	Headquarters + 4 branches

1) net result / average assets

2) gross result / average assets

3) net result / average equity

4) gross result / average equity

5) (overhead costs + amortisation and depreciation) / total income (defined as net interest income + net fee and commission income + net trading income + other operating income - other operating expenses)

6) interest income / average earning assets

7) net write-downs for impairment of credit and loans / average balance of credits and loans granted to clients

Average balance sheet amounts were calculated based on monthly data considering the opening and closing balance of the reporting period.

Chart 1. Key financial ratios

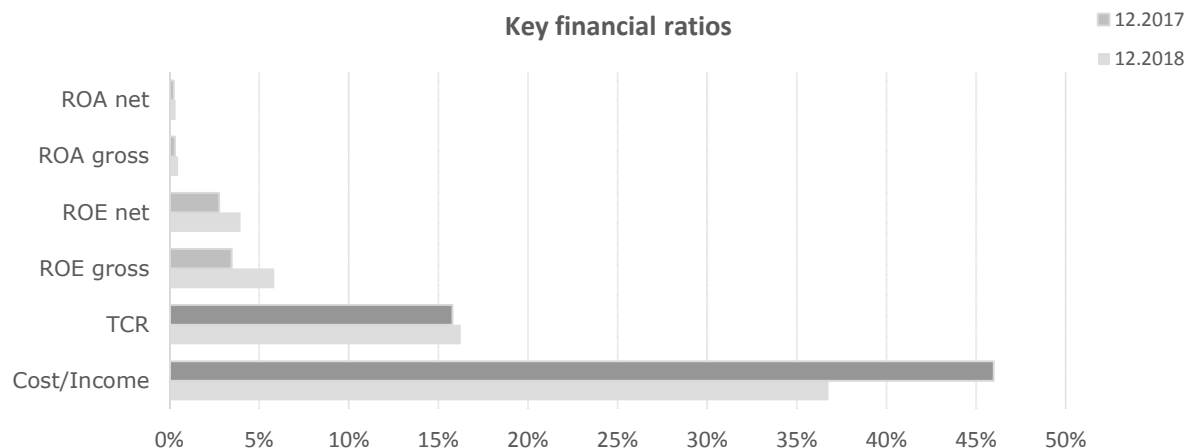
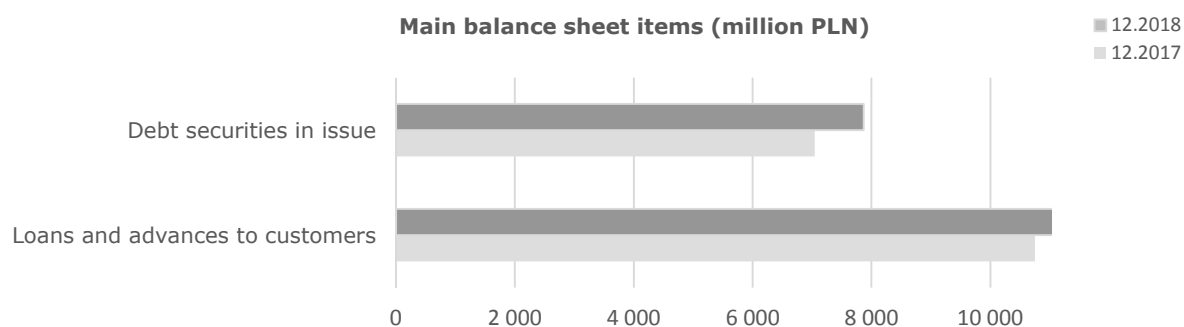


Chart 2. Main balance sheet items (in PLN million)



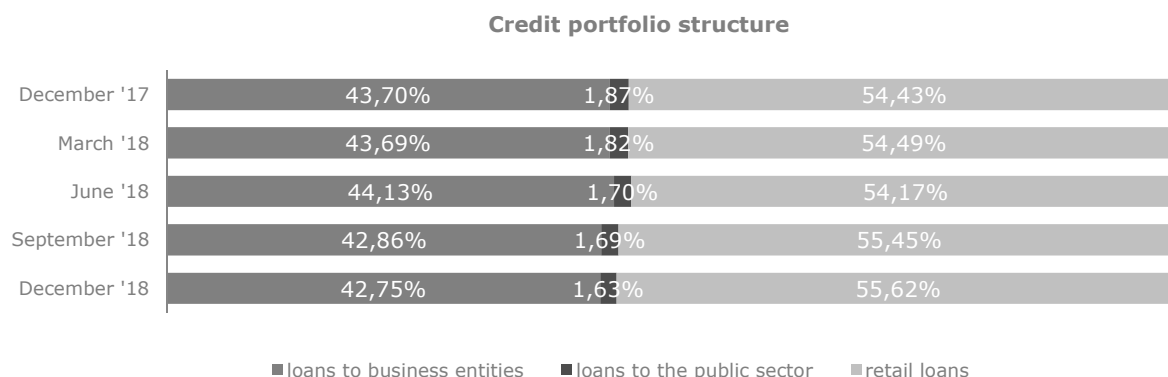
1.4. Lending

In 2018, the Bank continued activities in the area of sales of loans to business entities. Following the transfer of the entire retail loan sales process to mBank on 22 July 2017, pooling transactions were the source of supply of retail assets to the Bank's loan portfolio. The net value of the entire loan portfolio, including off-balance sheet exposure, increased at the end of 2018 by 2.41% as compared to the end of 2017, reaching PLN 12.6 billion.

In 2018, the Bank reported very good sales of commercial loans at the level of PLN 1.824 million, including PLN 679 million attributable to residential developers. In the discussed period, no commercial pooling from mBank S.A. was carried out.

In the retail area, in line with the mBank Group's strategy, the Bank recorded an increase in the portfolio of mortgage loans for retail customers by PLN 324 million or 5.53%. In 2018, 6 pooling transactions were carried out.

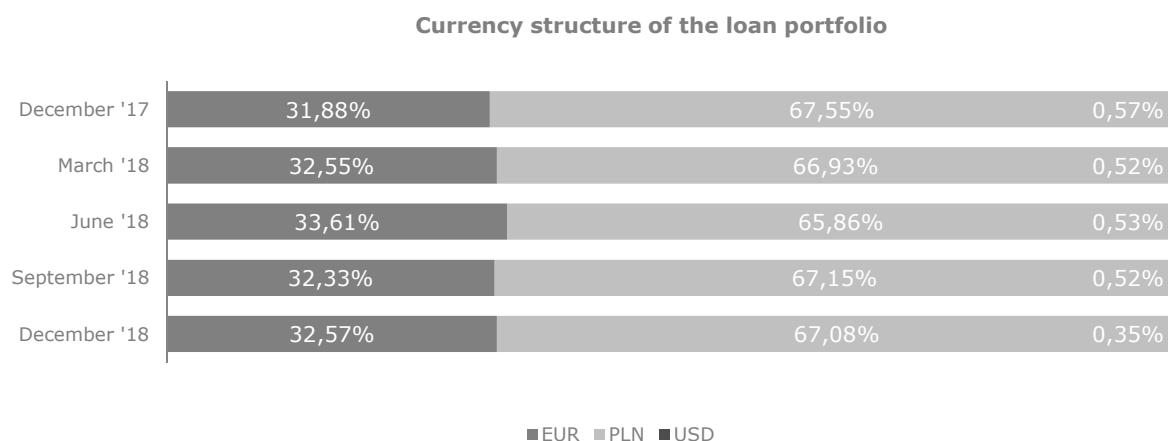
Chart 3. The structure of the loan portfolio



In 2018, the currency structure of the loan portfolio changed slightly. Compared to the end of 2017, the share of loans in PLN decreased by 0.47 percentage points and as at the end of 2018 it accounted for 67.08% of the loan portfolio. The share of loans in EUR amounted to 32.57%.

The Bank was not involved in any activity outside the Republic of Poland.

Chart 4. The currency structure of the loan portfolio



Corporate loans

Net balance sheet exposure to business entities amounted to PLN 4,748 million. The dominant part (89.76%) accounted for refinancing of completed commercial facilities, the exposure in housing projects constituted 3.61%, and credits for financing of construction of commercial objects 6.63%.

In the area of commercial real estates the Bank finances in particular office buildings and shopping centres. The Bank focuses on financing of the purchase or refinancing of completed facilities of appropriate standard and financing of the construction process upon the completion of which the construction loan is converted into a long-term mortgage.

Chart 5. Corporate loans by type of financed real estate

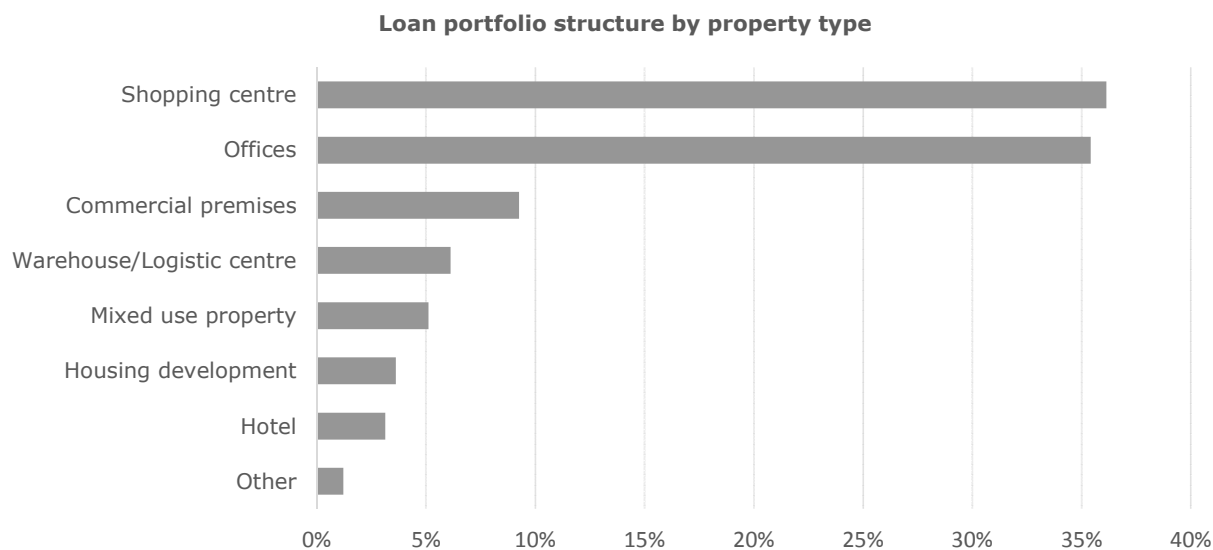
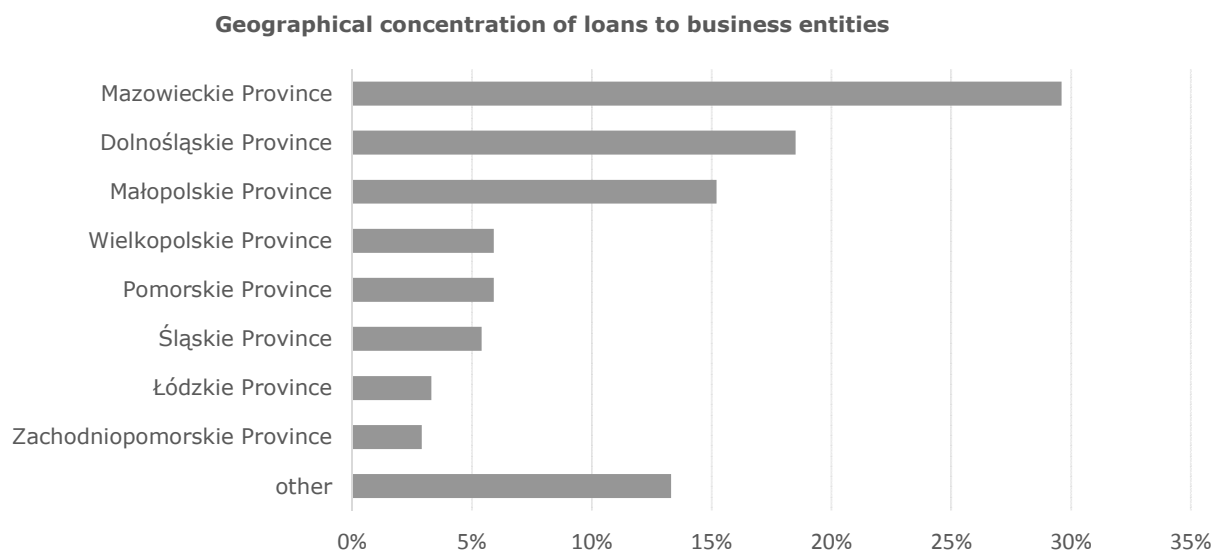


Chart 6. Geographical concentration of loan portfolio for business entities



The largest number of financed projects is concentrated in Mazowieckie province, where 29.6% of all credit resources is involved. In Dolnośląskie, Małopolskie and Wielkopolskie province the total balance sheet exposure accounts for 39.6%.

As of the reporting date loans granted in EUR (75.9%) and PLN (23.3%) dominated the corporate loans portfolio.

Public sector loans

Due to the strategy of the Bank the portfolio does not contain new agreements, which in connection with significant prepayments is reflected in a lower, as compared to 31 December 2017, balance sheet exposure to public sector. As at the reporting date the exposure was PLN 181 million (down by 10.0%).

Retail loans to natural persons

In 2018, the Bank's activities in the area of retail loans focused on the implementation of a new strategy in the mBank Group, connected with a change of the model of acquiring retail loans by the Bank. The existing so called "agency model" of cooperation with mBank was replaced by the „pooling model“. As of 22 July 2017, retail loans for to natural persons are offered only by mBank. In 2018, the Bank actively cooperated with mBank with the aim to develop the product and maximise sales of newly granted retail loans at the side of mBank, meeting the requirements of transfer to the Bank. Actions were undertaken to build a new, innovative process ensuring the transfer of retail assets in monthly cycles.

1.5. Issuing of covered bonds and refinancing

mBank Hipoteczny is a mortgage bank with the longest history of issues of covered bonds on the Polish capital market. The value of outstanding mortgage covered bonds issued by the Bank as at 31 December 2018 was PLN 7.1 billion, which accounts for 34% of the total market, which already amounts to PLN 21.1 billion.

The covered bond issue activities of the Bank is a significant element of the Strategy of the mBank Group in the area of financing. The scale of bond issue activities in 2018 and parameters of individual issues are a confirmation of the implementation of the Bank's financing strategy, which provides for fund raising and refinancing of long-term mortgage loans by the issues of covered bonds with the assumption of the reduction of mismatches between the maturity dates of liabilities and assets, currency mismatch and lower costs of funds raised.

In 2018, the Bank successfully placed on the market three issues of mortgage covered bonds of the total nominal value of PLN 1.58 billion.

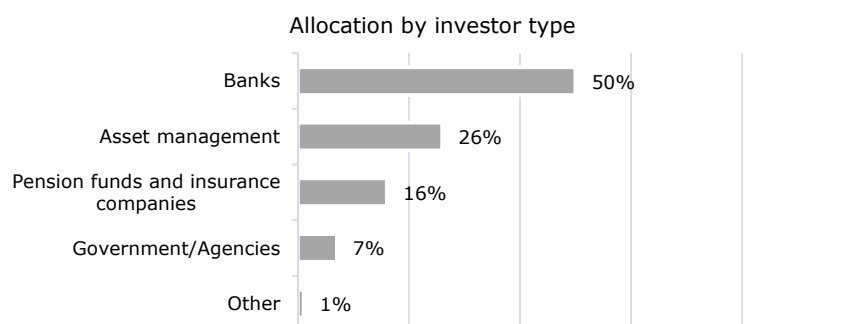
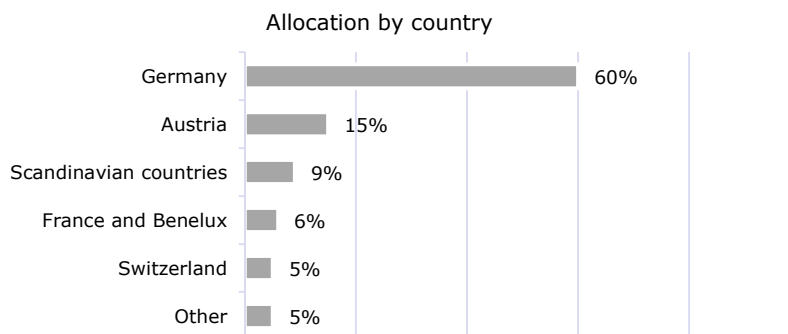
The summary of bond issue activities of the Bank on the public market in 2018 is presented in the table below.

Volume	Currency	Issue date	Redemption date	Tenor (years)	Coupon	Stock exchange
300 M	EUR	26.04.2018	05.03.2025	7	1,073% (MS+42bps)	Luxembourg Stock Exchange
300 M	PLN	22.06.2018	10.06.2024	6	WIBOR3M +58bps	WSE and Bondspot
10 M	PLN	15.10.2018	10.06.2024	6	WIBOR3M +58bps	WSE and Bondspot

The issue of EUR 300 million is the inaugural benchmarking issue of covered bonds on the international market conducted under the International Covered Bonds Issue Programme. The final valuation was 42 base points above MidSwap, and the coupon was 1.073%. It is the biggest issue of covered bonds in the Bank's history – it constitutes the equivalent of approx. PLN 1 250 million.

From the perspective of the mBank Group, this has been so far the longest and most favourably placed debt issue on the international market. Declaration forms for purchase of mBH covered bonds for the total amount of over EUR 800 million (2.7x the value of the placed issue) were submitted by more than 60 investors. The issue is listed on the Luxembourg Stock Exchange.

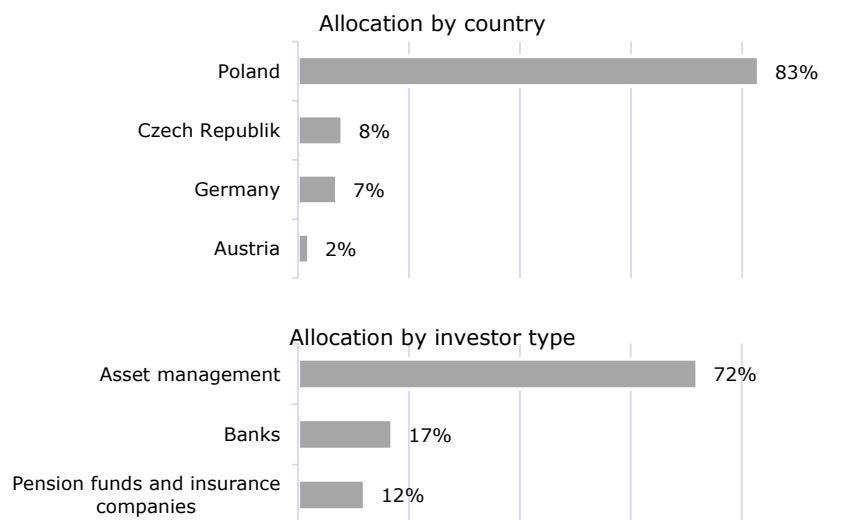
After the allocation, the transaction structure by geographical location and entity is as follows:



The issue of PLN 300 million was conducted under the International Covered Bonds Issue Programme in a new distribution model. The Bank entrusted book-building to mBank with regard to the offer for domestic institutional investors, and Erste Group Bank AG, representing the demand of investors from outside Poland.

Through them, 23 investors submitted Covered Bond Purchase Declaration Forms for a total amount of over PLN 577 million, i.e. over 1.9x of the value of the offer.

After the allocation, the transaction structure by geographical location and entity is as follows:



The issue of PLN 10 million from October 2018 was conducted for the purpose of assimilation with the issue of PLN 300 million from June 2018. The scope of powers of covered bond holders is the same for two combined series, as upon assimilation they are listed under the same ISIN code on the Regulated Market of the WSE and Bondspot. It was the first assimilation of two series of covered bonds in the history of the Polish capital market.

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The Bank covered bonds are instruments that carry low investment risk, resulting from the statutory requirement of multi-tiered security of their issue and trade. This is confirmed by the ratings granted by Fitch Ratings Ltd. to the mortgage covered bonds issued by the Bank. On 22 June 2018 the rating of mortgage covered bonds was confirmed at level A, with a positive outlook.

Issues of mortgage bonds of mBank Hipoteczny S.A. in the public offering

Issue date	Redemption date	Currency	Value	Rating Fitch Ratings Ltd.
20.06.2013	21.06.2019	PLN	80,000,000	A
28.07.2014	28.07.2022	PLN	300,000,000	A
04.08.2014	20.02.2023	PLN	200,000,000	A
20.02.2015	28.04.2022	PLN	200,000,000	A
15.04.2015	16.10.2023	PLN	250,000,000	A
17.09.2015	10.09.2020	PLN	500,000,000	A
02.12.2015	20.09.2021	PLN	255,000,000	A
09.03.2016	05.03.2021	PLN	300,000,000	A
28.04.2016	28.04.2020	PLN	50,000,000	A
11.05.2016	28.04.2020	PLN	100,000,000	A
29.09.2017	10.09.2022	PLN	500,000,000	A
11.10.2017	15.09.2023	PLN	1,000,000,000	A
22.06.2018	10.06.2024	PLN	310,000,000	A
TOTAL		PLN	4,045,000,000	
Issue date	Redemption date	Currency	Value	Rating Fitch Ratings Ltd.
26.07.2013	28.07.2020	EUR	30,000,000	A
28.02.2014	28.02.2029	EUR	8,000,000	A
17.03.2014	15.03.2029	EUR	15,000,000	A
30.05.2014	30.05.2029	EUR	20,000,000	A
28.11.2014	15.10.2019	EUR	50,000,000	A
25.02.2015	25.02.2022	EUR	20,000,000	A
24.04.2015	24.04.2025	EUR	11,000,000	A
24.06.2015	24.06.2020	EUR	50,000,000	A
23.03.2016	21.06.2021	EUR	50,000,000	A
28.09.2016	20.09.2026	EUR	13,000,000	A
26.10.2016	20.09.2026	EUR	35,000,000	A
01.02.2017	01.02.2024	EUR	24,900,000	A
30.10.2017	22.06.2022	EUR	100,000,000	A
26.04.2018	05.03.2025	EUR	300,000,000	A
TOTAL		EUR	726,900,000	

The Bank continues to issue unsecured bonds. At the end of 2018, the Bank held five issued series for the total amount of PLN 630 million. The Bank's offer includes zero-coupon bonds and coupon bonds denominated in PLN with a maturity of over 1 year.

The basis for issuing of covered bonds

According to the Act on covered bonds and mortgage banks, the basis for the issuing of mortgage covered bonds are receivables entered into the cover register for mortgage bonds, secured by mortgages established on the right of perpetual usufruct or the right of ownership of the real estate entered into the land and mortgage registry as the first item.

As of the reporting date the collateral of mortgage covered bonds consisted of receivables of value PLN 9,349.4 million from total number of 20,937 loans.

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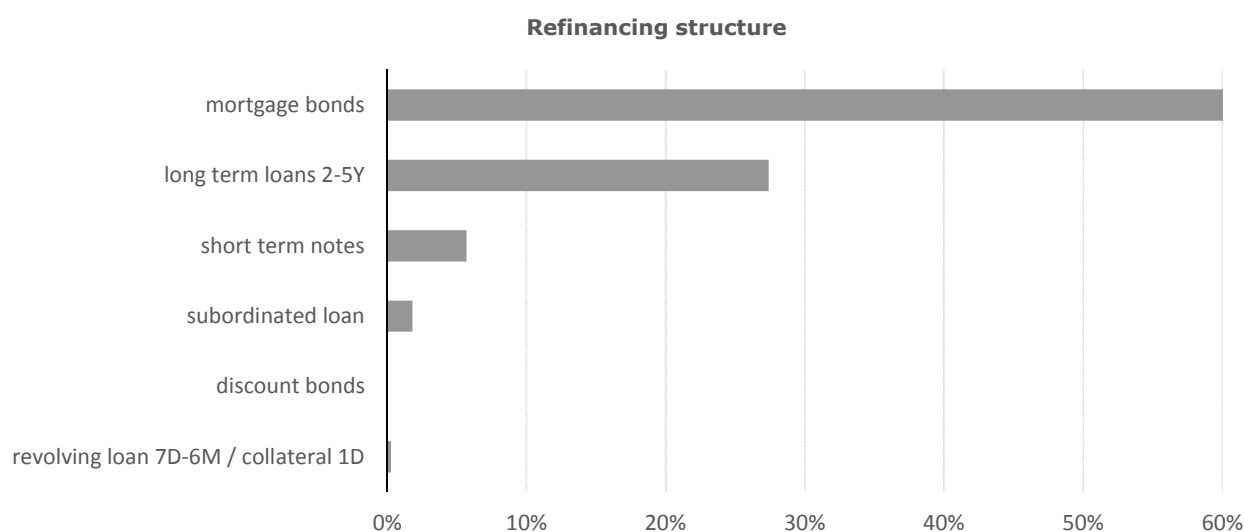
Loans for commercial clients constituted 43.71% and for retail clients 56.29% of the total amount of receivables entered into the mortgage cover register. Loans granted in PLN (66.16%) dominated, loans in EUR (33.55%) and USD (0.29%) constituted the remaining part.

Additionally to the credit receivables, the additional collateral in a form of treasury bonds of nominal value of PLN 200 million was also entered into the mortgage cover register.

The level of over-collateralisation (including substitute cover) of mortgage covered bonds and public sector covered bonds amounted to 32.05%.

The Bank raises funds for the lending activity predominantly through issuing of covered bonds and subsequently through issuing short-term bonds and received loans, mainly from the interbank market.

Chart 7. The structure of refinancing of the Bank activity



1.6. Legal environment

In 2018 intensive works were carried out in the Bank to adjust operating procedures to the requirements of Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data (...). Particular emphasis was placed on fulfilling obligations towards individuals who are customers and counterparties of the Bank and ensuring the exercise of their rights under the Regulation. These efforts were a continuation of works carried out already in 2017. The Regulation entered into force on 25 May 2018.

A legal challenge for 2018 was the alignment of operating procedures with the Anti-Money Laundering and Anti-Terrorism Financing Act of 1 March 2018 (Journal of Laws of 723, as amended) which came into force on 13 July 2018 and superseded the previous Act of 2000, which was the transposition of the AML IV Directive into the Polish legal framework.

Following the announcement by the European Commission of the proposal for a directive of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and the proposal for a regulation of the European Parliament and of the Council amending Regulation No 575/2013 as regards exposures in the form of covered bonds – legal acts concerning the rules for issuing covered bonds and the rules for activities of their issuers (mortgage banks), the bank analyses these draft acts on an ongoing basis. The Bank participates in public consultations on these drafts through the institutions set up for this purpose. In the opinion of the bank, the proposed measures do not pose a threat related to the need to fundamentally change the business model in the future. Most of the proposed arrangements are in line with those currently in force in Poland, in particular the Act on Covered Bonds and Mortgage Banks. Minor discrepancies are reported by the bank on an ongoing basis in the consultation process through authorised institutions.

As a bank crediting the real estate market, the Bank in 2018 monitored the works on the Act of 20 July 2018 on Transformation of the Right of Perpetual Usufruct of Land Developed for Residential Purposes into Ownership of Land (Journal of Laws, item 1716, as amended) and analysed the solutions included in the amendments to that Act, which entered into force on 1 January 2019. The Act provides for transformation of the right of perpetual usufruct of land developed for residential purposes into ownership of that land by force of the Act as of 1 January 2019. The analysis has not demonstrated the real risk of the Bank as the institution crediting the real estate market, as the mortgages established on the right of perpetual usufruct become mortgages on the ownership right. The amendments to the Act introduced the mechanisms allowing entrepreneurs, particularly developers, to avoid possible classification of the transformation as public aid.

2. Risk management

2.1. Credit risk

Loan portfolio

The principles for granting loans have been specified in the Bank's Credit Policy and the management of existing loan portfolio is done mainly through current monitoring of credit exposures.

The share of non-performing loans in the loan portfolio increased in 2018 from the level of 2.99% to 3.59%, as a result of reclassifying two commercial exposures to the default category. Most of the loans are repaid in a timely manner, and the borrowers of higher risk profile are subjected to a more strict monitoring.

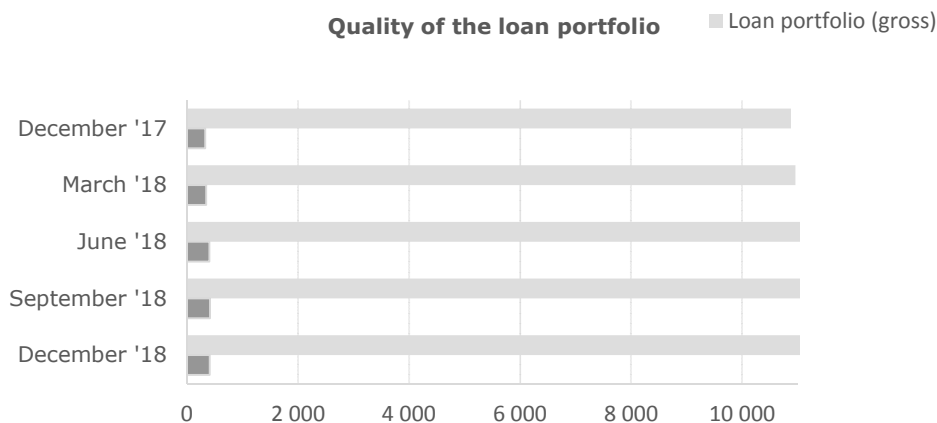
Impairment provisions (including the adjustment to the fair value and CEIR) reaching PLN 171 million together with mortgages on the financed real estates constitute an appropriate security against potential losses resulting from credit risk.

The level of NPL coverage with provisions amounted to 42%.

The main area of activity of the Bank in 2018 was refinancing of commercial real estates, especially shopping centres and offices. This activity is based on a uniform for the whole mBank S.A. group commercial real estate financing policy, including key elements of acceptance policy for individual segments of the real estate market. Drawing on past experiences in housing investments financing, the Bank continued financing of residential construction projects focusing on selective financing of projects of the most favourable market parameters (e.g. adaptation of the offer to the needs of the market, positive history of the developer's activity, adequate level of own contribution and verified pre-sale).

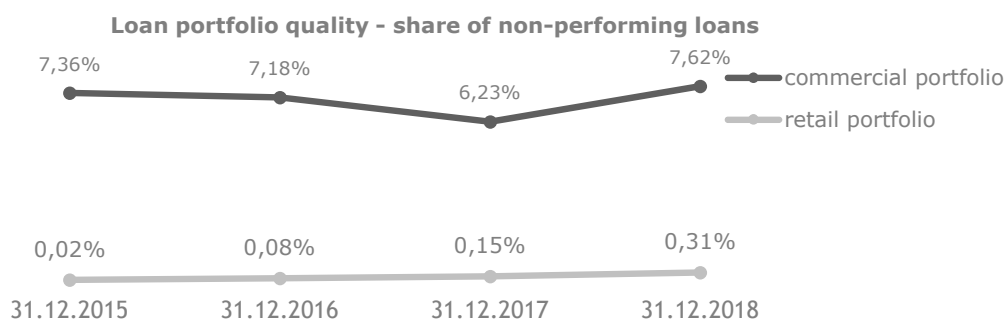
The retail portfolio is characterised by very high quality, which results from the applied credit policy (until the moment of transferring the whole process of selling retail mortgage loans to mBank S.A.) as well as the fact that this portfolio is very young. As of the reporting date there were only 50 cases with reported loss of value. Loans for natural persons are monitored monthly for timely repayments and correctness in terms of established effective mortgage collaterals. Realisation of all contractual obligations of the client is verified in the same monitoring period (including insuring of the real estate and assignment of the rights under insurance policies).

Chart 8. Non-performing loans* in the loan portfolio (gross value, in PLN million)



* non-performing loans – loans classified in basket 3 or POCI, in accordance with IFRS 9

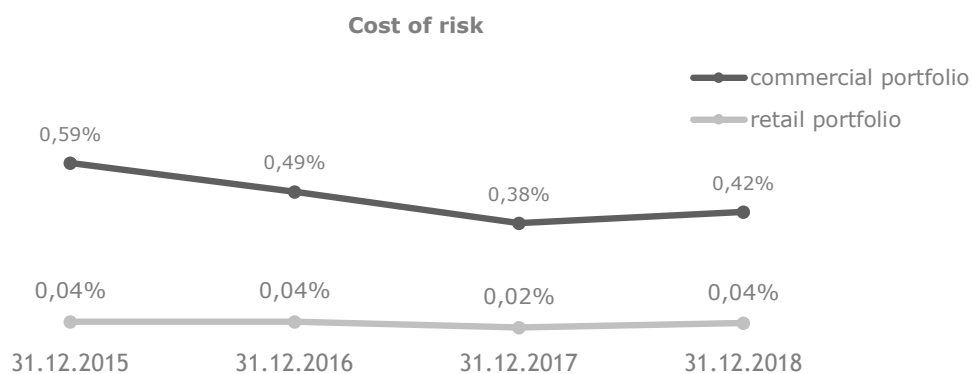
Chart 9. Share of non-performing loans by portfolio



*retail portfolio – the portfolio of loans granted in cooperation with mBank S.A. (agency portfolio) and the portfolio acquired from mBank S.A. (the pooling portfolio)

The cost of risk is an important indicator monitored by the Bank. The cost of risk is maintained at a very good level.

Chart 10. Cost of risk by portfolio



*retail portfolio – the portfolio of loans granted in cooperation with mBank S.A. (agency portfolio) and the portfolio acquired from mBank S.A. (the pooling portfolio)

Credit risk management

The Bank assumes that the level of credit risk will be maintained in line with the risk appetite defined by the target level of capital adequacy and exposure limits. At the same time the objective of the credit risk management is ensuring the quality required by the Act on covered bonds and mortgage banks for individual exposures in order to utilise them to the greatest extent as a basis for issuing of covered bonds.

Following a change in the model of the Bank's activity in the commercial area financing as from 1 January 2019, the Bank will continue cooperation with its existing customers. The establishment of cooperation with new customers having experience on the real estate market, companies with a strong market position will be possible only in the form of purchase of claims granted by mBank. These claims will be used to finance: the purchase of finished or refinancing of existing or new commercial real estates or completely renovated real estates, which are comprehensively utilised and remain economically competitive over a longer period of time.

In the area of retail loans, the loan portfolio will be built by transferring loans which meet the criteria specified by the Bank from mBank S.A. The criteria selected will ensure maintaining a portfolio with a low loss ratio, based on the foundation of customers with confirmed creditworthiness.

Lawsuits brought by the Bank, insolvency proceedings

In the second half of 2018, the Bank did not bring any lawsuits, but filed with courts three bankruptcy petitions with respect to commercial clients.

The first petition was filed with a court on 23 July 2018. The petition concerned the claim, which was earlier asserted by the Bank by way of enforcement proceedings. In this case, on 28 January 2016 the Bank submitted a declaration of takeover of ownership of the real estate, after the second unsuccessful auction. However, due to the obstructive actions of the debtor and persons related to the borrower, until the date of preparing this report the real estate has not been successfully taken over by the Bank. Until 31 December 2018, the court has also not considered the bankruptcy petition in the case concerned. The temporary court administrator has been appointed in the case.

Two bankruptcy petitions, concerning two loans of two companies related by the person of the partner and the president of the management board, were filed with the court on 20 December 2018. Until 31 December 2018, the court has not considered the petitions concerned, but only assigned court file numbers to the cases.

In the first half of 2018, an auction sale of one of the real estates subject to enforcement proceedings took place. The real estate was auctioned at the price of PLN 10 million. As results from the information currently available to the Bank, the auctioneer did not fulfil the adjudication conditions (did not pay the price for the auctioned claim). In the same case, on 24 May 2018 another entity filed a petition for declaration of bankruptcy of the company which was the owner of the auctioned real estate. On 25 July 2018, the Bankruptcy Court declared the company bankrupt. The Court's decision on the declaration of bankruptcy became final and binding on 6 December 2018. Due to the auctioneer's failure to pay the price, the receiver will strive to discontinue the enforcement proceedings and to conduct bankruptcy proceedings.

In the second half of 2018, the real estate was sold in the auction in Lublin. The real estate was sold for the amount of PLN 4.8 million plus VAT 23%. By the order of 18 December 2018, the court partially approved the list of claims. Currently, the Bank awaits preparation of a partial plan of division of the sum obtained from the sale of the real estate concerned (the plan concerns indisputable claims). It should be expected that the Bank's claim will be satisfied in full.

In the area of retail loans, in the second half of 2018, two lawsuits were brought in the total amount of PLN 615.3 thousand. The lawsuits concern a new portfolio (two pooling loans). As at the date of this report, the Bank had already obtained an enforcement title in one of the cases brought to the court in the first half of the year. Other cases are pending.

2.2. Market risk

The risk of loss resulting from adverse changes of market parameters from the point of view of the term structure of items in the portfolio of the Bank is maintained as low as possible, which results from the

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nature of the Bank's activity, properly functioning system of risk limitation and managing of the risk at the operational level.

In order to limit the market risk, the Bank adjusts the currency and term structure of acquired sources of financing to the structure of loans, uses linear plain vanilla derivatives and concludes spot or forward currency transactions and FX SWAP transactions.

The amount of market risk the Bank is exposed to in the day horizon is determined using Value at Risk (VaR) method at the confidence level of 97.5%. As of the end of December 2018 VaR amounted to PLN 498.1 thousand. The currency risk was PLN 19.2 thousand, the interest rate risk was PLN 140.1 thousand and the credit spread risk was PLN 491.2 thousand.

The interest rate risk results from exposure of the financial result and the Bank's capital to adverse effect of interest rates changes. The Bank manages the interest rate gap through matching the repricing dates of assets and liabilities. The sensitivity of the Bank's portfolio to interest rates fluctuations is determined on the basis of results of stress tests and scenario analyses. The interest rate risk is measured among others by using Earnings At Risk (EaR) ratio, which by the end of December 2018 reached a safe level of 3.96%. The banking books items that are exposed to interest rate risk are hedged with linear interest rate derivatives.

The currency risk is limited through immediate closing the foreign exchange position. The measurement of scale and structure of currency risk is done on the basis of the current foreign exchange position taking into account anticipated repayments and disbursements of loans. The currency risk is limited using foreign exchange position limits for each currency.

2.3. Liquidity risk

Liquidity risk management is conducted at the level of intraday, short-, medium- and long-term liquidity, the lack of which means inability to finance assets and timely settle liabilities in the normal course of business of the Bank.

Due to the mismatch between the maturity dates of long-term securities and assets, the higher security of liquidity is guaranteed through maintaining of liquid assets in case of unforeseen events.

At the end of December 2018, the excess of liquid assets amounted to approx. 6.9% of the balance sheet total.

In 2018 financing of Bank's lending was performed primarily through issuing covered bonds in PLN and EUR. The long-term situation of the Bank in terms of liquidity is stable. Loans obtained from mBank S.A. have significant share in financing of long-term receivables.

Due to necessity to maintain liquidity indicators on an appropriate level, the needs to bridge the mismatch of the assets structure to the liabilities that finance them as well as increasing the stability of financing sources, mBank Hipoteczny S.A. will continue actions aimed at replacing short-term financing with financing in a form of new issues of covered bonds with maturity period of 5 years or more.

The share of stable financing sources and liquidity reserves adequate to the scale of the Bank's activity determines meeting of long-term liquidity standard M4 required by KNF. The M4 ratio at the end of December 2018 was 1.067. M1 and M2 short-term liquidity standards were maintained at a safe level, PLN 1,631,031 thousand and 3.507 respectively. The M3 standard was 130.479.

Net outflows coverage ratio, determining the relation of the liquidity buffer to the net liquidity outflows under stressed conditions lasting 30 calendar days (LCR) at the end of December 2018 amounted to 1081%.

As at the end of December 2018 the liabilities limit, resulting from Art. 15.2 of the "Act on covered bonds and mortgage banks", was used in 56.21%. In 2018 this limit was not exceeded.

As at the end of December 2018 average maturity of issued mortgage covered bonds was 4.2 of a year while the average maturity of loans obtained from other banks was 3.5 of a year. The margin of mortgage covered bonds issued in 2018 on average amounted to 0.58%, with average maturity of 6.0 of a year.

2.4. Operational risk

The Bank has a simplified organisational structure, and the products offered are consistent with the nature of the mortgage bank's activity.

In 2018, the Bank developed a new business strategy, resulting in the next change of the Bank's business profile, after transferring the sale of retail loans to mBank in 2017.

Since January 2019, the Bank is planning to develop the commercial loans portfolio, similarly like the retail loans portfolio, in the formula of close cooperation with mBank, i.e. assuming that the sale will be executed by the forces of mBank.

The operational risk connected with the loan sale stage was transferred together with the sales process. It has an impact on reducing the level of the operational risk of the Bank, nevertheless increases the significance of the tasks entrusted in the outsourced processes, relating to the processes of loan acquisition by pooling and maintenance of the loan portfolio. The outsourcing processes are subject to continuous monitoring.

The Bank has a Business Continuity Plan that was implemented in 2014 in accordance with ISO 22301 standard and since then periodically tested. It is accordant with provisions of Recommendation D of KNF. The purpose of the Plan is to implement mechanisms that ensure maintenance of mBank Hipoteczny S.A. activity in the scope defined by a list of critical processes within a period of up to five days. This plan is tested at least two times a year and the list of critical processes is subjected to analyses and updates not less than every two years. Actions that improve the plan, in accordance with adopted internal regulations, are measured and the Management Board is informed about them. In order to comply with the postulate of accountability in IT systems, events monitoring and notifying systems were implemented together with internal safety procedures for individual IT systems for which the IT safety risk assessment is performed. Furthermore, the information security management system was supplemented with redesigned processes: the Bank's physical and environmental safety management as well as knowledge management of knowledge on information safety (raising users' awareness). The processes were incorporated into complete policy of IT service model of management. Considering the probability of occurring of critical situations in the areas of liquidity management, currency risk or interest rate risk the Bank has an "Emergency plan in case of liquidity crisis." Additionally, the Bank also has an "Emergency plan in case of unexpected, radical changes in prices on the real estate market."

The factors influencing the increase of Bank's level of exposure to operational risk:

- changes in the organisational structure,
- number of conducted undertakings and IT projects,
- turnover of employees,
- changes in the profile of operational activity, related to the transfer of the sales process of retail and commercial loans to mBank S.A.

The factors that stabilise the Bank's level of exposure to operational risk:

- operational risk management system implemented in the Bank,
- simple organisational structure, no subsidiaries,
- small scale and the degree of complexity resulting from the specificity characteristic for mortgage banks,
- no electronic banking services,
- procedures governing the process of making decisions on entrusting of activities (analysis of benefits, risks and means of their limitation, business continuity plans and insourcer's financial situation as well as the ability to implement services in a timely and qualitative manner).
- Bank's business continuity plans,
- highly qualified staff,
- efficient internal control system,
- monitoring of the quality of the outsourced tasks (periodic control of the insourcer with monitoring of post-control recommendations; transparent procedure of problem solving (Joint Committee and

the Outsourcing Committee); monitoring of the quality and timeliness of service performance, also for the purpose of calculation of the remuneration level).

The Bank will monitor and analyse any changes affecting its operational risk profile.

2.5. Covered bonds investment risk

In 2018 the investment risk profile associated with covered bonds issued by mBank Hipoteczny S.A. did not change. Those securities are a financial instrument of a low investment risk, resulting from the requirements of multi-stage collateralisation of their issuing and trade by the issuer, accordant with the Act on covered bonds and mortgage banks. In addition to compliance with a number of statutory requirements during economic slowdown, high safety of investing in covered bonds is also a result of the Bank's conservative policy of valuation of real estates constitute their collateral, which has been applied for many years. According to the amended Act on covered bonds and mortgage banks, the minimum level of over-collateralisation of mortgage and public sector covered bonds since 1 January 2016 is 10%.

The increase of investment attractiveness of such securities also results from the fact that covered bonds issued by mortgage banks may constitute a collateral for a lombard loan as well as repurchase transactions conducted with other banks.

2.6. Internal control system

The Bank has an internal control system, which is divided into the following:

- 1) **control function** – whose task is to ensure compliance with controls relating, in particular, to risk management at the Bank, which comprises positions, groups of people or organizational units responsible for performing tasks assigned to this function. The Control function comprises all controls put in place in the processes executed in the Bank, independent monitoring of the compliance with these controls and reporting within the function.
- 2) **Compliance Department** - compliance cell with the following responsibilities:
 - it manages compliance risk (construed as the risk of effects of non-compliance with legal regulations, internal regulations and market standards) through identification, assessment, controlling, monitoring and reporting on compliance risk regarding the law, internal regulations and market standards;
 - it performs horizontal monitoring tasks of the compliance unit and vertical monitoring tasks within the so-called second line of defence, assigned to the compliance unit to assure compliance of the Bank's operations with legal regulations, internal regulations and market standards. CD performs other tasks, provided that it does not undermine its effectiveness and independence.

The Compliance Department is responsible for implementation of the standards of the mBank Group and, indirectly, of Commerzbank AG in areas regarded as "compliance areas" in accordance with the Group standards, which include in particular:

- anti-money laundering and counter-terrorist financing
- protection of personal data
- banking outsourcing
- preventing conflicts of interest, fraud and corruption
- supervision over the process of handling of client's complaints
- Inside information according to Market Abuse Regulation.

- 3) **Internal Audit Department** - independent internal audit department whose task is to independently and objectively examine and assess the adequacy of the risk management system and the internal audit system. Internal audit supports the Bank in achieving objectives through systematic and disciplined approach to examination, assessment and improvement of effectiveness of risk management, audit and organisational governance processes.

Within the scope of its activity the internal audit provides services:

- providing - covering objective assessment of evidence, performed by internal auditors in order to provide independent opinion and proposals related to a process, system or other issues,
- consulting - covering advisory and related service activities, which nature and scope are arranged in detail with principal, and which purpose is to add value to and improve organisational governance, risk management and internal audit processes.

Internal Audit Department, within the scope of implemented function, is subject to periodical assessment of independent competent entity from outside the Bank. The entity is selected by the Bank's Management Board and approved by the Audit Committee. The work assessment covers compliance of the internal audit with IIA Standards, Recommendation H and best market practices.

2.7. Remuneration policy

The Bank runs a remuneration scheme for the Bank's Management Board and employees with significant influence on Bank's risk profile, based on phantom shares settled in cash; the scheme is further referred to as the "Policy". These benefits are accounted for in accordance with IAS 19 "Employee benefits". Phantom share valuation is debited to relevant period expenses with a credit to liabilities. Costs are recognised over time during the period of the right to benefits and included in "General administrative expenses". Allocation of phantom shares results from their valuation for the assessment period. Phantom shares valuation is calculated always as at the end of a reporting period by dividing Bank's book value over the number of ordinary shares. The payout under phantom shares depends on the average valuation of these shares obtained on the basis of two values: the phantom share value at the end of the annual period preceding the payment date and the phantom share value at the end of the first half of the year in which the payment is due in a given reporting period. The aforementioned average value is multiplied by the number of phantom shares to be executed in a given period, and the outcome determines the amount of the cash payment resulting from phantom shares held. The final value of the premium, which is a product of the number of shares and their estimated value as at the balance sheet date preceding the realisation of each of the deferred tranches is subject to actuarial discounting. The discounted amount is reduced by amounts of allocations to the relevant provision, which are subject to annual actuarial discounting at the same date. The actuarial discount is the product of the financial discount and the probability of each of the participants individually reaching the moment of obtaining full entitlement to each of the deferred tranches. Annual allocations are calculated according to the Projected Unit Credit Method. The aforementioned probability was determined using the Multiple Decrement Model, where the following three risks were taken into account: the possibility of dismissal, the risk of total incapacity for work, the risk of death.

3. Directions of development and key elements of the Bank strategy

Mission statement

With regard to the real estate market, the mission of mBank Hipoteczny is to support the development of an effective mechanism for financing the real estate market in Poland by issuing long-term debt securities (covered bonds), which are an instrument that makes it possible to refinance attractive forms of real estate financing based on strong competences, the longest market experience and the highest standard of service.

With regard to mBank Group, the mission of mBank Hipoteczny is to provide stable, long-term and safe refinancing.

From the investors' point of view, the mission of mBank Hipoteczny is to ensure a high level of long-term covered bonds with a high level of security.

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The vision

mBank Hipoteczny will be focused on issuing covered bonds in Poland and on the international market within the most cost-effective business model possible, i.e. aimed at maximising synergies within mBank Group, in particular on using the available resources of each bank, primarily mBank, in accordance with their economic purpose, as well as the knowledge and experience within mBank Group.

In view of the development of the covered bond market in Poland, and in particular in view of the expected establishment of new mortgage banks, the Bank's ambition is to maintain its current position among the leading issuers of such instruments in Poland.

The Bank's strategic objectives for 2019–2022 are the following:

- Maximum utilisation of covered bonds as a tool for refinancing the portfolio of long-term mortgage loans.
- Dynamic development of the portfolio of real estate loan assets (housing and commercial loans) under the applicable risk management strategy, compliant with the covered bond collateral criteria.
- Optimal use of resources and competencies in both banks as well as other entities of mBank Group, making it possible to achieve synergy in order to ensure an effective issuance process while maintaining the principles of safe and prudent management of the Bank so that the Bank is a safe, efficient and effective issuer of covered bonds on the market.

Strengthening mBank Group's independence with regard to the financing of its operations and better matching the time horizon of financing with assets is a key element of the financing strategy. The issuance of covered bonds is a factor supporting the financing of operations on the real estate market.

mBank Group assumes a dynamic growth of the issuance operations of the Bank in the coming years. The issuance of covered bonds allows the Bank to generate stable and long-term financing on affordable terms. The Bank assumes issuance of covered bonds secured by both residential and CRE mortgage loans – both types of collaterals will be acquired in cooperation with mBank.

Housing mortgage loans will be the main driver of the increase in the covered pool for the issuance of covered bonds at the Bank. Covered bonds will be issued both in PLN and in EUR, and their maturity will vary between 5 and 10 years.

4. Bank Authorities

Shareholders

As at 31 December 2018, the total number of ordinary shares was 3,210,000 shares with a nominal value of PLN 100 per share. On 8 February 2017, the Extraordinary General Meeting adopted resolution on the increase of the share capital and the exclusion of the shareholder from the pre-emptive right to shares, under which the share capital will be increased to the amount of PLN 321,000,000.00 by way of issuing 120,000 series H ordinary registered shares with a nominal value of PLN 100.00 each and the issue price of PLN 1,000.00 each. The new shares were offered for subscription to mBank S.A. through private placement. The shares were paid-up in full on 28 February 2017. On 3 April 2017, the registry court entered the increased share capital in the registry of entrepreneurs.

The Bank did not issue preferred shares, there are no limitations of rights associated with shares. All shares participate equally in the dividend distribution. All issued shares are fully paid. The Bank does not possess own shares.

As of the reporting date the ownership structure of registered share capital of the Bank is as follows:

Name of shareholder	Registered share capital in PLN	Shares		Votes at the General Meeting of Shareholders	
		Amount	%	Amount	%
mBank S.A.	321,000,000	3,210,000	100.00	3,210,000	100.00
Total	321,000,000	3,210,000	100.00	3,210,000	100.00

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The Bank does not collaborate with international public institutions.

Management Board

The Management Board of mBank Hipoteczny S.A. included the following members:

- Piotr Cyburt – President of the Management Board
- Andrzej Kulik – Member of the Management Board
- Grzegorz Trawiński – Member of the Management Board
- Marcin Wojtachnio – Member of the Management Board

Appointment and dismissal of members of the Management Board and their rights:

The Supervisory Board appoints and dismisses members of the Management Board of the Bank, including the President of the Management Board.

Appointing of two members of the Management Board, including the President of the Management Board and a member of the Management Board responsible for risk takes place upon Financial Supervision Authority approval. A request for approval is submitted by the Supervisory Board.

The Management Board of the Bank manages the Bank's operations and represents it. The Management Board adopts annual financial plans and operating strategy which are approved by the Supervisory Board. In these plans, the Management Boards specifies the maximum volume of mortgage bond and bond issues for a given year. The scope of activities of the Bank's Management Board includes all matters not reserved for the competence of other Bank's bodies based on its Articles of Association or the provisions of the law.

Rules on amending articles of association

In accordance with Art. 430 § 1 of the CCC the change of articles of association requires resolution of the general meeting and entry into register.

Pursuant to art. 34 par. 1 Banking Law the change of bank's articles of association requires approval of the Financial Supervision Authority, if it relates to the matters specified below, i.e.:

- a company's name must include a separate word "bank" and differ from the names of other banks as well as indicate whether it is a national bank, bank in the form of a joint stock company or cooperative bank;
- registered office, business objectives and scope of activities of a bank including activities referred to in Art 69 para. 2 item 1-7 dated 29 July 2005 on trading in financial instruments which the bank intends to perform in accordance with Art. 70 para. 2 thereof;
- bodies and their competencies with particular emphasis on competencies of members of the management board referred to in Art. 22b para. 1 banking law, as well as principles of decision-making, basic organisational structure of the bank, rules for submission of statements in the scope of rights and financial obligations, procedures of issuing internal obligations and decision-making procedures regarding commitments or disposal of assets which total value in relation to one entity exceeds 5% of own funds;
- principles of operation of the management system, including the internal audit system;
- own funds and financial management principles

as well as principles of share privilege and restrictions in relation to voting rights in the bank in the form of a joint stock company.

Supervisory Board

Composition of mBank Hipoteczny S.A. Supervisory Board:

- Frank Bock – Supervisory Board Chairman
- Lidia Jabłonowska-Luba - Supervisory Board Vice-Chairman
- Andreas Boeger – Supervisory Board Member
- Jakub Fast – Supervisory Board Member
- Paweł Graniewski – Independent Supervisory Board Member

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- Cezary Kocik - Supervisory Board Member
- Michał Popiołek - Supervisory Board Member
- Mariusz Tokarski – Independent Supervisory Board Member

According to the wording of paragraph 14 clause 1 point 5 of the Articles of Association of mBank Hipoteczny S.A., the General Meeting, in a form of resolution, makes a decision regarding appointment or dismissal of the Supervisory Board members and determination of principles of their remuneration.

According to the wording of paragraph 3 clause 1 point 9 of the Rules and Regulations of the Supervisory Board of mBank Hipoteczny S.A., establishing of terms and conditions of contracts and remuneration for members of the Management Board of the Bank lies within the competence of the Supervisory Board.

Two Committees operate within the Supervisory Board: Audit Committee and Risk Committee.

Audit Committee

The Audit Committee included the following members:

- Paweł Graniewski - Committee Chairman
- Andreas Boeger - Committee Member
- Mariusz Tokarski - Committee Member

In 2018 the Audit Committee held meetings on 2 March, 5 September and 14 December.

Risk Committee

The Risk Committee included the following members:

- Lidia Jabłonowska-Luba – Chairwoman of the Committee
- Frank Bock - Committee Member
- Michał Popiołek – Committee Member

The tasks of the Risk Committee include:

- expressing opinions about the comprehensive risk appetite of the Bank at present and in the future,
- expressing opinions about the strategy of risk management in Bank's activities developed by the Bank's Management Board and about the information on implementing this strategy submitted by the Management Board,
- supporting the Bank's Supervisory Board in monitoring the implementation of the strategy of risk management in Bank's activities by top management,
- verifying whether the prices of liabilities and assets offered to customers fully comply with the Bank's business model and its risk strategy, and if these prices do not reflect appropriately the types of risks in accordance with this model and this strategy, providing the Bank's Management Board with proposals aiming at ensuring the adequacy of liabilities and assets prices to these risks,
- recommending approval or rejection of the Bank's operational strategy and principles of prudent and stable management of the Bank to the Supervisory Board,
- supervision over risk management in the Bank,
- supporting the Bank's Supervisory Board in the task of supervision over risk management activities in the Bank,
- supporting the Supervisory Board in the task of supervision over the compliance of changes implemented in the credit policy with the strategy and financial plan of the Bank/mBank Group,
- verifying the quality of assets,
- supporting the Bank's Supervisory Board in the task of supervision over cooperation of the Bank with the Commerzbank AG group with respect to consolidated supervision over risk and information exchange.

In 2018 the Risk Committee held meetings on 11 January, 7 September and 7 December.

The procedure for convening and powers of the General Meeting of Shareholders

General Meeting of Shareholders is convened as ordinary (annual) and extraordinary meeting, in accordance with the Bank's Articles of Association and the provisions of the commercial companies' code.

Key competencies of the General Meeting of Shareholders include decision making through resolutions on the following matters:

- review and approval of the Management Board's report on Bank's activities and financial statements for the previous financial year,
- acknowledgement of the fulfilment of duties by the Bank's authorities (vote of confidence),
- Bank's profit distribution or loss coverage,
- amendments to articles of association,
- appointment and dismissal of members of the Supervisory Board and determination of their remuneration,
- increasing or decreasing Bank's share capital,
- liquidation, disposal of the entire Bank's enterprise or merger (combination) with another bank,
- appointment of receivers and determination of their remuneration,
- any decisions relating to claims for rectification of damages caused during the establishment of the company or during its management or supervision,
- decision on dividend payment date,
- disposal or establishing lien on Bank's real property being the location of Bank's authorities,
- matters submitted by the Supervisory Board,
- matters submitted by shareholders under the procedure provided for by the articles of association,
- other matters reserved under the law or the provisions of the Articles of Association.

5. Other information

Loans and interest rates

Basic variable interest rates applied in the Bank are based on LIBOR or EURIBOR interest rates for foreign currency loans and WIBOR for loans in PLN. The loan interest rate in a given day is equal to the sum of margins of the Bank established in the agreement as well as the base rate.

Transactions with affiliated entities

The direct parent entity of mBank Hipoteczny S.A. is mBank S.A. The direct parent entity of mBank S.A. is Commerzbank AG.

All transactions between the Bank and affiliated entities were typical and routine transactions, according to the Management board concluded on conditions that did not vary from the market conditions, and their nature and conditions resulted from current operational activity conducted by the Bank. Transactions with affiliated entities concluded in the scope of ordinary operational activity cover loans, deposits, liabilities arising from the issue of debt securities and derivative transactions.

Information on meeting of requirements specified in Art. 22aa of the Banking Law Act by members of the Supervisory Board

On 21 March and 29 March 2018, the Annual General Meeting of mBank Hipoteczny S.A. appointed the Supervisory Board of the eleventh term of office, composed as above. The General Meeting verified the candidates for the Supervisory Board members and decided that they fulfilled the requirements set forth in Article 22a of the Banking Law.

When appointing the current Management Board, the Supervisory Board verified the persons being appointed as Members of the Management Board and decided that they fulfilled the requirements set forth in Article 22a of the Banking Law.

Proceedings before a court, arbitration body or public administration authority

Information on pending proceedings is provided in Note 32 to the Financial Statements.

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Public aid

In 2018, the Bank did not receive any public subsidies, in particular on the basis of the Act on the Government support for the financial institutions dated February 12, 2009 (Journal of Laws of 2014 item 158).

Guarantees and sureties granted by the Bank

No guarantees or sureties were granted by the Bank in 2018.

Events after the balance sheet date

1. As of 31 December 2018, Grzegorz Trawiński resigned from the function of the member of the Management Board (due to his appointment as a director of the Real Estate Financing Department of mBank S.A.). As from 1 January 2019, the composition of the Management Board of mBank Hipoteczny S.A. is as follows: Piotr Cyburt - President of the Management Board, Andrzej Kulik – Member of the Management Board and Marcin Wojtachnio – Member of the Management Board.
2. On 1 February 2019, a portfolio transfer agreement was concluded between mBank S.A. and mBank Hipoteczny S.A., whereby mBank Hipoteczny S.A. acquired from mBank S.A. a retail portfolio of mortgage-backed loans with the total fair value of PLN 716,225 thousand.
3. On 11 February 2019, the Fitch agency maintained the rating for mortgage covered bonds issued by the Bank at the „A” level and revised the rating outlook from „Positive” to „Stable”.
4. On 22 February 2019, the Bank issued covered bonds in the total amount of PLN 100,000 thousand, as part of its Polish mortgage covered bonds issuance program.
5. Between 28 January and 26 February 2019, the PFSA Office held a comprehensive inspection in the Bank, on the basis of the notification of 10 January 2019. At the date of signing of the financial statements, the Bank did not receive the record of the inspection.
6. On 7 March 2019, the Extraordinary General Meeting of mBank Hipoteczny S.A. adopted the Resolution No 1 on the increase of the share capital of mBank Hipoteczny S.A. and the exclusion of shareholder from the pre-emptive right to shares. The share capital will be increased by PLN 15,000 thousand, i.e. up to PLN 336,000 thousand, by way of issuing 150,000 ordinary registered shares of series I with a nominal value of PLN 100 each and issue price of PLN 1,000 each. The shares will be offered for subscription to mBank S.A. through private placement. The share subscription agreement should be signed by 28 March 2019.

6. Statements of the Management Board

Corporate governance

In its activity the Bank is guided by the rules of corporate governance and best banking practices which set high standards based on transparency of operations, ethics in business and maintaining the balance between interests of all entities involved in the functioning of the Company.

On 16 December 2014 the Management Board, and on 19 January 2015 the Supervisory Board accepted the application of the Principles of Corporate Governance for Supervised Institutions (“Principles”), adopted by the Financial Supervision Authority on 22 July 2014, with the exclusion of Principles indicated in § 8 para. 4, §25 para.1, § 29 , §53-57. The principles addressed to shareholders were presented by the Management Board on the Annual General Meeting of mBank Hipoteczny S.A. on 22 April 2015. On the same day, the General Meeting adopted resolution No 15 on the application of Principles of Corporate Governance for Supervised Institutions, in which it adopted these Principles for application within the scope in which they relate to the general meeting, excluding the principle set forth in § 29 of the Principles (remuneration for holding the position of a Member of the Supervisory Board is awarded by the General Meeting only to an independent member). The resolution came into force on the date of adoption.

The Principles are available at:

https://www.knf.gov.pl/dla_rynku/regulacje_i_praktyka/zasady_ladu_korporacyjnego

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Principles of Corporate Governance for Supervised Institutions is the only set of corporate governance rules followed by the Bank. The Bank did not adopt any other voluntary rules of corporate governance to be followed, nor does it apply any corporate governance practices which go beyond the requirements provided for in the national law.

The Bank has excluded the application of the Principles of Corporate Governance for Supervised Institutions as regards the rules set out in §8(4), §25(1), §29, §53-57. The justification of waiver of said Principles is presented in an Appendix to the Management Board's Resolution No 247 of 16.12.2014.

§8 (4): The Bank does not apply the following Principles: If it is justified by the number of shareholders, the supervised institution should strive to facilitate the participation of all shareholders in the meeting of the decision-making body of the supervised institution by, without limitation, enabling active participation in the meetings of the decision-making body using electronic means.

Shares of mBank Hipoteczny S.A. are acquired indirectly or directly by the sole shareholder i.e. mBank S.A. The General Meetings are held without a formal convocation, and 100% of the share capital shall always be represented at the General Meetings. Accordingly, the number of shareholders does not justify the need for organizing meetings by the use of electronic devices.

§25(1): The Bank does not follow the Principle: Supervision exercised by the supervisory body should be of permanent nature, and the supervisory body meetings should be held as needed. If an audit committee or other committees operate in the supervised institution, and they have been entrusted with specific matters of the supervised institution's activity, meetings of the supervisory body should be held at least four times a year, and otherwise at least every two months.

Deviation from the above Principle is dictated by the close cooperation with the shareholder, in particular as regards consolidated supervision, large exposure risk management, application of statistical methods, risk area, compliance, internal audit, and elaborate regular reporting. The above cooperation results in particular from the obligation defined in Resolution of the Polish Financial Supervision Authority No 258/2011 on detailed principles of operation of the risk management system and the internal control system, and detailed conditions for estimation of internal capital by banks and for reviews of the internal capital retention and estimation process and the principles of determining the policy of variable components of the remunerations of persons in managerial positions at banks, concerning the obligation of risk management by the shareholder (mBank) in subsidiaries. In view of the above, the Supervisory Board's meetings held 3 times a year are sufficient to ensure security of the Bank.

§29: The Bank does not apply the Principle: 1. Remuneration of members of the supervisory body shall be established adequately to the function they hold and to the scale of operations of the supervised institution. Members of the supervisory body appointed to work on committees, including the audit committee, should be remunerated adequately to the additional tasks performed on the committee.

2. Remuneration of members of the supervisory body, unless payment of such remuneration is prohibited by the law, should be established by the decision-making body.

3. The rules for remunerating members of the supervisory body should be transparent and included in the relevant internal regulation of the supervised institution.

Remuneration for holding the position of a member of the Supervisory Board is awarded by the General Meeting to an independent member. The other Board Members do not receive remuneration.

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The Bank does not apply the Principles:

§ 53.

The supervised institution which manages assets at a client's risk should efficiently manage the assets so as to provide the required protection of the clients' interests.

§ 54.

1. The supervised institution should employ the available corporate supervision measures over entities – issuers of securities under management, in particular when the level of involvement in the securities is considerable or when it is required for protection of the clients' interests.

2. The supervised institution which manages assets at the client's risk should introduce transparent rules of cooperation with other financial institutions when executing corporate supervision over entities – issuers of securities under management.

3. The supervised institution which manages assets at the client's risk shall create and communicate to clients the policy of corporate supervision measure used, which includes the procedures of participation and voting at meetings of the decision-making bodies.

§ 55. In its operations, the supervised institution which manages assets at the client's risk should avoid situations which might cause a conflict of interests, and if a conflict of interests arises, the institution should be guided by the client's interest, and notify the client thereof.

§ 56. The supervised institution which manages assets at the client's risk should introduce transparent rules for cooperation with other supervised institutions with respect to transactions executed at the client's risk.

§ 57. The supervised institution, when acquiring assets at the client's risk, should act in the client's interest. The decision-making process should be duly documented.

Deviation from the above Principles is dictated by the fact that the Bank, as a specialized institution, does not engage in the activity of asset management at the client's risk.

The Bank does not use any restrictions concerning the exercise of the voting right afforded by the securities. As regards the transfer of ownership of the securities, the only restriction is that issuances of covered bonds in the primary market are not addressed to individual (retail) investors and in the case of issuances introduced abroad – not addressed to Polish residents.

Rules for appointment and dismissal of the management:

The Supervisory Board shall appoint and dismiss members of the Management Board of the Bank, including the President of the Management Board, taking into account the assessment of fulfilment of the requirements, referred to in Article 22aa of the Banking Law. The President of the Management Board and the Management Board Member supervising the management of material risk in the Bank's operations shall be appointed and the function of the member of the Management Board supervising the management of material risk in the Bank's operations shall be entrusted to the appointed member of the Management Board with the consent of the Polish Financial Supervision Authority. The application for such consent shall be submitted by the Supervisory Board. Promptly after appointing the Management Board and changing the composition thereof, the Supervisory Board shall notify the Polish Financial Supervision Authority of the composition of the Management Board and changes in the composition thereof, and shall provide the information resulting from the assessment referred to in (1) on fulfilment by the members of the Management Board of the requirements referred to in Article 22aa of the Banking Law. Additionally, the Supervisory Board shall notify the Polish Financial Supervision Authority of the approval of and changes in the internal division of competence in the Management Board of the Bank. The Management Board shall be composed of the President of the Management Board and other members of the Management Board. The internal division of competence in the Management Board of the Bank shall be established by the Management Board and approved by the Supervisory Board. The President and other members of the Management Board shall be appointed for a joint 3-year term of office. Mandates of the Management Board

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members shall expire on the day of the General Meeting that approves the financial statements for the last full financial year of the term of office of the Management Board members at the latest. Furthermore, the mandate of a Management Board member shall also expire in case of death, resignation or dismissal of the member from the Management Board, as of the date of the event which causes the expiry, unless the resolution on dismissal provides for a different expiry date. Members of the Bank's Management Board may be dismissed at any time before their term of office expires. The Management Board of the Bank shall manage the Bank's affairs and shall represent the Bank. The Management Board shall accept the annual financial plans and the business strategy, which shall be approved by the Supervisory Board. The Management Board shall determine therein the maximum size of an issue of covered bonds and other bonds issued during the year.

Audit Committee

The Bank complies with the regulations governing the appointment, composition and operation of the audit committee, including those which apply to fulfilment by the audit committee members of the independence criteria and the requirements of knowledge and skills in banking and in accounting and financial statements auditing.

In 2018 the Audit Committee of the Supervisory Board of mBank Hipoteczny S.A. operated in accordance with the Rules of the Audit Committee introduced upon Resolution of the Supervisory Board No 36/2017 of 28 December 2017. In 2018 the Audit Committee's members were appointed upon Resolution of the Supervisory Board No 26/2017 of 17 August 2017:

Paweł Graniewski - Chairman of the Audit Committee, independent member of the Supervisory Board

Andreas Boeger – Member of the Audit Committee

Mariusz Tokarski - Chairman of the Audit Committee, independent member of the Supervisory Board

All members of the Audit Committee satisfy the requirements of knowledge and skills in banking and in accounting and financial statements auditing.

The basic tasks of the Audit Committee result from the Act of 11 May 2017 on statutory auditors, audit firms and public supervision, the Bank's Articles of Association, the Regulations of the Supervisory Board, "Recommendations regarding the operation of the Audit Committee" adopted by the Polish Financial Supervision Authority.

In 2018 the Audit Committee performed the tasks of the audit committee provided for in the mandatory legal regulations by way of performing ongoing supervision, based on the information provided by the Management Board of mBank Hipoteczny, the certified auditor, the Internal Audit Department, the Compliance Department, the Accounting and Clearance Department and by way of meetings - three meetings of the Committee were held.

The Audit Committee with Resolution No. 6/2017 of December 14, 2017 adopted the "Policy regarding the selection of an audit firm and the audit company conducting the audit by entities related to this auditing company and by a member of the auditing company's network of permitted services that are not auditing the financial statements at mBank Hipoteczny SA together with the attachment " Procedure for selecting the Audit Company in mBank Hipoteczny SA". The policy meets the requirements of the Act on statutory auditors, auditing companies and public supervision as well as the Regulation of the European Parliament and the Council of the European Union of 16/04/2014 No. 537/2014.

mBank Hipoteczny's policy on the selection of an audit firm includes the principle of statutory auditor rotation. The duration of total uninterrupted statutory audit engagements referred to in Article 17 (1) paragraph 2 of Regulation (EU) No. 537/2014 carried out by the same audit firm or an audit firm related to this audit firm, or any member of the network operating within the European Union to which these audit firms belong, must not exceed five years. The key statutory auditor may carry out a statutory audit again in the bank after at least three years of the completion of the last statutory audit. In the case of a statutory audit, the first agreement on statutory audit is concluded with an audit firm for the period not shorter than two years with an option to extend it for another two-year period.

Pursuant to the policy on the performance of permitted non-audit services in mBank Hipoteczny S.A. by the audit firm carrying out the audit, by entities related to the audit firm and by a member of an audit firm network, a statutory auditor or an audit firm carrying out the audit, or any member of the network to

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which the statutory auditor or the audit firm belongs, must not directly or indirectly provide to the audited entity, to its parent undertaking or to its controlled undertakings within the Union:

- any prohibited non-audit services in the period between the beginning of the period audited and the issuing of the audit report;
- any services that consist in designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems.

Under Article 136 of the Act on Statutory Auditors, prohibited services do not include the following:

1. services that consist in:

- a. conducting due diligence procedures with regard to economic and financial condition,
 - b. issuing comfort letters in connection with prospectuses issued by the audited entity, in accordance with the national standard of related services and by means of agreed procedures,
2. assurance services with regard to pro forma financial information, forecasts of results or estimated results, published in the prospectus issued by the audited entity,
 3. examination of historical financial information of the prospectus,
 4. verification of consolidation packages,
 5. confirmation of fulfilment of conditions of the concluded loan contracts on the basis of the analysis of financial information coming from financial statements audited by a given audit firm,
 6. assurance services in reporting concerning corporate governance, risk management and corporate social responsibility,
 7. services consisting in the assessment of compliance of information revealed by financial institutions and investment companies with the requirements for disclosing information concerning capital adequacy and variable remuneration,
 8. certification concerning financial statements or other financial information for supervision bodies, the supervisory board or other supervisory authority of the company, or owners, exceeding the scope of the statutory audit, to help these authorities to perform their statutory duties.

The audit firm auditing the financial statements of mBank and mBank Group provided the permitted non-audit services to mBank Hipoteczny S.A. Therefore, the Audit Committee each time assessed the independence of the audit firm and granted its consent to the provision of the services.

Services of a statutory auditor other than annual financial statements auditing

Presented below is a list of services other than annual financial statements auditing provided by Ernst & Young Audyt Polska spółka z ograniczoną odpowiedzialnością sp. k. to mBank Hipoteczny S.A. in 2018.

1. Review of the summary semi-annual financial report of mBank Hipoteczny S.A. for the period of 6 months ended 30 June 2018.
2. Review of the consolidated package of mBank Hipoteczny S.A. for mBank S.A. for the period of 6 months ended 30 June 2018 and for the period of 9 months ended 30 September 2018.
3. Review of the consolidated package of mBank Hipoteczny S.A. for Commerzbank AG for the period of 6 months ended 30 June 2018.
4. Audit of the annual consolidated package of mBank Hipoteczny S.A. for mBank S.A. for the year ended 31 December 2018.
5. Audit of the annual consolidated package of mBank Hipoteczny S.A. for Commerzbank AG for the year ended 31 December 2018.

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6. Assessment of compliance of the information disclosed by mBank Hipoteczny S.A. with the requirements regarding disclosure of capital adequacy information and variable components of remuneration as of 31 December 2018.
7. Performance of the agreed procedures concerning the issuance of certification letters related to the prospectus of mBank Hipoteczny S.A. consisting in reconciliation of the financial data comprised in the annex to the Polish prospectus of mBank Hipoteczny S.A. and the data originating from the summary semi-annual financial statements of mBank Hipoteczny S.A. for the period of 6 months ended 30 June 2018.
8. Performance of the agreed procedures concerning the issuance of certification letters related to the prospectus of mBank Hipoteczny S.A. consisting in reconciliation of the financial data comprised in the annex to the Polish prospectus of mBank Hipoteczny S.A. and the data originating from the annual financial statements of mBank Hipoteczny S.A. for the year ended 31 December 2018.

Diversity policy

At the moment, the Bank is at the stage of developing the diversity policy applicable to the bodies administering, managing and supervising the issuer, particularly in terms of age, gender or education and professional experience. The policy is planned to be adopted in the first half of 2019.

True and fair picture in the presented reports

The Management Board of mBank S.A. declares that according to their best knowledge:

- the financial statements and the comparative figures were prepared in compliance with the binding accounting principles and present a true, fair and clear picture of the financial position and the condition of the assets of mBank Hipoteczny S.A. as well as its financial performance,
- The report of the Management Board on activities presents a true picture of the situation of mBank Hipoteczny S.A., including a description of the main risks and threats.

The process of preparation of the financial data for the purpose of reporting is automated and based on the Bank's accounting data. Preparation of the data in the source systems is subject to formalized operational and acceptance procedures. The set of accounting balances based on the main ledger system of the Bank is created in a process which includes the relevant internal controls. Manual adjustments are subject to special control.

The Bank continuously monitors changes in legislation and internal bylaws governing the preparation of financial reports and updates the internal bylaws on an ongoing basis, adjusting the IT systems if necessary.

Preparation of the financial statements of mBank Hipoteczny S.A. is the responsibility of the Financial Reporting Unit of the Accounting and Clearance Department. Keeping of the financial books and administration of the model chart of accounts is the responsibility of the Accounting and Clearance Department.

The Bank prepares annual and semi-annual financial statements which are submitted to the Management Board of mBank Hipoteczny S.A. for approval. At the same time the statements are submitted to the members of the Audit Committee of the Supervisory Board. Following consultations with an external auditor and members of the Management Board, the Audit Committee recommends adoption or rejection of the annual financial statements to the Supervisory Board.

The annual and semi-annual financial statements of mBank Hipoteczny S.A. are subject to an independent audit and review by a certified auditor. The certified auditor for the Bank is selected upon a resolution of the Supervisory Board of mBank Hipoteczny S.A. The recommendation concerning the certified auditor selection is issued by the Audit Committee of the Supervisory Board.

mBank Hipoteczny S.A. complies with the rules of rotation of the certified auditor. On 2 March 2018 the Supervisory Board of mBank Hipoteczny S.A. selected Ernst & Young Audyt Polska sp. z o.o. spółka komandytowa to be the auditor and to audit the financial statements of mBank Hipoteczny S.A. for the years 2018-2019. Previously, this company was authorized to audit the financial statements of mBank Hipoteczny S.A. in the period 2013-2015. In the period of 2016-2017, the Bank's financial statements were audited by PricewaterhouseCoopers sp. z o.o.

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Piotr Cyburt

President of the
Management Board

(signed electronically)

Andrzej Kulik

Member of the
Management Board

(signed electronically)

Marcin Wojtachnio

Member of the
Management Board

(signed electronically)