mBank Hipoteczny S.A.
Directors' Report
for the year 2013

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1. Operations of mBank Hipoteczny in 2013

In 2013, mBank Hipoteczny redefined its strategic objectives, vision, directions of further development, as well as its target position in the banking market. In the previous period, numerous actions and decisions were taken aimed at increasing the efficiency and dynamics of the Bank's development, by making the best use of its resources and market potential as well as defining its role and responsibilities in the mBank Group, in which the Bank intends to strengthen its position as a strategic entity and issuing bank. The Bank's objective is secure growth through the specialization which, given the nature of the Bank and the narrow scope of its activity, is the source of its competitive advantage and high market position.

The adoption of new strategy entails the extension of the Bank's operations by lending activities in the retail area, as well as significant development of its role and importance as an issuer of covered bonds — both within the mBank Group and in the domestic market of these securities. This will be associated with the creation of new business model, based on close cooperation with the parent universal bank, through the use of specialist expertise and market experience of the mortgage bank. Implementation of the strategic goals and the Bank's development within new areas requires numerous changes, adaptation of the organizational structure and the level of employment to the current business needs and challenges, including the allocation of resources and remodelling of ICT infrastructure.

In mid-2013, the Bank opened a new facility in Łódź, dedicated to a new business line — retail mortgage loans granted in cooperation with mBank. Another matter of material importance is the development of IT systems and infrastructure, necessary for the achievement of new business goals, which in many of its aspects requires increased coherence and compatibility with the mBank systems in order to ensure optimum cooperation in the implementation of joint business ventures.

In 2013, the Bank carried out its tasks in the conditions of increased competition on the commercial real estate financing market, dominated by strong universal banks.
Major trends observable in this market include:

- stricter criteria for project assessment and, as a consequence, a more selective choice of financed undertakings; similar approach of most banks to such key parameters of investment projects as borrower's share, extent of leased area, and pre-sale;
- limited exposure to single entities and projects and, as a consequence, greater tendency to share the risk by participating in bank consortia;
- the financing period shortened to 5–7 years with balloon payments applied.

As regards the financing of residential construction for commercial purposes,

- the withdrawal of several banks from this segment could be observed,
- stricter criteria for project selection;
- higher credit margins;
- greater credit risk.

Due to the planned commencement of lending activity in the retail area, works concerning the creation of mortgage loans for individuals were carried out, on the basis of the Bank's business objectives and the analysis of the market situation. The Bank intends to build its portfolio in this area on the basis of many years of mBank's market experience in this segment.

As the rate of economic growth in Poland is slowing down, one can observe the evidence of attenuation in the real estate market as well as growing geographic differentiation of that market. However, it is stable, which gives a good basis for further development of the Bank's lending activity.

Since 2010, when Poland started leaving the global economic crisis behind, the real estate market has been subject to systematic growth, expressed in a greater number of new projects, more new space available, and higher volume of transactions executed on this market. The residential real estate market is more predictable and more stable than at the time of the 2006–2008 boom, and the existing surplus in apartment supply will define the situation on this market in the next few years.

1.1 Key projects in 2013

"Covered Bonds" Project

The priority project for 2013 was the remodelling of the mBank Group's balance sheet on the basis of a long-term source of refinancing composed of covered bonds issued by mBank Hipoteczny. Works regarding the project began in 2012, and their aim was to create a comprehensive model of cooperation between the mortgage bank and the universal bank in terms of sales, service and management of the portfolio of retail loans secured by mortgage, and subsequently the issuance of covered bonds on this basis. The division of tasks between mBank and mBank Hipoteczny, in line with the competencies and specializations of the two banks, helps to effectively build and refinance the retail portfolio on the basis of shared lending policy and the operational synergy effect. In the course of the project implementation, the two banks cooperate on an inter-bank outsourcing basis, based on an agency model, which in 2014 may be supplemented with a pooling model, consisting in the take-over of the existing retail loan portfolio of mBank for the purpose of refinancing.

The implementation of the model is aimed at:

- improving the stability of financing of banks within the mBank Group through the application of long-term and innovative solutions regarding the mortgage portfolio in the mBank Group, anticipating liquidity needs resulting from external factors (new regulations — Basel III) and internal ones (including changes in the financing of subsidiary banks in the Commerzbank group),
- diversification of the financing sources — increasing independence from Commerzbank with regard to the financing of the existing portfolio of retail mortgage loans,
- improving long-term liquidity in the mBank Group — adaptation to the requirements of Basel III by increased long-term financing.

The project is a pioneering solution in the Polish banking sector, and its successful implementation will be the determinant of directions of the market's further development as well as searching for long-term sources of refinancing by banks.

Rebranding

A strategic change introduced in 2013 was the change of the Bank's name as part of the re-branding of the entire BRE Bank Group, which involved all the entities within the group. On 29 November 2013, the Bank began to operate under a new name — mBank Hipoteczny S.A., in accordance with the current entry in the register of entrepreneurs.

This decision follows from the development strategy of the mBank S.A. Group and from the introduction of a single brand across the group. The choice was dictated by the value of the mBank brand, its high recognisability and growth potential. It is one of the strongest Polish brands with a high market value. Thus, the Bank entered the fifteenth, jubilee year of its existence under a newly-changed name.

Implementation of the IRB approach

The Bank is working on the implementation of the integral ratings-based (IRB) approach, as a matter of high priority and long-term nature. Seven internal models in the commercial area were conditionally approved by the PFSA on 27 August 2012. In April 2013, the Bank submitted to the Polish Financial Supervision Authority a request for extension of its consent for application by mBank Hipoteczny S.A. of statistical methods for calculation of credit risk capital requirement in accordance with the adopted plan of gradual implementation. The request is currently undergoing supervisory analysis.

The works are also aimed at covering the planned retail portfolio with this method, on the basis of adaptation of models used in mBank. In December 2013, the Bank notified the PFSA on the extension of the gradual implementation of the IRB approach to include the class of retail exposures secured on residential properties.

Optimisation of sales processes

The implementation of ambitious sales objectives entails optimization of the lending process in order to increase its efficiency and, consequently, higher competitiveness of the Bank as a lender. To this end, steps have been taken to streamline the process by defining the system of decision-making competencies and clear division of responsibilities, adopting new standard of documentation, reducing time needed for credit decisions and project selection, as well as simplifying the internal procedures. These works resulted in a new lending process, characterized by shorter duration, increased flexibility, standardization of assessment, and the accuracy of selecting projects for financing.

IT projects

Implementation of Recommendation D

Implementation of Recommendation D is one of the key tasks and projects implemented by the Bank. It comprises 43 initiatives, of which 21 had been completed as at the end of 2013, which made it possible to implement 41 out of 110 specific recommendations. Other specific recommendations are implemented under initiatives whose completion is expected to take place in the last quarter of 2014.

Modification of the Bank's Business Continuity Plan

In view of the Gap Analysis under Recommendation D, internal audit recommendations and the expansion of business activity relating to the Covered Bonds project, it was necessary to modify and update the Bank's existing Business Continuity Plan with regard to re-analysing and identifying critical business processes, taking into account the identified critical processes and the Bank's new business needs. Another phase of the project will involve the development of the Bank's Viability Strategy and the whole project of modification of the Bank's Business Continuity Plan is expected to be finalised in mid-2014.

Implementation of a Service Model for IT management

In view of the implementation of Bank's new strategy, including the expansion of business activity, and also as a result of the audit recommendations and gaps identified in the Gap Analysis process for PFSA Recommendation D, several initiatives were introduced, involving the improvement, optimisation and adjusting of the IT operations to the Bank's new needs and business challenges. The new service model of IT management relies on developed and parameterised IT processes adapted to the Bank's business model and is aimed at implementing mechanisms facilitating efficient management of resource allocation in the IT area among key business projects supporting the Bank's strategy.

1.2 Financial credibility

The financial credibility of mBank Hipoteczny is assessed by an international rating agency — Fitch Ratings Ltd. At the end of 2013, the following ratings were applicable:

A/F1 — international long-term and short-term rating
1 — support rating
A — for public covered bonds
A — for mortgage covered bonds

Fitch Ratings Ltd. awards its ratings on the following scale (on a decreasing basis):

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

In addition, the Bank terminated its cooperation with Moody's Investors Service Ltd. rating agency upon a notification sent on 29 March 2013, and demanded the withdrawal of all ratings assigned to the Bank and its covered bonds. The decision to terminate the cooperation stemmed from the Management Board's refusal to accept the Joint-Default Analysis (JDA) assumptions used by the agency with regard to the Bank's financial strength based on the rating of major shareholders. The withdrawal of ratings for covered bonds took place on 21 May 2013, and the withdrawal of domestic and foreign currency ratings related to long- and short-term deposits and the Bank's financial strength occurred on 4 July 2013.

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

1.3 Financial results

The Bank's financial statements for 2013 are prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union. Data presented in the Management Board's report is presented according to the management approach and does not have to be consistent with data contained in the financial statements.

Table 1. Dynamics of selected elements of the statement of financial position

Key balance sheet items	31.12.2013	31.12.2012	Dynamics
ASSETS	4,782,443	4,809,712	-0.57%
including			
Loans and advances to customers*	4,045,000	4,108,155	-1.54%
EQUITY AND LIABILITIES	4,782,443	4,809,712	-0.57%
including			
Debt securities in issue	2,661,407	2,852,445	-6.70%
Amounts due to customers	295,167	179,033	64.87%
Share capital	275,000	275,000**	-

* The item "loans and advances to customers" includes other receivables from customers (instalment sales of assumed apartments) in the amount of: PLN 312 thousand as at the end of 2012, PLN 8 thousand as at the end of December 2013.

** As at 31 December 2012, the share capital included the amount of PLN 100,000 thousand constituting an unregistered share capital.

Due to the Bank's specialist nature, its assets comprise mainly loans and advances secured with mortgages, and its liabilities comprise mainly liabilities in respect of covered bonds issuance, which is the main source for the refinancing of lending activity.

Table 2. Dynamics of selected elements of the income statement

Income statement	31.12.2013	31.12.2012	Dynamics
Net interest income	74,779	77,158	-3.08%
Net fee and commission income	3,693	3,785	-2.42%
Net impairment write-downs on loans and advances	-34,866	-26,260	32.77%
Overhead costs	-39,189	-36,867	6.30%
Amortisation and depreciation	-4,162	-3,748	11.05%
Profit before income tax	4,897	14,099	-65.27%
Net profit	2,154	9,287	-76.80%
Weighted average number of ordinary shares/diluted weighted average number of ordinary shares (in '000)	2,750	1,857	48.09%
Earnings per ordinary share/Diluted earnings per ordinary share (in PLN)	0.78	5	-84.33%

Table 3. Business effectiveness ratios

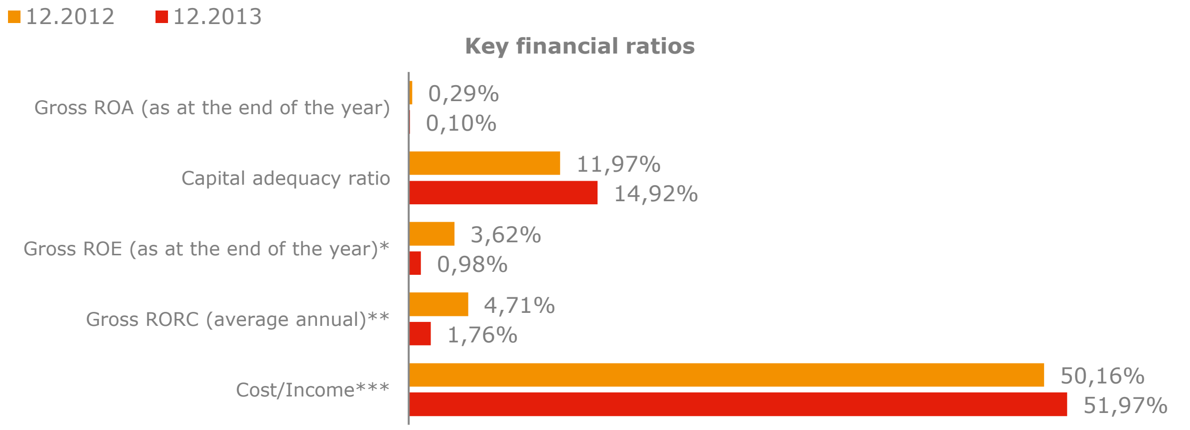
BUSINESS EFFECTIVENESS RATIOS	2013	2012
Gross ROE (as at the end of the year)	0.98%	3.62%
Gross ROA (as at the end of the year)	0.10%	0.29%
Cost/income*	51.97%	50.16%
Capital adequacy ratio	14.92%	11.97%**
RATINGS of Fitch Ratings Ltd		
international long-term rating	A	A
international short-term rating	F1	F1
support rating	1	1
public covered bonds	A	A
mortgage covered bonds	A	A
OTHER		
Average employment	144	128 persons
Branches	Head Office + 6 branch offices	Head Office + 5 branch offices

* (overheads + amortisation and depreciation) / the result on banking operations (defined as the operating result less the general administrative costs, amortization and depreciation, and the value of net impairment write-downs on loans and advances)

** when calculating the capital adequacy ratio at the end of 2012, the Bank did not include the amount of share capital unregistered as at 31 December 2012 (PLN 100,000,000) in its own funds. The additional capital was registered on 8 January 2013. If the increased amount of capital were to be included in the Bank's own funds, the capital adequacy ratio would have reached the value of 14.82%.

As at the end of 2013, the Bank generated a positive gross financial result of PLN 4.9 million and a balance sheet total of PLN 4,782.4 million. The Bank generated a significantly lower profit than in the previous year mainly due to write-downs for the impairment of loans and advances, totalling PLN 34.9 million. A lower net interest income (due to a lower value of the loan portfolio and reductions in interest rates) and higher operating costs associated with the reorganization of the Bank (commencement of loan operations in the retail area) also contributed to a lower profit before tax.

Chart 1. Key financial ratios



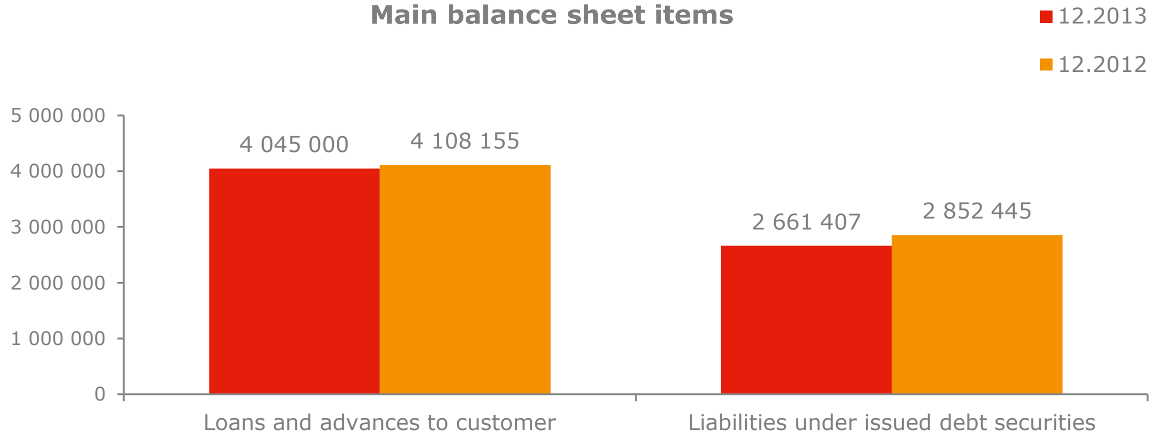
* gross result / (share capital + financial result from the previous years)

** gross result / average regulatory capital

*** (overheads + amortisation and depreciation) / the result on banking operations (defined as the operating result less the general administrative costs, amortization and depreciation, and the value of net impairment write-downs on loans and advances)

In January 2013, an additional share capital in the amount of PLN 100,000 thousand was registered and included in the Bank's own funds. The higher capital value is the main reason for the capital adequacy ratio increase in comparison to the previous year. Differences between other comparable ratios are mainly due to lower gross result of the Bank at the end of 2013.

Chart 2. Main financial items (in PLN '000)



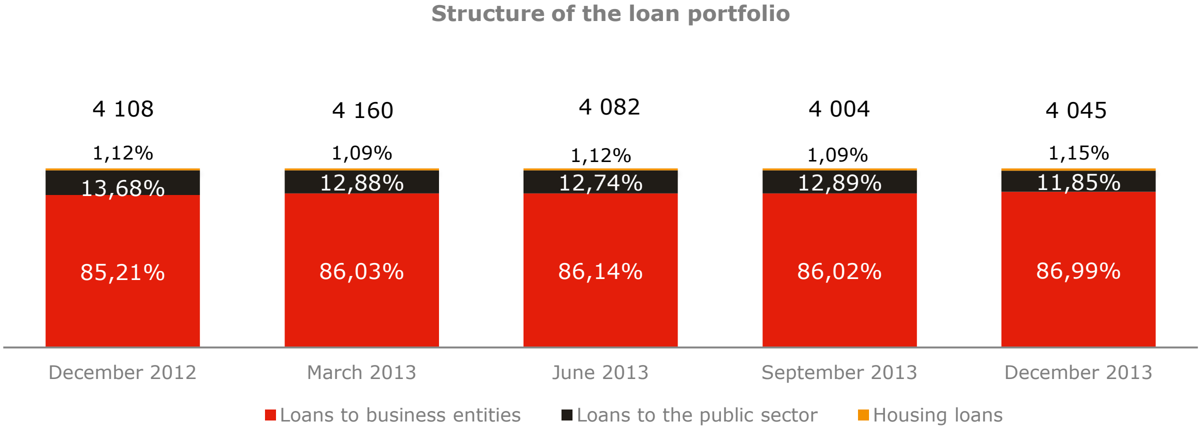
* the value of loans and advances to customers includes other receivables from customers (instalment sales of assumed apartments) in the amount of: PLN 312 thousand as at the end of 2012, PLN 8 thousand as at the end of 2013.

In 2013, there was an increase in lending activity, primarily in terms of loans granted to business entities. The value of newly granted loans exceeded PLN 1 billion and was 20% higher than the sales in the previous year. The volume of the loan portfolio in 2013, taking into account off-balance sheet exposure, increased by 2.4%, reaching the level of PLN 5.02 billion. Nevertheless, a considerable volume of early repayments and higher impairment write-downs on loans (33% y/y) meant that the net value of the loan portfolio as at the end of 2013 amounted to PLN 4.05 billion and was close to the value as at the end of 2012.

1.4 Lending activity

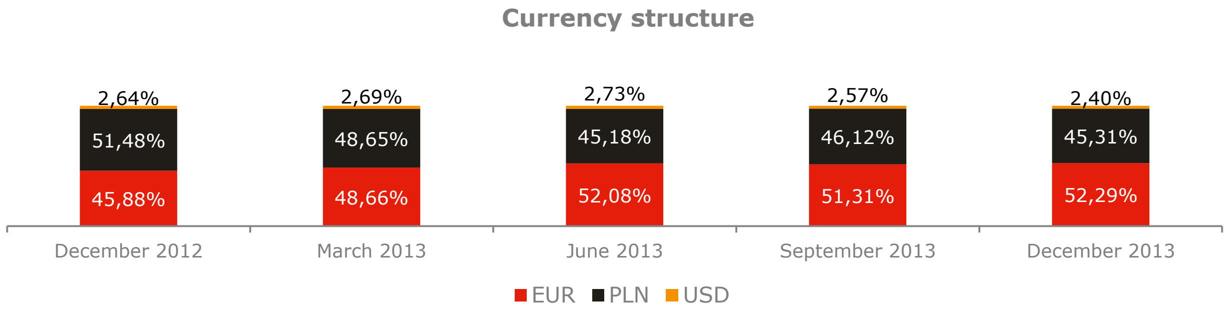
In nearly 15 years of its operations in the market, the Bank has secured a strong position in the commercial real estate financing sector that guarantees its presence among the top lenders in this market. In September 2013, mBank Hipoteczny, as part of the reconstruction of the mBank Group's balance sheet, expanded its range of products by retail loans.

Chart 3. Structure of the loan portfolio in the period 31.12.2012–31.12.2013 (in PLN million).



On the basis of revised credit policy, optimised lending process and streamlined internal procedures, and taking into account the conditions and risks of the market environment, the Bank developed its activity mainly in the area of loans to business entities, with a view to increasing the volume of that portfolio. As a result of this approach, the currency structure of the loan portfolio slightly changed over 2013. The share of loans in EUR increased, which is characteristic of commercial investment, whereas lending to the public sector, where loans are granted in PLN, decreased.

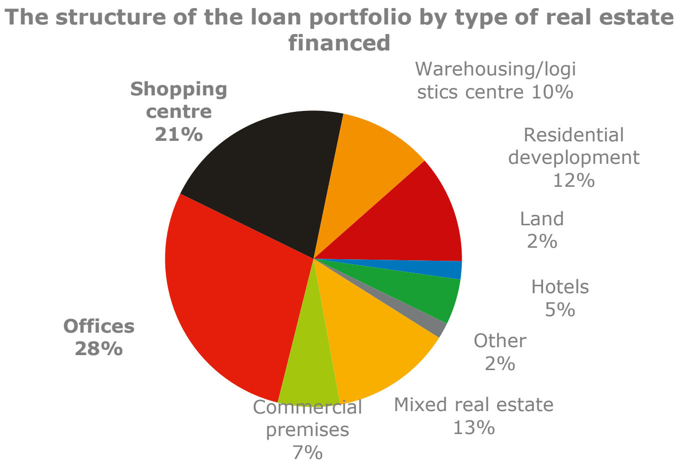
Chart 4. Currency structure of the loan portfolio in the period 31.12.2012–31.12.2013.



Loans to business entities

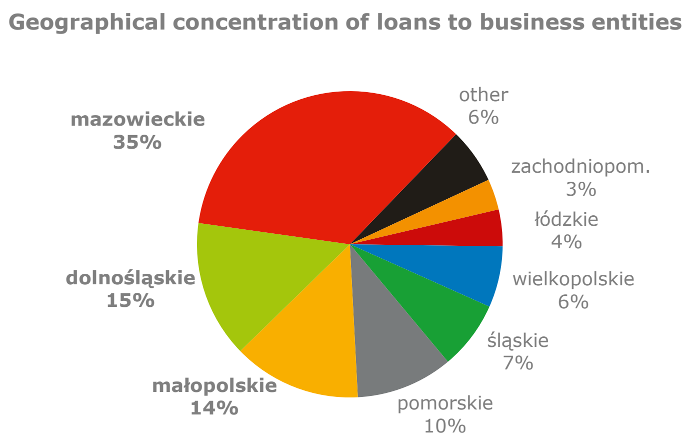
At the end of the year, net balance sheet exposure towards business entities amounted to PLN 3,519 thousand, including a total of PLN 1,071 million of loan agreements concluded with businesses in 2013. The largest share in last year's sales was that of loans for new construction projects (50.16%), followed by the refinancing of completed buildings (33.66%). Loans to housing developers, with a share of 16.19%, accounted for the smallest portion of the newly signed loan agreements.

Chart 5. Loans to business entities by type of real estate financed.



In 2013, within the area of commercial real estate, the Bank particularly financed office buildings and shopping centres. The Bank focused on the financing of purchases or refinancing of completed facilities with the relevant standard, as well as the financing of the construction process after which the construction loan is converted into a long-term mortgage loan. In the field of loans for housing developers, the Bank's purpose was to finance medium size projects (up to 100 apartments) located in attractive areas.

Chart 6. Geographical concentration of loans to business entities.



The largest number of financed projects is concentrated within the Mazowieckie province, where the exposure amounts to 35.05% of all credit funds. In the provinces of Dolnośląskie, Małopolskie and Pomorskie, total balance sheet exposure amounts to 38.28%.

As at the end of 2013, the portfolio of loans to business entities is dominated by loans in EUR (59.48%) and PLN (37.90%).

Loans to the public sector

As in 2012, the Bank limited its sales activity in the financing of local government units. The lack of new agreements in 2013, coinciding with a substantial volume of early repayments, is reflected in a lower (as compared to the previous year) balance sheet exposure for such loans (-14.55% y/y).

Retail loans to individual customers

The so-called old portfolio of mortgage loans to individuals includes loans granted by the Bank in 2000–2004 and its carrying amount (net) as at the end of 2013 amounted to PLN 40,573 thousand, representing 1% of the total loan portfolio.

In September 2013, the Bank resumed lending in the retail area, selling loans under an agency agreement through the network of mBank S.A. branches. Loans are recognised in the books of mBank Hipoteczny S.A.
The Bank focused on acquiring a specific group of customers, whose loan applications — in line with the requirements of the act — were eligible for consideration by a mortgage bank and met the requirements for backing covered bond issues. Recommendation S, implemented in late 2013, was a major impediment, as it limited the maximum LTV and tenor, thus increasing market demand for loans with a high LTV, which — according to the requirements of the Act — could not be offered by mBank Hipoteczny.

As at the end of 2013, sales reached the level of PLN 6,351 thousand. The Bank developed its sales activity by providing loans mainly for the purchase of apartments on the secondary market (82.1% of the portfolio value).

All agreements concerned loans granted in PLN. The portfolio is dominated by loans with a tenor of 20–30 years, accounting for 70.7% of the portfolio. The largest share of financed project is concentrated in the provinces of Mazowieckie, Łódzkie and Małopolskie.

1.5 Refinancing and issues of covered bonds

In 2013, mBank Hipoteczny successfully placed on the market 1 issue of mortgage covered bonds in PLN with a total value of PLN 80 million, and in the second half of the year — two issues in EUR totalling EUR 80 million. The value of all covered bonds issued by the Bank and outstanding as at the end of 2013 was over PLN 2.3 billion, representing ca. 71% of the market of such bonds according to the Bank's estimates.

Covered bonds of mBank Hipoteczny are classified as instruments marked by a low level of investment risk due to legal requirement of multi-stage collateral for their issue and trading. This is confirmed by the Fitch rating agency, which assigned A level ratings to mortgage and public covered bonds issued by the Bank.

Issues of mortgage covered bonds of mBank Hipoteczny S.A. in public offerings

Organizers of the offering: Offerer: Dom Maklerski mBanku S.A., Biuro Maklerskie mBanku S.A.; Leading manager: mBank S.A.

Date of issue	Date of redemption	Currency	Value	Fitch Rating
28.04.2010	28.04.2014	PLN	25,000,000	A
28.07.2010	28.07.2014	PLN	200,000,000	A
28.09.2010	28.09.2015	PLN	100,000,000	A
29.11.2010	28.11.2014	PLN	100,000,000	A
28.04.2011	20.04.2016	PLN	200,000,000	A
16.05.2011	15.05.2015	PLN	100,000,000	A
15.06.2011	16.06.2017	PLN	200,000,000	A
07.07.2011	07.07.2015	PLN	100,000,000	A
20.04.2012	20.04.2017	PLN	200,000,000	A
15.06.2012	15.06.2018	PLN	200,000,000	A
30.11.2012	15.11.2016	PLN	100,000,000	A
20.06.2013	21.06.2019	PLN	80,000,000	A
TOTAL		**PLN**	**1,605,000,000**	

Date of issue	Date of redemption	Currency	Value	Fitch Rating
19.10.2012	19.10.2017	EUR	10,000,000	A
26.07.2013	28.07.2020	EUR	30,000,000	A
22.11.2013	22.10.2018	EUR	50,000,000	A
TOTAL		**EUR**	**90,000,000**	

Issues of public covered bonds of mBank Hipoteczny S.A. in public offerings

Organizers of the offering: Offerer: Dom Maklerski mBanku S.A., Biuro Maklerskie mBanku S.A.; Leading manager: mBank S.A.

Date of issue	Date of redemption	Currency	Value	Fitch Rating
29.11.2010	30.11.2015	PLN	100,000,000	A
27.07.2012	28.07.2015	PLN	100,000,000	A
28.09.2012	28.09.2016	PLN	150,000,000	A
TOTAL		**PLN**	**350,000,000**	

Basis for issuing covered bonds

According to the Act on covered bonds and mortgage banks, the basis for the issue of mortgage covered bonds are receivables entered in the register of covered bond collaterals, secured with mortgages established on the right of perpetual usufruct or the ownership of real estate, entered in the first place into the land and mortgage register.

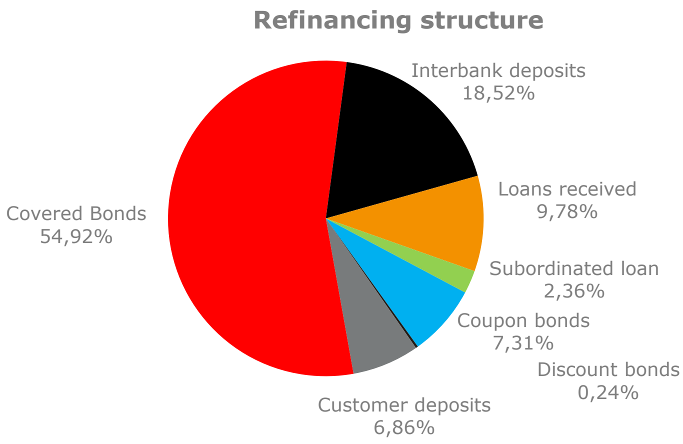
Public covered bonds are backed with receivables in respect of loans granted to local government units and loans secured with guarantees or warranties of local government units.

At the end of 2013, the collaterals of:

- public covered bonds comprised receivables of PLN 480,604 thousand relating to 79 loans in total
- mortgage covered bonds comprised receivables of PLN 2,404,717 thousand relating to 535 loans in total.

The Bank raises funds for lending activities mostly by the issuance of covered bonds followed by term deposits — mainly from the interbank market — and coupon bond issues.

Chart 7. The structure of refinancing of the Bank's operations as at 31.12.2013



2. Risk management

2.1 Credit risk

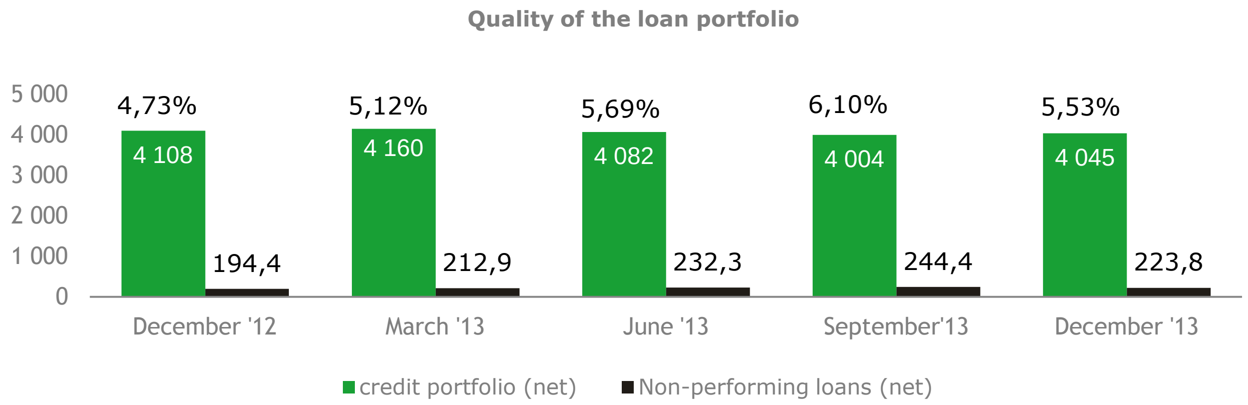
Loan portfolio

The Bank engages in credit activities in accordance with the lending policy and the principles for credit decision-making, and the basic principle is the ongoing monitoring of credit assets and credit exposures, in accordance with the relevant regulations of the International Financial Reporting Standards (IFRS), as approved by the EU.

Due to continuing unfavourable market conditions, the share of non-performing loans in the loan portfolio (mainly commercial loans classified for a case-by-case analysis according to IAS 39) increased to the level of 5.53%. Most liabilities are repaid in a timely manner, but borrowers with a higher risk profile have been subjected to intensified monitoring.

Impairment write-downs in the amount of PLN 75,587.92 thousand (including PLN 7,205.47 thousand of portfolio write-downs and PLN 68,382.45 thousand of individual write-downs) as well as collateral in the form of mortgages on financed properties comprise the relevant collateral against potential losses resulting from credit risk.

Chart 8. The share of non-performing loans* in the Bank's loan portfolio (in PLN million)



* Non-performing loans — loans for which stringent or lenient premises of impairment arise — in accordance with IAS 39

The Bank has been observing a sustained increased level of credit risk for portfolios of loans granted to purchase land for housing developments and to finance developers' housing projects, in particular in tourist towns and cities. In 2013, on the basis of the previous experience in the financing of residential projects, the Bank continued to finance projects in the field of housing development. In this area, the Bank focused on the selective financing of projects with the most favourable market parameters (the offer's adjustment to the market needs, positive history of the developer's activity, adequate level of own shares, as well as verified pre-sales).

Credit risk management

The Bank's strategy is to maintain the level of credit risk in line with the level of risk appetite defined by the target level of capital adequacy and exposure limits. At the same time, the objective of credit risk management is to ensure that individual exposure limits are of the quality defined by the Act on Mortgage Bonds and Mortgage Banks in order to ensure the maximum use of such limits as a basis for MBS issue.

One of the key objectives is to achieve the maximum diversification of credit risk and to avoid risk concentration, in particular related to the size of individual projects and participation in similar projects on the same local markets.

In the corporate area, the Bank plans to work mainly with reliable customers, who have considerable experience in the real estate segment (without any delay in the performance of their obligations towards the Bank, borrowers who continue to work with the Bank in the next stages of project implementation, companies with a strong market position).

The priority is to increase a share in the crediting action of the loans for the purchase or refinance of the existing or new commercial real estate or completely renovated real estate, which are comprehensively utilised and remain economically competitive over a longer period of time.

In the retail loans area, the Bank's objective is to acquire affluent clients of the previously indicated target group who have a verified record of transactions within the banking system. The Bank seeks to maximise the share of loans secured on typical residential real estate located in highly liquid markets.

The Bank seeks to maintain a low portfolio loss ratio through the use of a conservative approach to the assessment of customer creditworthiness. In this area, the Bank intends to operate in accordance with the best market practices and draw on the experience of its parent company, providing the basis for credit policy and decision-making process according to the principles successfully applied by mBank S.A.

The Bank seeks to eliminate the foreign exchange risk — in the case of new transactions, the Bank aims to give loans only in the currency of the customer's income.

Enforcement titles issued by the Bank

In 2013, the Bank issued 4 banking enforcement titles (BTE), including 3 titles concerning commercial loans and 1 title concerning a housing loan. The total amount of debt covered by the BTEs was: PLN 3,266.86 thousand and EUR 4,716.02 thousand. The total value of the collateral (the current market value of properties) is: EUR 1,561.0 thousand and PLN 21,749.0 thousand. Liquid collateral does not occur.

2.2 Market Risk

The risk of incurring a loss due to unfavourable changes in the market parameters from the perspective of the ageing structure of the Bank's portfolio is maintained at the lowest possible level, owing to the nature of the Bank's operations and its efficient system of risk mitigation and management on the operating level.

In order to mitigate market risk, the Bank adjusts the currency structure and the structure of revaluation of its sources of financing to the structure of loan liabilities held, uses linear derivatives, and concludes spot or forward currency purchase/sale transactions and FX SWAP transactions. The amount of market risk to which the Bank is exposed daily, is determined using the Value at Risk (VaR) method at the 99% confidence level. As at the end of December 2013, VaR amounted to PLN 115.4 thousand. The currency risk amounted to PLN 19.6 thousand, and the interest rate risk amounted to PLN 95.8 thousand.

The interest rate risk is a risk arising from exposure of the financial result and capital of the Bank to the unfavourable effect of changes in the interest rates. The Bank manages the interest rate gap by matching the revaluation dates of assets and liabilities. Sensitivity of the Bank's portfolio to extreme interest rate fluctuations is determined on the basis of results of stress tests and scenario analyses. The interest rate risk is measured, among other things, by the Earnings at Risk (EaR) ratio, which at the end of December 2013 reached a safe level of 5.61%. The Bank's portfolio components which are exposed to interest rate risk are hedged with linear interest rate derivatives.

The currency risk is mitigated by the ongoing closure of the foreign exchange position. The currency risk scale and structure are measured on the basis of the Bank's current foreign exchange position. The foreign exchange position which accounts for the expected repayments and disbursements of loans is also subject to the monitoring process. The currency risk is controlled using the foreign exchange position limits for each of the currencies together with the stop loss limit (limit of the acceptable maximum loss) for open intra-day positions as at the end of a given business day, separately for each currency.

2.3 Liquidity risk

Liquidity risk management is carried out at the level of ongoing, short-term, medium-term and long-term liquidity, the absence of which indicates the Bank's inability to finance its assets and settle its liabilities in a timely manner as part of the Bank's ordinary business activities.

Due to the fact that the maturities of long-term securities and assets are not matched, the Bank secures its liquidity by maintaining contingency reserves of liquid assets.

As at the end of 2013, liquidity reserves represented ca. 12.90% of the balance sheet total. The Bank is not exposed to the risk of short-term refinancing to maturity or to the risk of withdrawal of deposits by the largest deposit holders due to a small share of deposits from the non-financial sector in the balance sheet total (5.98%).

In 2013, the financing of the bank's lending activities was performed through obtaining short-term deposits in EUR and USD from the main shareholder, as well as issues of short- and medium-term unhedged bonds in PLN and covered bonds in PLN and EUR. The Bank's long-term liquidity is stable. Short-term deposits obtained from mBank S.A. under the available Money Market credit line constitute a significant share in the financing of long-term credit receivables.

With the need to preserve liquidity ratios at the appropriate level, the need to offset the maladjustment of the structure of assets to liabilities financing them, and the need to increase the stability of financing sources, mBank Hipoteczny will seek to replace short-term financing with financing in the form of new credit lines with maturities from 2 to 5 years, as well as to lengthen the maturities of covered bonds.

The share of stable sources of financing and liquidity reserves adequate to the scale of the Bank's operations enables the Bank to meet the M4 long-term liquidity standard set by the Polish Financial Supervision Authority. M4 ratio as at the end of 2013 amounted to 1,079. M1 and M2 liquidity standards were maintained at a safe level of PLN 427,979 thousand and 1.712 respectively. The M3 standard amounted to 29.347.

Over 2013, the limit of liabilities arising from Article 15.2 of the "Act on covered bonds and mortgage banks" was utilised in 60.5% (on average). In the analysed period, this limit was not exceeded.

As at the end of December 2013, the average maturity of covered bonds issued amounted to 3.08 years for mortgage covered bonds and to 2.17 years for public covered bonds, whereas the average maturity of long-term deposits in other banks amounted to 0.96 years. The margin on mortgage covered bonds issued in 2013 was 1.25%, with an average maturity of 5.7 years. No public covered bonds were issued in 2013.

2.4 Operational Risk

The process of operational risk mitigation within mBank Hipoteczny is realized through the application of controls, risk transfers, contingency plans, business continuity plans and outsourcing.

Operational risk measurement is performed by using both the qualitative and quantitative methods, which complement each other in assessing the risk profile of the Bank. The risk is monitored through the implemented mechanisms and internal control procedures, based on the Key Risk Indicators (KRIs) and the statistics of operating loss events.

At present, the Bank's exposure to operational risk is low due to:

- operational risk management system implemented in the Bank,
- a small team and flat organisational structure,
- the small scale and complexity of operations, resulting from the specific nature of mortgage banks,
- an integrated IT system in operation since the commencement of the Bank's activity,
- highly qualified staff,
- effective system of internal control.

The Bank is in the process of implementing a process for the refinancing of retail loans with covered bonds. With the extension of the Bank's scope of operations to include the sale of retail loans, the Bank's operational risk profile may change due to:

- the risk of an increase in the number of complaints and claims by individuals against the Bank,
- the risk of credit frauds — individuals obtaining loans under false pretences,
- the risks associated with the outsourcing of a significant part of the processes related to the handling of retail loans.
- the Bank will monitor, analyse and report any changes affecting the operational risk profile.

2.5 Risk of investing in covered bonds

In 2013, the risk profile of investments in covered bonds issued by mBank Hipoteczny did not change. These securities constitute financial instruments with a low investment risk, resulting from the required multi-level collateralization of their issue and trading by the issuer in accordance with the Act on covered bonds and mortgage banks. The fact that for many years the Bank has followed a conservative policy of real estate valuation on which the bonds are secured also contributes to high security of this investment. Besides ensuring that the Bank meets a number of statutory requirements, taking into account the security of investments in covered bonds under the conditions of slower economic growth. The minimum level of excess security with regard to mortgage covered bonds amounts to 10%, and to 6% with regard to public covered bonds.

The increased attractiveness of investments in such securities is also attributed to the fact that covered bonds issued by mortgage banks may constitute collateral for lombard facilities and repo transactions entered into with other banks.

3. Development directions and key elements of the Bank's strategy

In June 2013, the Management Board of the Bank adopted a strategy for the period 2014–2017, setting new directions of activity and development of the Bank, and strengthening, on their basis, its market position in the challenging competitive environment. It sets out the strategic objectives of the Bank, including in particular:

- increase in the balance sheet total through dynamic growth of credit assets based on the planned increase of the crediting action in the commercial area and the creation of a new retail mortgage loan portfolio,
- development of cooperation with the parent universal bank in the area of establishing and refinancing the retail mortgage loan portfolio through the issuance of covered bonds. It is the first project of this kind in the Polish banking sector. This solution envisages the provision by the Bank of services related to the bond issuer's function within the mBank Group.

In the third quarter of 2013, the Bank began to implement a strategic project based on the model of cooperation with mBank in the area of establishing and refinancing the retail mortgage loan portfolio through the issuance of covered bonds. In September last year, the Bank began to offer mortgage loans to individuals through mBank’s sales network. This applies to loans that meet the criteria of entry in the register of covered bond collateral and potentially form a basis for their issuance.

Implementation of the project comprises 2 stages:

- Stage 1 — launch of lending activity in the retail area, based on operational cooperation and sales structures of mBank, as well as consistent credit policy. The retail mortgage loan portfolio of mBank Hipoteczny is be established solely on the basis on loans that meet the criteria of entry in the register of covered bonds and may form the basis for their issue.
- Stage 2 — issuance of covered bonds on the basis of the retail mortgage loan portfolio.

As part of the project, in 2013, the Bank implemented the agency model, while the plans for 2014 provides for the implementation of a pooling model, involving the acquisition of the existing retail mortgage portfolio from mBank to refinance it by issuing mortgage covered bonds.
In addition, the objectives of the Bank include:

- a significant increase in the commercial loans portfolio subject to new credit policy, consistent credit risk management policy, and optimised credit process, taking into account the market conditions,
- changing the structure of refinancing through a significant increase in the share of covered bonds as a long-term secured debt,
- maintaining the credit risk at a possibly safe level, through diversification of the portfolio in terms of exposure and regionalisation. Risk management policy assumes increasing the share of smaller credit amounts in the Bank’s commercial credit portfolio,
- significant development of the issuance activity and establishment of a new model of selling covered bonds, based on patterns functioning in developed European markets. This initiative is aimed at increasing the number of new institutional customers and acquiring new segments of the market.

The refinancing or crediting of the purchase of completed, commercialized facilities, particularly office buildings, retail space and warehouse space will continue to be the Bank’s main sales objective. The Bank intends to be an active creditor operating in the segment of prestigious medium-scale commercial projects financed with loans of up to EUR 25 million.
The purpose of the Bank is to maintain the leading position on the market of mortgage banking for business entities and strengthening the role of the leader in the area of covered bonds, by increasing the scale of their issues.

4. The Bank’s authorities

Shareholders

Shareholding structure of mBank Hipoteczny

Shareholder’s name	Share capital (PLN ‘000)	Shares		Voting rights at the General Shareholders' Meeting	
		Number (‘000)	%	Number of shares (‘000)	%
MLV.45 Sp. z o.o. Sp. komandytowa*	208,200	2,082	75.71	2,082	75.71
mBank S.A.**	66,800	668	24.29	668	24.29
Total	**275,000**	**2,750**	**100**	**2,750**	**100**

* BRE Holding Sp. z o.o. was transformed into MLV 45 Sp. z o.o. spółka komandytowa. The transformation was registered in the National Court Register on 29 August 2013.

The Bank did not conclude any contracts which could result in a change of the proportion of shares held by existing shareholders and bondholders.

The Bank does not cooperate with international public institutions.

Management Board

In 2013, the composition of the Management Board changed. On the date of the General Meeting of Shareholders, i.e. on 29 April 2013, Mr Sven Torsten-Kain's term of office as a member of the Management Board expired. He served as advisor to the Management Board from 1 May to 4 July 2013.

For another term of office, the Supervisory Board, by way of Resolution No 12/2013 of 29 April 2013, appointed the following composition of the Management Board of mBank Hipoteczny:

- Piotr Cyburt — President of the Management Board
- Marcin Romanowski — Member of the Management Board
- Marcin Wojtachnio — Member of the Management Board

Information on the remuneration of the members of the Management Board and changes in its composition over the last financial year are disclosed in Note 40 to the Financial Statements.

Supervisory Board

In 2013, the composition of the Supervisory Board changed. As at 31 December 2013, its Members included:

- Cezary Kocik — Chairman of the Supervisory Board
- Hans-Dieter Kemler — Deputy Chairman of the Supervisory Board
- Piotr Baranek — Member of the Supervisory Board
- Jolanta Daniewska — Member of the Supervisory Board
- Joerg Hessenmueller — Member of the Supervisory Board
- Lidia Jabłonowska-Luba — Member of the Supervisory Board
- Michał Popiołek — Member of the Supervisory Board
- Dariusz Solski — Member of the Supervisory Board

Information on the remuneration of the members of the Supervisory Board and changes in its composition over the last financial year are disclosed in Note 40 to the Financial Statements.

In accordance with paragraph 14, item 5 of the Memorandum of Association of mBank Hipoteczny S.A., the General Shareholders' Meeting decides, by way of a resolution, on appointing and dismissing Members of the Supervisory Board and establishing the terms of their remuneration.

In accordance with paragraph 3, item 9 of the Rules and Regulations of the Supervisory Board of mBank Hipoteczny S.A., the Supervisory Board is responsible for determining the terms of contracts and remuneration for Members of the Bank's Management Board.

The Supervisory Board has two Committees: the Audit Committee and the Risk Committee.

As at 31 December 2013, the composition of the Audit Committee was as follows:

- Joerg Hessenmueller — Chairman of the Committee
- Jolanta Daniewska — Member of the Committee
- Dariusz Solski — Member of the Committee

In December 2013, there was a change in the composition of the Audit Committee. By way of Supervisory Board Resolution No 35 of 12 December 2013, Mr Dariusz Solski was appointed to the Committee, replacing Mr Łukasz Witkowski.

Duties of the Audit Committee include:

- monitoring the financial reporting process,

- monitoring the performance of internal control, internal audit and risk management systems,
- monitoring the performance of financial auditing activities,
- monitoring the independence of the statutory auditor and the entity authorised to audit financial statements,

In 2013, three meetings of the Audit Committee took place: on 17 April, 17 October and 9 December.

As at 31 December 2013, the composition of the Risk Committee was as follows:

- Lidia Jabłonowska-Luba — Chairwoman of the Committee
- Michał Popiołek — Member of the Committee
- Piotr Baranek — Member of the Committee
- Joerg Hessenmueller — Member of the Committee
- Hans-Dieter Kemler — Member of the Committee

The present composition of the Committee was appointed by way of Supervisory Board Resolution No 36 of 12 December 2013.

Duties of the Risk Committee include:

- recommending to the Supervisory Board whether to approve or reject the Bank's operating strategy and the principles of cautious and sound management,
- supervision over risk management at the Bank,
- supporting the Supervisory Board in the exercise of supervision over the compliance of the Bank's policy with regard to risk assumption with the Bank's strategy and financial plan,
- recommending to the Supervisory Board whether to approve or reject the Bank's internal procedures for the processes of internal capital estimation, capital management and capital planning,
- recommending to the Supervisory Board whether to approve or reject transactions between the Bank and the members of the Bank's authorities,
- supervision over cooperation of the Bank with the Commerzbank AG group with respect to consolidated supervision over risk and information exchange.

In 2013, two meetings of the Risk Committee took place: on 23 May and 9 September.

5. Other information

Related party transactions

All transactions between the Bank and related entities were concluded on arm's length terms, and their nature and terms resulted from the current operating activities conducted by the Bank. Transactions with related entities concluded in the normal course of operating activities include loans, deposits and foreign currency transactions. Information on transactions between the Bank and its related entities is provided in Note 40 to the Financial Statements.

Loans, deposits and interest rates

Amounts due to other banks as at the of 2013 amounted to PLN 1,203,488 thousand. Cash in current accounts and term deposits from corporate customers and other liabilities totalled PLN 295,167 thousand.

Amounts due to other banks (PLN '000)

	31.12.2013	31.12.2012
Term deposits	787,862	1,049,799
Loans received	415,626	122,668
Total amounts due to other banks	1,203,488	1,172,467

Amounts due to customers in (PLN '000)

	31.12.2013	31.12.2012
Corporate customers:	294,978	178,854
Cash in current accounts	226,551	123,265
Term deposits	64,663	54,354
Other liabilities (in respect of):	3,794	1,235
- cash collateral	2,169	475
- other	1,625	760
Individual customers:	174	150
Other liabilities (in respect of):	174	150
- cash collateral	65	65
- other	109	85
Public sector customers:	15	29
Other liabilities (in respect of):	15	29
- other	15	29
Total amounts due to customers	295,167	179,033

All loans received are based on floating interest rates.

In 2013, the average amount-weighted interest rates on term deposits were as follows: EUR — 0.37%, PLN — 2.73, USD — 0.49%, In 2012: EUR — 0.89%, PLN — 4.52%, USD — 0.50%.

mBank Hipoteczny S.A. did not provide any collateral to its lenders. The Bank did not register any violations of contractual terms related to liabilities in respect of loans raised.

Post balance-sheet events

On 16 January 2014, mBank Hipoteczny S.A. performed the issue of five-year bonds with a nominal value of PLN 20,000 thousand. On 28 January 2014, the Bank performed the issue of five-year bonds with a nominal value of PLN 60,000 thousand.
On 17 February 2014, the Bank issued four-year mortgage covered bonds with a nominal value of EUR 7,500 thousand.
On 28 February 2014, the Bank issued fifteen-year mortgage covered bonds with a nominal value of EUR 8,000 thousand.

The Bank act as the assignee under an agreement for the transfer of receivables in respect of an insurance policy. The assignment was made to secure a loan granted by the Bank to a borrower. The borrower had suffered a loss due to a property fire. The insurer paid compensation which did not cover the loss. The Bank, as an authorise entity under the policy, applied for compensation, at first by submitting a request for payment, and subsequently, on 4 February 2014, by filing a lawsuit at the District Court in Warsaw thousand against the Insurer for the payment of compensation in the amount of PLN 18,494 thousand.

6. Information on appointment of the Auditor

The audit contract was concluded on 17 June 2013.

The total gross fee of Ernst & Young Audyt Polska spółka z ograniczoną odpowiedzialnością s.k. (formerly: Ernst & Young Audit sp. z o.o.) for the audit and review of financial statements and reporting packages to Commerzbank AG and mBank S.A. for 2013 amounted to PLN 295 thousand, including the amount of PLN 196 thousand paid in 2013.

7. Management Representations

Corporate governance

In its activities, the Bank is guided by the principles of corporate governance and good banking practices, which set high standards based on transparency and ethics in business and maintain balance between the interests of all parties involved in the operation of the Bank.

Correctness and fairness of the presented financial statements

The Management Board of mBank Hipoteczny S.A. represents that according to its best knowledge:

- financial statements and comparable data have been drawn up in accordance with the applicable accounting principles and reflect truly, fairly and clearly the assets and the financial position of mBank Hipoteczny as well as its financial results,
- the Director's report on operations for 2013 presents a true picture of the situation of mBank Hipoteczny, including a description of basic risks and threats.

Appointment of the registered audit company

The registered audit company auditing the annual financial statements of mBank Hipoteczny was appointed in accordance with the legal regulations. This entity and the registered statutory auditors performing the audit met the requirements regarding the expressing of an unbiased and independent audit opinion, in accordance with the respective legal regulations in force in Poland.

Piotr Cyburt

President of the Management Board

Marcin Romanowski

Member of the Management Board

Marcin Wojtachnio

Member of the Management Board