mBank Hipoteczny S.A.
Directors' Report
for the year 2014

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1. Operations of mBank Hipoteczny in 2014

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 which 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 to secure growth through specialisation 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 the new strategy entailed 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.

In the retail line, the Bank implemented a new business model based on close cooperation with the parent universal bank through the use of specialist expertise and market experience of a mortgage bank. Strategic objectives and the Bank's development within new areas required numerous changes, adaptation of the organisational structure and the level of employment to the current business needs and challenges, including the allocation of resources and remodelling of ICT infrastructure.

In 2014, the Bank focused its operations on the development of lending activities in the area of retail mortgage loans, closely cooperating with mBank as regards the product offer and sales network. The Bank builds its portfolio in this area based both on the acquisition of new customers, as well as by systematically taking over the existing retail loan portfolio from mBank. This refers only to loans which may constitute a basis for issuing covered bonds.

In the commercial line, the implementation of tasks and the pursuit of goals were undertaken in an increasingly competitive commercial real estate financing market, which is currently 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, a 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 the following could be observed:

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

1.1. Key projects in 2014

"Covered Bonds" Project

The primary project for 2014 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 August 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 specialisations of the two banks, helps to effectively build and refinance the retail portfolio on the basis of shared lending policy and operational synergy. Over the course of the project implementation, the two banks have been cooperating on an inter-bank outsourcing basis, based on an agency model, which in the second half of 2014 was 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, taking into account 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 determine the directions of the market's further development as well as searching for long-term sources of refinancing by banks.

Implementation of the IRB approach

The Bank is working on the implementation of the internal 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 Polish Financial Supervision Authority (PFSA) on 27 August 2012. Three further rating models for the refinancing and financing of hotels and utility premises obtained the approval of the Federal Financial Supervisory Authority (BaFin) and the PFSA on 10 April 2014. A positive conditional decision on expanding the application scope of the IRB approach for the aforementioned models enabled immediate application of the IRB approach (slotting approach) to calculate capital requirements with respect to credit risk on a consolidated (the Commerzbank Group), sub-consolidated (the mBank Group) and individual (mBank Hipoteczny S.A.) basis.

The works are also aimed at covering the retail portfolio with this method, on the basis of adaptation of models used in mBank S.A. In March 2014, in response to the letter of the PFSA, the Bank provided the PFSA with a plan of the gradual implementation of the IRB approach, supplemented with the class of retail exposures secured on residential properties. It is expected that retail exposures secured on residential properties may be covered by the IRB approach at the turn of 2016 and 2017.

IT projects

Implementation of Recommendation D

Implementation of the Recommendation D of the Polish Financial Supervision Authority is one of the key tasks and projects implemented by the Bank. It comprises 42 initiatives, of which 39 had been completed as at the end of December 2014, which made it possible to implement 98 out of 109 specific recommendations identified in the gap analysis process. Other specific recommendations, which had not been implemented until the end of 2014, were presented to the Management Board together with the schedule for 2015. As at 10 February 2015, only one initiative relating to the management of data at the Bank is left, and it is being implemented in accordance with the policy adopted in the group of mBank and the agreed schedule, with the completion date set for September 2015.

Modification of the Bank's Business Continuity Plan

In view of the gap analysis results under the 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 in order to cover the identified critical processes and the Bank's new business needs. As at the end of the first half of 2014, the Bank's Viability Strategy was developed, including critical processes approved by the Management Board. As part of the last stage of the project, the entire Bank's Business Continuity Plan Management Process was implemented. The operational test for this Business Continuity Plan was conducted on 2 August 2014, based on the developed continuity strategy for the entire Bank. The test report has been submitted to The Bank's Management Board at the end of August 2014. In October 2014, training for the managers and members of the crisis teams was conducted, including updated roles and responsibilities within the new Business Continuity Plan.

Implementation of a Service Model for IT Management

In view of the implementation of the Bank's new strategy, including the expansion of business activity, and also as a result of the post-audit recommendations and gaps identified in the Gap Analysis process for the 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 implemented 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. As at 31 December 2014, the following ratings were applicable:

A/F1 – international long-term and short-term rating

1 – support rating

A – for public sector covered bonds

A – for mortgage covered bonds

On 28 March 2014, Fitch Ratings Ltd, a rating agency, changed long-term rating outlook of mBank Hipoteczny S.A. for foreign currency (long-term foreign currency Issuer Default Rating) at the level "A" from stable to negative.

The change in mBank Hipoteczny S.A. rating outlook results from the change of Commerzbank AG long-term rating outlook from stable to negative, which occurred on 26 March 2014 and was the consequence of the global review of the support granted by states for European banks conducted by Fitch Ratings Ltd. As a result of the review the agency lowered the long-term rating outlook to negative for 18 commercial banks.

In addition, on 7 April 2014, Fitch Ratings Ltd. changed rating outlook for mortgage and public sector covered bonds of mBank Hipoteczny at the level "A" from stable to negative.

Fitch Ratings Ltd. assigns ratings on the following scales (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

Besides its financial results, ratings assigned 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 2014 are prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union. Data presented in the Director's Report are presented according to the management approach and do not always have to be consistent with data contained in the financial statements.

Table 1. Dynamics of selected elements of the statement of financial position (in PLN '000)

Key balance sheet items	31.12.2014	31.12.2013	Dynamics
ASSETS	6,176,326	4,782,443	29.15%
including			
Loans and advances to customers	5,325,741	4,045,000	31.66%
EQUITY AND LIABILITIES	6,176,326	4,782,443	29.15%
including			
Debt securities in issue	3,171,588	2,661,407	19.17%
Amounts due to customers	250,012	295,167	-15.30%
Registered share capital	285,000	275,000	3.64%

Due to the Bank's specialised profile, 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 (in PLN '000)

Income statement	2014	2013	Dynamics
Net interest income	86,183	74,779	15.25%
Net fee and commission income	4,046	3,693	9.56%
Net impairment write-downs on loans and advances	-20,945	-34,866	-39.93%
Overhead costs	-46,839	-39,189	19.52%
Amortisation and depreciation	-4,310	-4,162	3.56%
Profit before income tax	29,475	4,897	501.90%
Net profit	22,371	2,154	938.58%
Weighted average number of ordinary shares/diluted weighted average number of ordinary shares	2,759,589	2,750,000	0.35%
Earnings per ordinary share/Diluted earnings per ordinary share (in PLN)	8.11	0.78	934.97%

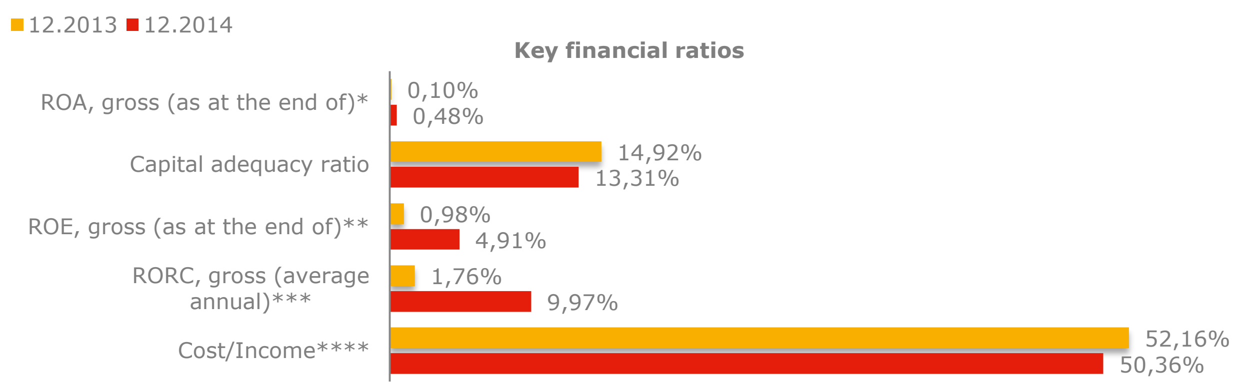
As at the end of 2014, the Bank achieved gross profit amounting to PLN 29.5 million. Good performance results mainly from net trading income (high valuation of hedging instruments), which was significantly higher than expected, and net commission income, which was also higher than expected. A 40% decrease in provisions for loans in comparison with 2013 also contributed to the achieved results.

Table 3. Business effectiveness ratios

BUSINESS EFFECTIVENESS RATIOS	2014	2013
Gross ROE (as at the end of the period)	4.91%	0.98%
Gross ROA (as at the end of the period)	0.48%	0.10%
Cost/income*	50.36%	52.16%
Capital adequacy ratio	13.31%	14.92%
RATINGS of Fitch Ratings Ltd		
international long-term rating	A	A
international short-term rating	F1	F1
support rating	1	1
public sector covered bonds	A	A
mortgage covered bonds	A	A
OTHER		
Average employment	187 persons	144 persons
Branches	Head Office + 6 branch offices	Head Office + 6 branch offices

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

Chart 1. Key financial ratios



* gross result / assets

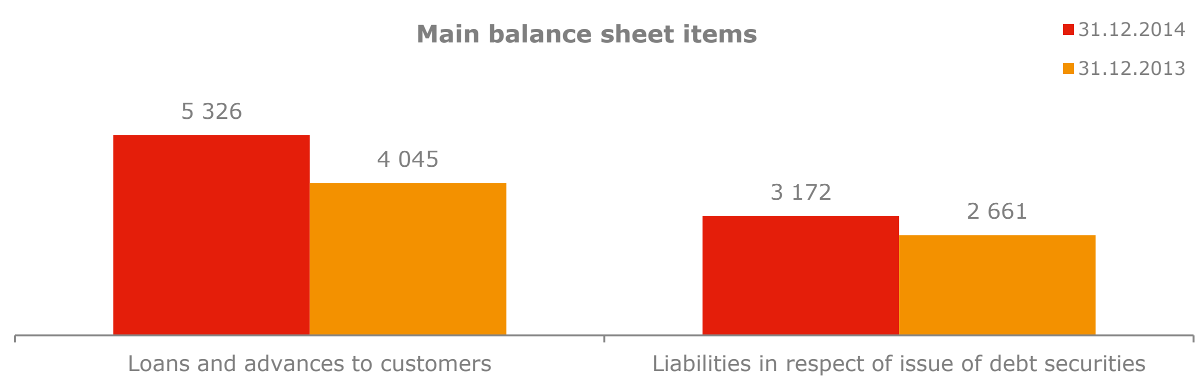
** gross result / (share capital + financial result from the previous years)

*** gross result / average (from the last 12 months) of the total risk exposure amount

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

Improvement in financial ratios in 2014, as compared to the end of 2013, results primarily from the higher gross result achieved by the Bank in 2014.

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



On the basis of the revised credit policy, optimised lending process and streamlined internal procedures, as well as taking into account the conditions and risks of the market environment, the Bank developed its activity both in the area of loans to business entities and retail customers.

In 2014, the value of loans granted reached PLN 2,069.6 million and was 93% higher than the value of agreements signed in 2013. Over PLN 526 million of sales referred to lending activity in the retail area, which was resumed in 2013. Moreover, the loan portfolio increased as a result of pooling transactions which, on the date of transfer, amounted to PLN 301.1 million in the retail area and EUR 8.6 million in the commercial area. The net value of the entire loan portfolio, taking into account pooling transactions and off-balance sheet exposure, increased at the end of 2014 by 27.7% in comparison with the end of 2013, reaching the level of PLN 6.4 billion.

1.4. Lending activity

2014 was a record year as regards sales of commercial loans in the 15-year history of the Bank. The amount of PLN 1.579 billion allowed the Bank to exceed the plan and improve the sales results by over PLN 100 million (7%) in comparison with the best year so far, i.e. 2008.

Commercial projects (office buildings, commercial facilities, warehouses) accounted for more than 55% of sales, with the remaining part relating to housing projects. Due to a close relationship between the financing of housing projects with economic cycles, the recovery in this market supported the acquisition. In 2008, the good performance resulted from the sales of low-margin loans for local government units or related entities and loans for the purchase of land, i.e. loans with a higher risk profile. Both segments were not subject of acquisition in 2014 which, in terms of quality, is an additional positive factor.

The Bank intensifies cooperation with Corporate Branches of mBank, through which 16% of the projects were acquired. There was a significant increase in derivative transactions executed by mBank on the Bank's projects, as well as in the number of the Bank customers who opened accounts in mBank, allowing the mBank's sales network the possibility of providing them with comprehensive services within the Group.

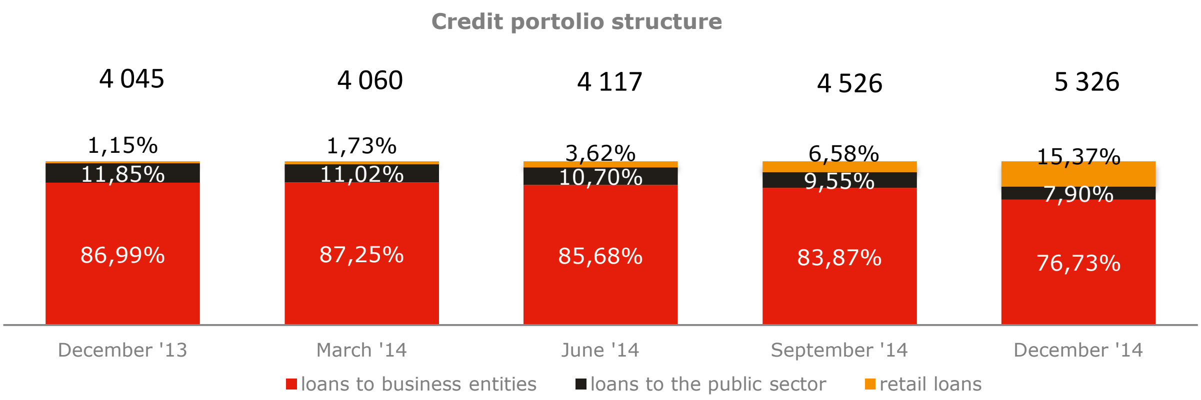
The Bank, in cooperation with many entities of mBank, commenced the implementation of commercial pooling (1 project was transferred; the value of the project, as at the date of the transfer, was EUR 8.6 million). As part of this project, exposures from mBank's balance sheet will be transferred to the Bank's balance sheet, which is essential for refinancing with the cheapest and long-term instruments, covered bonds.

The Bank also extends its cooperation with the Group companies: a training for Aspiro representatives was held and preparations for the cooperation with mFactoring with respect to financing contractors in construction projects who have received loans from the Bank were commenced.

Considering the organisational changes which took place at the turn of 2013 and 2014, the Bank's net profit should be considered a great success.

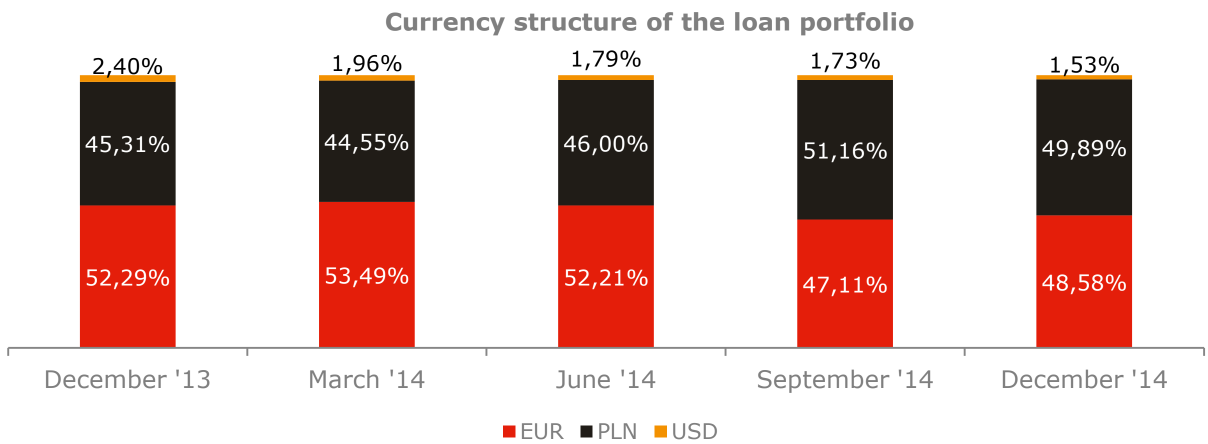
Since September 2013, as part of the project involving the reconstruction of the mBank Group's balance sheet, the Bank's offer has also included retail loans. In 2014, the sale of retail loans in the agency model, through the mBank's sales network, was supplemented with a "pooling" model, under which the Bank will acquire mortgage loans granted by mBank which may constitute a basis for the issuance of covered bonds. The first pooling transaction concerning retail loans was conducted in September 2014 (8 loans) and the next one — in October 2014 (1438 loans).

Chart 3. Structure of the loan portfolio in the period 31.12.2013–31.12.2014 (in PLN million)



In 2014, the currency structure was subject to changes resulting from a systematic growth of the portfolio of retail loans granted only in PLN. In comparison with the end of 2013, the share of loans in PLN increased by 4.6 percentage points and, as at the end of 2014, loans in PLN accounted for nearly half of the loan portfolio. The share of loans in EUR decreased to 48.58%.

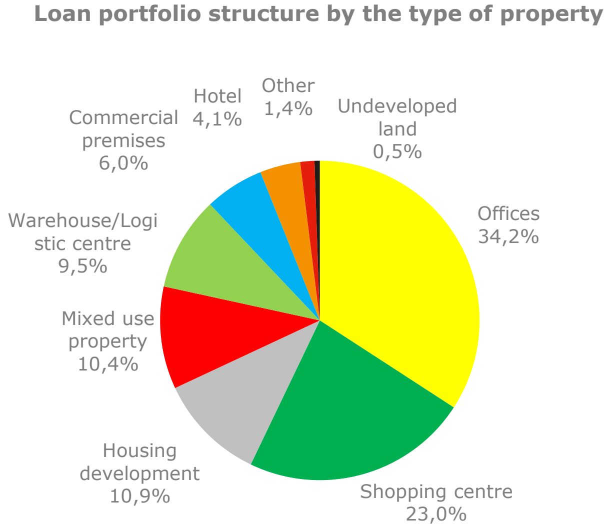
Chart 4. Currency structure of the loan portfolio in the period 31.12.2013–31.12.2014



Loans to business entities

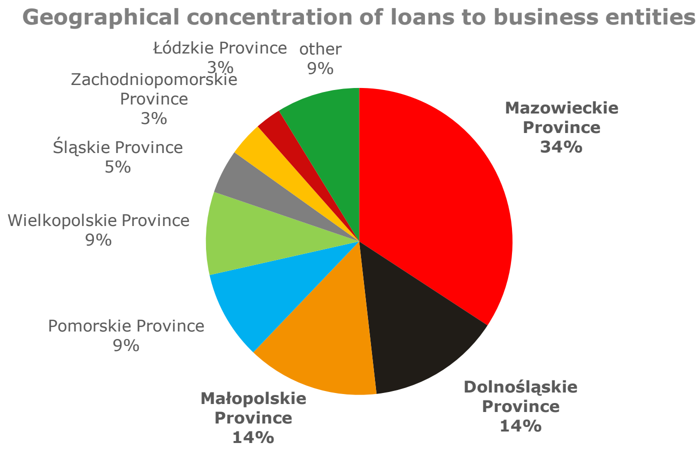
As at 31 December 2014, net balance sheet exposure towards business entities amounted to PLN 4,086.4 million. The main part (78%) was attributed to refinancing finished commercial facilities, exposures in housing projects accounted for 10.9% and loans for financing of the construction of commercial facilities accounted for 10.6%.

Chart 5. Loans to business entities by type of real estate financed as at 31 December 2014



As at the end of December 2014, within the area of commercial real estate, the Bank predominantly 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 financing the construction process after which the construction loan is converted into a long-term mortgage loan.

Chart 6. Geographical concentration of loans to business entities as at 31 December 2014



The largest number of financed projects is concentrated within the Mazowieckie province, where the exposure amounts to 34.2% of all credit funds. In the provinces of Dolnośląskie, Małopolskie and Pomorskie, the total balance sheet exposure amounts to 37.2%.

As at 31 December 2014, the portfolio of loans to business entities was dominated by loans in EUR (62.8%) and PLN (35.3%).

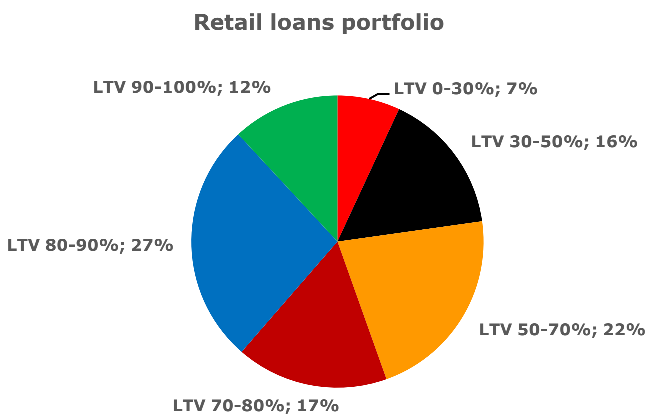
Loans to the public sector

In the first half of 2014, the Bank ceased to provide financing to local government units. The lack of new agreements in 2014 together with a substantial volume of early repayments is reflected in lower (as compared to the end of 2013) balance sheet exposure in this area (-12.3%).

Retail loans to individual customers

The Bank implements its strategic objectives in the area of sales of mortgage loans for individuals in cooperation with mBank S.A. The offer of mortgage loans for individuals was extended by loans for the purchase of real property on the primary market (upon the consent of the developer to establish collateral prior to the completion of the investment). In April 2014, the Bank established cooperation with ACONS and Emmerson, third party companies, in the area of real estate valuation, i.e. preparing a mortgage lending value (bhwn) appraisal in order to streamline the processing of credit applications. On 1 July 2014, the Bank implemented recommendations of the second part of the Recommendation S according to which the Bank may grant loans in PLN only to applicants who obtain most of their income denominated in PLN.

Chart 6. Retail loans portfolio by LTV as at 31 December 2014



The total volume of loan agreements signed in 2014 amounts to approx. PLN 526.3 million. The average amount of loan was PLN 266 thousand. At the end of 2014, the portfolio volume weighted average margin amounted to 1.54%. The average commission weighted by the amount of a loan agreement for loans disbursed in 2014 was 0.63%. The largest share in sales is that of loans with LTV of 80–90% and verified customer net income of up to PLN 8 thousand.

1.5. Refinancing and issuance of covered bonds

In 2014, mBank Hipoteczny successfully placed on the market eight issues of mortgage covered bonds with a total nominal value of PLN 1.014 billion as at 31 December 2014.

The value of six issues denominated in euro was EUR 120.5 million, and three of them were distinguished by an exceptionally long, i.e. amounting to 15 years, maturity period.

The value of two issues of mortgage covered bonds, at the turn of July and August 2014, denominated in Polish currency was PLN 500 million, which was the biggest offering of mortgage covered bonds in the history of mortgage banking in Poland.

The value of all covered bonds issued by the Bank and outstanding as at the end of 2014 was over PLN 3 billion, representing more than 70% of the covered bonds market in Poland 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 the legal requirement of multi-stage collateral for their issuance and trading. This is confirmed by the Fitch Limited Ltd rating agency, which assigned A level ratings to mortgage and public sector covered bonds issued by the Bank.

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

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

Issue date	Redemption date	Currency	Value	Rating by Fitch Ratings Ltd.
28.09.2010	28.09.2015	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
28.07.2014	28.07.2022	PLN	300,000,000	A
04.08.2014	20.02.2023	PLN	200,000,000	A
TOTAL		**PLN**	**1,780,000,000**	

Issue date	Redemption date	Currency	Value	Rating by Fitch Ratings Ltd.
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
17.02.2014	15.02.2018	EUR	7,500,000	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
22.10.2014	22.10.2018	EUR	20,000,000	A
28.11.2014	15.10.2019	EUR	50,000,000	A
TOTAL		**EUR**	**210,500,000**	

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

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

Issue date	Redemption date	Currency	Value	Rating by Fitch Ratings Ltd.
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

In accordance with the Act on covered bonds and mortgage banks, the basis for the issue of mortgage covered bonds are receivables entered into the cover register, secured with mortgages established on the right of perpetual usufruct or the ownership of real estate, entered as the first item in the land and mortgage register.

Public sector 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.

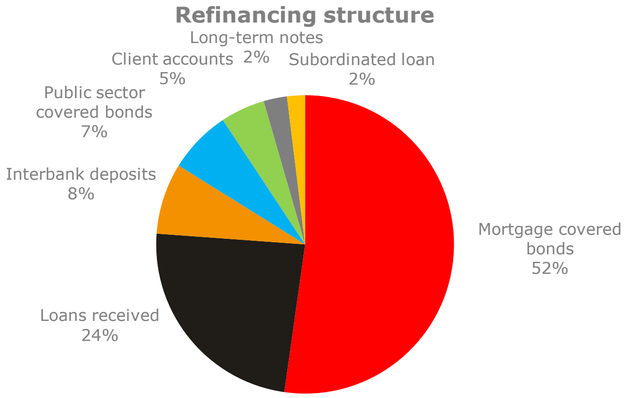
As at 31 December 2014, the collaterals of:

- the public sector covered bonds comprised receivables of PLN 421.8 million relating to 71 loans in total,
- the mortgage covered bonds comprised receivables of PLN 3,263.9 million relating to 1148 loans in total.

In addition to loan receivables, a substitute cover in the form of treasury bonds with the nominal value of PLN 30 million (for public sector covered bonds) and PLN 160 million (for mortgage bonds) was entered in the respective register.

The Bank raises funds for lending activities mostly by the issuance of covered bonds, followed by loans received and term deposits — mainly from the inter-bank market.

Chart 8. The structure of refinancing of the Bank's operations as at 31 December 2014.



2. Risk management

2.1. Credit risk

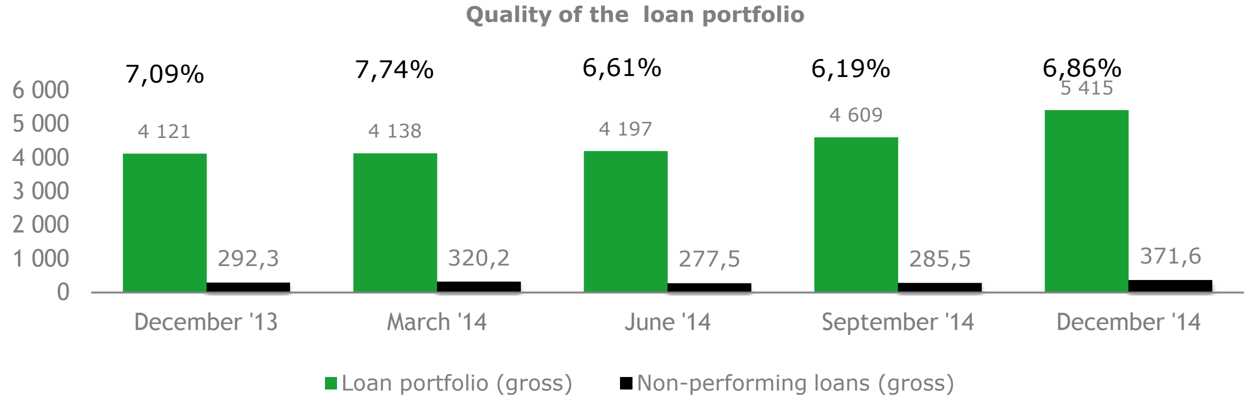
Loan portfolio

The rules of granting loans are specified in the Bank's credit policy and the existing loan portfolio is managed mainly through current monitoring of assets and credit exposures.

Due to actions taken by the Bank in the area of problem loans management and as a result of an increase in the loan portfolio, the share of non-performing loans in the Bank's loan portfolio decreased 6.86%. Most liabilities are repaid in a timely manner, but borrowers with a higher risk profile have been subjected to intensified monitoring. In 2014 the net value of the loan portfolio increased by PLN 1,280.8 million in comparison with the end of 2013, which resulted mainly from the increase in the retail portfolio (agency model loans and retail pooling).

Impairment provisions reaching PLN 87,700.3 thousand together with mortgages established on the financed properties constitute the relevant collateral against potential losses resulting from credit risk.

Chart 9. The share of non-performing loans* in the Bank's loan portfolio (gross values, 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 2014, 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 participation, as well as verified pre-sales). The main area of the Bank's activities in 2014 was the refinancing of commercial real estate including in particular shopping centres.

The retail loan portfolio granted in the agency model in cooperation with mBank S.A. is characterised by good quality (costs of risk are maintained at a low level). Loans to individuals are monitored on a monthly basis for the timeliness of repayment and regularities as regards the established effective mortgage collateral. In the same period, the implementation of all contractual obligations of the customer is monitored (including insurance of the real property and assignment of rights under insurance policies).

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 the loans are of the quality required under the Act on mortgage bonds and mortgage banks in order to ensure the maximum utilization of the loans as a basis for covered bonds issues.

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 delays in meeting 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 the share of the loans for the purchase or refinancing 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 total loan sales

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 2014, the Bank issued 2 banking enforcement titles (BTEs), both referring to commercial loans. The total amount of debt covered by the first BTE was EUR 7,199.3 thousand, whereby after issuing the BTE, this receivable was sold. The amount of debt covered by the second BTE was PLN 10,804.3 thousand, the value of collateral (the current market value of properties) amounts to: PLN 9,090.0 thousand – impairment write-down on the asset was established.

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 the market risk, the Bank adjusts the currency and term structure of the financing sources 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 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 2014, VaR amounted to PLN 70.5 thousand. The currency risk amounted to PLN 6.17 thousand, and the interest rate risk amounted to PLN 64.35 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 repricing 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 2014 reached a safe level of 5.27%. 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 immediate hedging 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 taking the expected repayments and disbursements of loans into account 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 current, 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 reserves of liquid assets.

As at the end of December 2014, liquidity reserves represented ca. 12.04% 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 small share of deposits from the non-financial sector in the balance sheet total (4.01%).

In 2014, the financing of the Bank's lending activities was performed mainly through the issuance of short- and medium-term covered bonds in PLN and EUR. The Bank's long-term liquidity is stable.

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 assets structure to liabilities that finance them and the need to increase the stability of financing sources, mBank Hipoteczny will continue its activities aimed at replacing short-term financing with financing in the form of covered bonds issues with maturities of 5 years and more.

The share of stable financing sources 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 December 2014 was 1.082. M1 and M2 short-term liquidity standards were maintained at a safe level of PLN 511,619 thousand and 2.610. The M3 standard amounted to 36.521.

Over 2014, the limit of liabilities set under Article 15.2 of the Act on covered bonds and mortgage banks was utilised in 61.7% (on average). During the entire year, this limit was not exceeded.

As at the end of December 2014, the average maturity of covered bonds issued amounted to 4.60 years for mortgage covered bonds and to 1.18 years for public sector covered bonds, whereas the average maturity of long-term deposits and loans received from other banks amounted to 3.25 years. The margin on mortgage covered bonds issued in 2014 was 0.98% (on average), with an average maturity of 7.9 years. No public sector covered bonds were issued in 2014.

2.4. Operational risk

In 2014, the main source of operational risk at the Bank were changes in the profile of operating activities and the significant scale of activities entrusted to third parties. Implementing the strategy assumptions, the Bank extends its activities by selling mortgage loans in the retail banking business line, applying solutions specified under agreements concluded with mBank. The identified factors contribute to an increase of the operational risk level, however the Bank analyses the risk in terms of threats and the level of materiality of the outsourced activity, the possibility to reduce the risk through insurance and in terms of business continuity plans of the insourcer and the Bank. Analyses cover also the financial standing of the entrepreneur and ability to perform services in a timely manner and ensuring proper quality.

The products offered are consistent with the nature of activities of a mortgage bank. In 2014, a large number of IT projects and undertakings were implemented. The level of operational risk was also materially affected by the project of reorganisation of Business Continuity Plans and the Bank's adjustment to the instructions of Recommendation D.

In 2014, a high turnover of staff was noted at the Bank, including key employees. In connection with the nature of business activities, despite an increase in the retail mortgage loan portfolio, operating losses are recorded mainly in the commercial banking business line.

Factors contributing to the increase of the Bank's operational risk exposure:

- numerous changes in the organisational structure,
- number of IT projects and undertakings implemented, including the project of the Bank's adjustment to the instructions of the Recommendation D and the Business Continuity Plans reorganization project,
- high staff turnover,
- changes in the profile of operating activities related to the development of the mortgage loan portfolio based on outsourcing agreements concluded, both in the business, as well as in the IT area.

With the extension of the Bank's scope of operations to include the sale of retail loans, the Bank may expect:

- an increase in the number of complaints and claims by individuals against the Bank,

- a larger number of credit frauds — individuals trying to obtain loans under false pretences.

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

Factors stabilising the level of the Bank's exposure to operational risk:

- operational risk management system implemented in the Bank,
- simple organisational structure, lack of subsidiaries,
- small scale and complexity of operations, resulting from the specific nature of mortgage banks,
- lack of e-banking services.

2.5. Risk of investing in covered bonds

In 2014, 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 collateralisation of their issue and trading by the issuer in accordance with the Act on covered bonds and mortgage banks. In addition to 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 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. The minimum overcollateralization level of mortgage covered bonds and public sector covered bonds is 10% and 6% respectively.

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. Property market in Poland in 2014

Residential property market

- the number of transactions calculated jointly for six markets[1] reached a record level in 2014 and was more than 43 thousand units, approx. 20% more than in record years 2007 and 2013, when approx. 36 thousand apartments were sold in each year,
- increased demand resulting from the improved economic situation, continued low level of interest rates, and stable housing prices,
- continuing activity of cash investors purchasing apartment for rent (low interest rate on bank deposits),
- over the entire year 2014, individual investors represented approx. 53% and developers approx. 41% in the structure of completed apartments by construction form,
- reduction of the available offer of housing and enhanced efforts in residential space construction,
- fading effect of cumulated number of residential space building permits issued before the Developer's Act came into force,
- growing experience in compliance with the provisions of the so-called "Developers Act",
- Warsaw is the leader in the number of completed dwellings, issued building permits, and opened constructions.

[1] Warsaw, Kraków, Wrocław, Poznań, Gdańsk, Łódź

Commercial property market

- in 2014, the total volume of transactions in the market of commercial property was approx. EUR 3.03 billion,
- the largest share of transactions recorded in the office sector (50%),
- an increase of the share of transactions in the warehouse market segment was recorded (23%).

Office property

- Warsaw remains the largest office market in Poland,
- new supply results in the increase of the level of uninhabited premises, in spite of the increased activity of tenants,
- strengthening of tenants' negotiating position (growth of supply and strong market competition),
- renovations, modernisation and reducing rental rates in old properties to win a better competitive position,
- unflagging interest of investors investing in Poland.

Retail property

- the majority of modern retail space is supplied to the markets of large and medium size cities in Poland,
- developers' growing interest in smaller towns (retail property format adjusted to local conditions),
- Poland is an attractive market for foreign brands,
- temporary ('pop-up') stores as a new trend on the market,
- continued expansion of discount grocery and clothing stores.

Warehouse property

- increased investor activity,
- projects for specific customer still dominant (like pre-let and BTS),
- increased developer interest in speculative projects (Properties previously not secured by lease contracts),
- central Poland, Poznań and Upper Silesia are the most active markets in terms of newly developed space,
- development of national roads and growing demand offer a chance for the development of smaller markets, i.e. Lublin, Rzeszów, Szczecin,
- large warehouse space is located around main transit roads and transport hubs.

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

In 2013, the Management Board of the Bank approved the strategy for the period 2014-2017 which set new directions of activity and development of the Bank. On their basis, the Bank strengthens its market position in the competitive environment.

The business strategy sets out two main strategic objectives of the Bank:

- increase in the balance sheet total through dynamic growth of credit assets based on the planned increase of the lending activity 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 Bank providing services related to the covered bonds issuer's function within the mBank Group.

For over a year, the Bank has been implementing 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 2013, the Bank began to offer mortgage loans to individuals through mBank's sales network. This applies to loans that meet the criteria of entry into the cover register and potentially constitute a basis for their issuance.

In 2014, the Bank focused its activities on creating a new retail mortgage loan portfolio in cooperation with mBank, improving the lending process and beginning the process of refinancing this portfolio with covered bonds. Intensive works in these areas resulted in the first issues of covered bonds based on the new retail mortgage loan portfolio.

In the third quarter of 2014, the creation of the new retail mortgage loan portfolio was additionally supported by the implementation of the pooling model under which the Bank started to take over the existing retail loan portfolio of mBank. The first transaction was conducted in September, the second one in October 2014, and further transactions planned under the assumed strategy will be performed in 2015 and subsequent years. The pooling mortgage loan portfolio will be gradually refinanced through the issues of covered bonds.

Other material objectives of the Bank include:

- a significant increase in the commercial loans portfolio subject to the new credit policy, consistent credit risk management policy, and optimised credit process, taking into account the current 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 low 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 offering 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.

Financing or refinancing the purchase of completed, commercialised facilities, particularly office buildings, retail space and warehouse space continues 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 covered bonds market by increasing the volume of issues.

5. The Bank's authorities

Shareholders

Shareholding structure of mBank Hipoteczny

Shareholder's name	Share capital in 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	73.06	2,082	73.06
mBank S.A	76,800	768	26.94	768	26.94
Total	**285,000**	**2,850**	**100**	**2,850**	**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.

On 30 December 2014, the registry court entered the increased share capital in the National Court Register. The issue of 100 thousand shares with the total nominal value of PLN 100 million was taken over by mBank S.A. mBank's share in the share capital increased from 24.29% to 26.94%.

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

As at 31 December 2014, the composition of the Management Board of mBank Hipoteczny was as follows:

- 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 is disclosed in Note 43 to the Financial Statements.

Appointment and dismissal of Member of the Management Board and their powers:

The Supervisory Board appoints and dismisses Members of the Management Board, including the President of the Management Board.
Appointment of two Members of the Management Board, including the President of the Management Board and Member of the Management Board responsible for risk takes place with the consent of the Polish Financial Supervision Authority. The application for such consent is submitted by the Supervisory Board.

The Bank's Management Board handles all matters of the Bank and represents the Bank, e.g. it makes decisions on the issuance of covered bonds and bonds, determining the scope of issue in line with the strategies and annual operating plans approved by the Supervisory Board. The scope of responsibility of the Bank's Management Board includes all matters not reserved for other bodies of the Bank, under the Statute or provisions of the law.

Principles of amending the Articles of Association

In accordance with Article 430 § 1 of the Code of Commercial Partnerships and Companies, an amendment to the Articles of Association requires a resolution of the Shareholders' Meeting and entry in the registry.
In accordance with Article 34(1) of the Banking Law, any amendment to the Bank's Articles of Association requires an authorisation of the Polish Financial Supervision Authority where such amendment relates to:

1) the business name, which should contain the word 'bank' and be distinct from the names of other banks, and indicate whether the bank is a state bank, a joint stock bank, or a cooperative bank;
2) the bank's registered office, objects and scope of activity, taking into account activities referred to in Article 69(2) items 1–7 of the Act on Trading in Financial Instruments of 29 July 2005 which the bank intends to perform in accordance with Article 70(2) of that act;
3) governing bodies and their competence, special consideration being given to the competence of the members of the Management Board, referred to in Art. 22b(1) of the Banking Law, procedures for decision taking, basic organisational structure of the bank, principles of making representations with respect to property rights and obligations, procedures for issuing internal regulations and procedures for adopting decisions with respect to assuming liabilities or disposing assets whose aggregate value in relation to one entity exceeds 5% of own funds;
4) principles for the functioning of the internal control system;
5) own funds and principles for financial management

and share privilege or restrictions with respect to the voting right in a joint stock bank.

Supervisory Board

The composition of the Supervisory Board of mBank Hipoteczny S.A. as at 31 December 2014:

- Cezary Kocik – Chairman of the Supervisory Board
- Hans-Dieter Kemler – Deputy Chairman 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
- Mariusz Tokarski – Member of the Supervisory Board

On 11 April 2014, the Supervisory Board was appointed for the ninth term of office by the Annual General Meeting of mBank Hipoteczny S.A. in the above composition, except for Mr Mariusz Tokarski. Mr Mariusz Tokarski was appointed a Member of the Supervisory Board on 3 July 2014 and a Member of the Audit Committee on 16 July 2014.

Information on the remuneration of the members of the Supervisory Board is disclosed in Note 42 of 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 resolution, on appointing and recalling 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.

Audit Committee

As at 31 December 2014, the composition of the Audit Committee was as follows:

- Joerg Hessenmueller – Chairman of the Committee
- Hans-Dieter Kemler – Member of the Committee
- Dariusz Solski – Member of the Committee
- Mariusz Tokarski — Member of the Committee

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 2014, three meetings of the Audit Committee took place – on 10 April, 17 October and 8 December.

Risk Committee

On 2 July 2014, a new composition of the Risk Committee was appointed:

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

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 2014, two meetings of the Risk Committee took place – on 26 March 2014 and 16 September.

6. Other information

Loans, deposits and interest rates

Basic floating interest rates applied by the Bank are based on the LIBOR and EURIBOR interest rates for foreign currency loans and on the WIBOR rate for loans in PLN. The interest rate applied for a loan on a given day is equal to the Bank's margin specified in the agreement and the base rate.

Related party transactions

MLV 45 sp. z o.o. spółka komandytowa is the direct parent entity of mBank Hipoteczny S.A. mBank S.A. is the parent entity of MLV 45 sp. z o.o. spółka komandytowa (formerly: BRE Holding Sp. z o.o.). Commerzbank AG is the ultimate parent company. Commerzbank AG is the direct parent entity of mBank S.A. Until 28 November 2013, the direct subsidiary of mBank Hipoteczny S.A. was BDH Development Sp. z o.o. (previous company name: Bankowy Dom Hipoteczny Sp. z o.o.).

All the transactions between the Bank and its related entities were, according to the Management Board, typical and routine transactions 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 derivative transactions.

As at 31 December 2014, the Bank's liabilities to mBank S.A. comprised mainly loans received in the amount of PLN 1,228,221 thousand, term deposits totalling PLN 396,627 thousand, other liabilities in respect of a deferred payment in the amount of PLN 346,533 thousand and a subordinated loan in the amount of PLN 100,257 thousand. As at 31 December 2013, the Bank's liabilities to mBank S.A. comprised mainly term deposits totalling PLN 757,809 thousand, a loan of PLN 415,626 thousand and a subordinated loan of PLN 10,268 thousand.

The most important agreements/transactions concluded with related companies in 2014 are disclosed in Note 43 of the Financial Statements.

Post balance-sheet events

On 30 January 2015, a portfolio transfer agreement was concluded between mBank S.A. and mBank Hipoteczny S.A. Under this agreement, mBank Hipoteczny acquired a retail portfolio of mortgage-backed loans with the fair value of PLN 114,917 thousand from mBank S.A.

On 3 February 2015, the Management Board of mBank Hipoteczny S.A., by way of resolution No 10/2015, decided to terminate the cash bonus agreement concluded on 7 January 2014 by and between mBank Hipoteczny S.A. and BRE Ubezpieczenia Sp. z o.o. The agreement with BRE Ubezpieczenia Sp. z o.o. will be terminated by mutual consent of the Parties, as of 31 March 2015.

On 20 February 2015, mBank Hipoteczny S.A. issued 7-year floating-rate mortgage covered bonds with a nominal value of PLN 200,000 thousand.

On 25 February 2015, mBank Hipoteczny S.A. issued 7-year fixed-rate mortgage covered bonds with a nominal value of EUR 20,000 thousand.

On 25 February 2015, the Bank concluded a new hedging relation to hedge against the interest rate risk. The hedged item are fixed-rate mortgage covered bonds issued on 25 February 2015, with a nominal value of EUR 20,000 thousand. The hedging item is an IRS transaction with a nominal value of EUR 20,000 thousand, swapping the fixed interest rate for a floating interest rate.

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 maintaining balance between the interests of all parties involved in the operation of the Bank.

On 16 December 2014, the Management Board and on 19 January 2015, the Supervisory Board accepted for application the Corporate Governance Principles for Supervised Institutions (the "Principles"), adopted by the Polish Financial Supervision Authority on 22 July 2014, excluding Principles specified in § 8(4), § 25(1), § 29 and § 53-57. The Principles addressed to shareholders shall be presented at the next General Meeting by the Management Board of mBank Hipoteczny S.A.

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 the operations for 2014 presents a true picture of the situation of mBank Hipoteczny, including a description of basic risks and threats.

The process of preparing financial data for reporting is automated and based on the General Ledger of the Bank. Preparation of data in source systems is subject to formalised operational and acceptance procedures. Creating the General Ledger of the Bank takes place within a process covering respective internal controls. Manual adjustments are subject to special controls.

The process of preparing financial statements at mBank Hipoteczny S.A. is carried out by the Financial Reporting Division in the Accounting and Settlement Department. The responsibility for keeping accounting books and administering the model chart of accounts lies with the Accounting and Settlement Department.

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.

Information about the auditor's fee is disclosed in Note 44 to the Financial Statements.

....	....	....
Piotr Cyburt	Marcin Romanowski	Marcin Wojtachnio
President of the Management Board	Member of the Management Board	Member of the Management Board