

**Management Board Report  
on the performance of mBank Hipoteczny S.A.  
in 2015**

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## **1. Activity of mBank Hipoteczny S.A. in 2015**

In June 2015 mBank Hipoteczny S.A. (hereinafter referred to as "Bank") updated its operation strategy for the following years (2016-2019). Key developments and strategic objectives remained consistent with those specified in the previous version of the strategy.

Commenced operations, aimed at increasing Bank's effectiveness and dynamics of development, were continued through the best possible use of its resources and market potential as well as determination of the role and competencies in the mBank Group, in which the Bank intends to strengthen its position as a strategic company and an issuing bank. A secure growth achieved through specialisation, which due to the nature of the Bank and its narrow scope of activities is the source of its competitive advantage and high market position, remains the Bank's objective. On the other hand, such characteristic of the Bank determines its sources of revenue and as a consequence its relatively low rate of return, wherein the revenue of the Bank is strongly linked with the applicable market interest rates.

The Bank has two business lines:

- retail, focused on mortgage lending to natural persons,
- commercial, which conducts financing of commercial real estate and residential real estate by development companies.

From the end of 2012 the Bank does not finance local government units or other entities with a guarantee of local government units, which results from the risk profile of this segment and inadequate credit margins. This approach has been maintained in the update of the strategy for years 2015-2019. Nevertheless, the Bank owns a historically developed portfolio of credit transactions for this segment, which constitutes a basis for issuing of public sector covered bonds.

In the retail line the Bank implemented a business model based on close cooperation with parent universal bank through the use of specialised expertise and market experience of a mortgage bank.

In 2015 the Bank focused its activities on the development of lending within the scope of retail mortgage loans through close cooperation with mBank in terms of product offer and distribution channels. The Bank continued the development of its portfolio in this area basing on both acquisition of new customers and systematic acquisition of existing retail loans portfolio from mBank. This applies only to the loans that may be a basis for issuing of covered bonds.

The following market trends were observed in the area of commercial projects:

- an increase in investor activity in real property trading,
- limiting of exposure to individual entities and projects, and as a consequence an increased propensity to share risk through participation in interbank consortia,
- investment growth in regional cities within the scope of offices,
- offering of low levels of credit spreads by banks, even below 2.0%.

In the area of commercial residential housing financing the following could be observed:

- increase of developers' activity in terms of project implementation,
- liberal approach of banks to assessment of projects, in particular in terms of own contributions and pre-sales along with convergent expectations of some developers,
- the pressure on banks to lower the margins even below the level of 2.5%.

Within the Bank, in terms of commercial and residential facilities, the levels of margins were maintained at the cost of only partial participation in the growth of investors' activity. In view of the expected

changes on the housing market, the Bank verified its credit policy aimed at lowering of risks in relation to changing environment.

## **1.1 Key projects of 2015.**

### **The "covered bonds" project**

The project of rebuilding of the balance sheet of mBank Group on the basis of long-term source of financing in a form of covered bonds issued by mBank Hipoteczny continued to be the highest priority venture in 2015. Works on the project started in August 2012, and their purpose was preparation of a comprehensive model of cooperation between a mortgage and a universal bank in terms of sales, service and management of retail mortgage loans portfolio and then issuing of covered bonds on its basis. The division of tasks between mBank and mBank Hipoteczny, accordant with competencies and specialisation of both banks, allows for effective development and refinancing of retail portfolio on the basis of common credit policy and operational synergy effect. Within the scope of implementation of the project the banks cooperate on the basis of interbank outsourcing, based on the agency model which in the second part of 2014 was extended with a pooling model consisting in acquisition of already existing retail loan portfolio from mBank in order to refinance it. Additionally, 5 loans were transferred by the Bank in 2015 as part of the commercial pooling.

The implementation of the model aims at:

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

The project is a pioneer solution in the Polish banking sector and the success of its implementation will indicate further developments in the market and searching for long-term sources of refinancing by banks.

### **Implementation of IRB method**

The Bank is working on the implementation of an internal rating method as a task of high priority and long-term nature. Seven internal models in the commercial area obtained a conditional clearance of KNF (the Financial Supervision Authority) on 27 August 2012. Three further rating models for refinancing and financing of hotels and business premises were approved by BaFin and KNF on 10 April 2014. The positive conditional clearance regarding the extension of application of IRB method for the above mentioned models allowed for application, with an immediate effect, of IRB method (slotting approach) in the calculation of capital requirements for the credit risks on a consolidated (Commerzbank Group), sub-consolidated (mBank Group) and unit basis (mBank Hipoteczny S.A.).

The works also focus on covering of the retail portfolio with this method on the basis of adaptation of models applied in mBank S.A. Submission of the Application for the use of statistical methods to calculate capital requirements for credit risk in relation to retail exposures obtained in cooperation with mBank is planned for the second half of 2016.

### **Implementation of Recommendation D**

Implementation of Recommendation D of the Financial Supervision Authority is one of the key tasks and projects realised in the Bank. It covers 42 initiatives, from which, at the end of December 2014, 39 were implemented, which means 98 of 109 detailed recommendations identified in the process of gap analysis were implemented. Remaining detailed recommendations, which could not be implemented by the end of 2014, were presented to the Management Board along with a schedule for 2015. The last initiative concerning the Data Governance in the Bank was implemented in accordance with the schedule, in September 2015. The Data Governance aims at ensuring that IT systems developed and applied in the Bank collect and process data in a secure manner and allow access to appropriate persons and units. Furthermore, the process aims to increase the awareness of users in terms of necessity to preserve the quality of data through imposing on them the responsibility to verify the accuracy of data. Due to implemented data quality management standards, the Bank will be able to maintain high reliability in the operating environment (investors, rating agencies). The meeting of supervisory requirements that qualify IRB systems and processes to be used in calculation of the Bank's capital requirements and benefits resulting from limitation of risk of the model which directly translates into mitigation of hazards arising from the operational risk of the Bank should also be mentioned.

### **Implementation of Recommendation W**

The Bank commenced works aimed at implementation of Recommendation W of the Financial Supervision Authority related to model risk management in banks. Gap analysis was carried out and work schedule was adopted, according to which a complete implementation of Recommendation W will take place on 30 June 2016.

## **1.2 Financial credibility**

Financial credibility of mBank Hipoteczny is assessed by an international rating agency - Fitch Ratings Ltd. As of 31 December 2015 the following ratings applied:

**BBB-/F3** - long- and short-term international rating

**2** - support rating

**BBB** - for public sector covered bonds

**BBB** - for mortgage covered bonds

On 19 May 2015, as a result of downgrading IDR („Issuer Default Rating”) of Commerzbank AG from „A+” to „BBB” and mBank S.A. from „A” to „BBB-”, Fitch Ratings Ltd. downgraded the long-term international IDR of mBank Hipoteczny S.A. from „A” (negative outlook) to „BBB-” (positive outlook). As a result of the above rating action the short-term international IDR of the Bank was downgraded from „F1” to „F3” and its support rating from „1” to „2”.

Furthermore, on 20 and 21 May 2015, Fitch Ratings Ltd. downgraded the rating for public sector and mortgage covered bonds issued by the Bank from „A” (negative outlook) to „BBB” (positive outlook).

The change of ratings of the Bank's covered bonds took place as a result of downgrading of the long-term international IDR of mBank Hipoteczny S.A. from „A” to „BBB-”.

The described above rating action did not result from the change of the Bank's financial situation or the quality of assets constituting the security for the issued covered bonds.

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

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

The ratings obtained by the Bank are also affected by, beside its financial results, the rating of mBank S.A. and Commerzbank AG, including the support granted by those institutions.

### 1.3 Financial results

The financial statement of the Bank for 2015 was prepared according to the International Financial Reporting Standards binding in the European Union (IFRS). The data presented in the Management Board Report are presented in the management view and they do not have to be consistent with the data included in the Financial Statement.

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

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

Main balance sheet items	31.12.2015	31.12.2014	Dynamics
<b>ASSETS</b>	8 419 125	6 176 326	36.31%
including			
Loans granted to customers	7 391 743	5 325 741	38.79%
<b>LIABILITIES AND EQUITY</b>	8 419 125	6 176 326	36.31%
including			
Short-term liabilities from issue of debt securities	4 164 902	3 171 588	31.32%
Amounts due to customers	265 509	250 012	6.20%
Share capital	514 856	374 938	37.32%

At the end of Q2 2015 the Bank introduced a change in the estimation methodologies of so called portfolio reserves (IBNR) for the credit portfolio of the commercial business line. The main purpose was to better adjust the method to the requirements of KNF which recommends the application of Point In Time approach to the estimation of probability of default (PD). In particular the loss identification period (LIP) was prolonged from six to eight months. As a consequence the level of reserves has increased in 2015.

In 2015 the Bank achieved a positive gross result in the amount of PLN 26,797 thousand. Due to a specialised activity profile in which the main source of the Bank's result is the interest income, the financial result in 2015 was greatly influenced by low interest rates. Despite this, the Bank reported a growth in the core business compared to 2014 (the net interest income was higher by PLN 24 579 thousand or 28.52%; the net fee and commission income grew by PLN 2,483 thousand or 61.35%).

The net trading income, which includes the result on swaps, other net trading income and result on hedge accounting was above the line in 2014 (PLN 12 292 thousand) with important contribution to the gross result, while in 2015 a corresponding result was below the line (PLN -434 thousand).

In 2015 the income of the Bank, calculated as the sum of net interest income, net fee and commission income, net trading income, other operating income and other operating expenses, amounted to PLN 114 147 thousand (2014: PLN 101 569 thousand). This income pertains in whole to the activity conducted within the Republic of Poland.

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

Profit and loss account	Period from 01.01.2015 to 31.12.2015	Period from 01.01.2014 to 31.12.2014	Dynamics
Net interest income	110 762	86 183	28.52%
Net fee and commission income	6 529	4 046	61.35%
Net trading income	-434	12 292	-103.53%
Net impairment write-downs on loans and advances	-24 775	-20 945	18.29%
Overhead costs	-57 876	-46 839	23.56%
Amortisation and depreciation	-4 699	-4 310	9.03%
Gross profit	26 797	29 475	-9.09%
Net profit	18 791	22 371	-16.00%
Weighted average number of ordinary shares / weighted average diluted number of ordinary shares	2 909 068	2 759 589	5.42%
Net profit per ordinary share / Diluted profit per ordinary share (in PLN)	6.46	8.11	-20.35%

Table 3. Effectiveness ratios

PERFORMANCE INDICATORS	31.12.2015	31.12.2014
ROA net <sup>1)</sup>	0.26%	0.43%
ROA gross <sup>1)</sup>	0.37%	0.57%
ROE net <sup>3)</sup>	2.74%	4.34%
ROE gross <sup>4)</sup>	3.91%	5.72%
Cost to income ratio (C/I) <sup>5)</sup>	54.82%	50.36%
Net interest margin <sup>6)</sup>	1.55%	1.69%
Cost of risk <sup>7)</sup>	0.39%	0.47%
Capital adequacy ratio	13.81%	13.31%
<b>RATINGI Fitch Ratings Ltd</b>		
long-term international rating	BBB-	A
short-term international rating	F3	F1
support rating	2	1
public sector covered bonds	BBB	A
mortgage covered bonds	BBB	A
<b>OTHER</b>		
Employment	222 employees / 212 FTE's	207 employees / 193 FTE's
Average employment	218 employees / 207 FTE's	187 employees / 175 FTE's
Facilities	Headquarters + 6 branches	Headquarters + 6 branches

1) net result / average assets

2) gross result / average assets

3) net result / average equity

4) gross result / average equity

5) (overhead costs + amortisation and depreciation) / result on banking operations (defined as operating result less overhead costs, amortisation and depreciation and net write-downs for impairment of credits and loans)

6) interest income / average assets

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

Average balance sheet amounts were calculated based on the most recent 13 months, that is considering the opening and closing balance of the reporting period.

Chart 1. Key financial ratios

■ 12.2014 ■ 12.2015

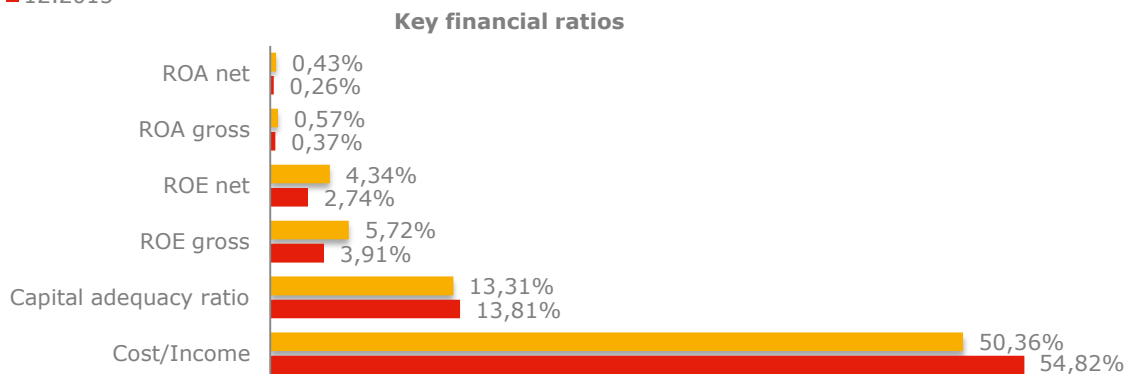
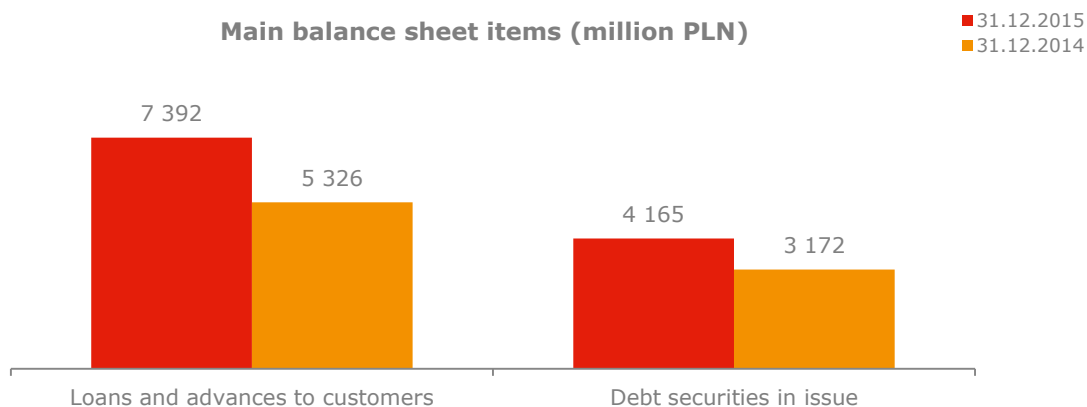


Chart 2. Main balance sheet items (in PLN million)



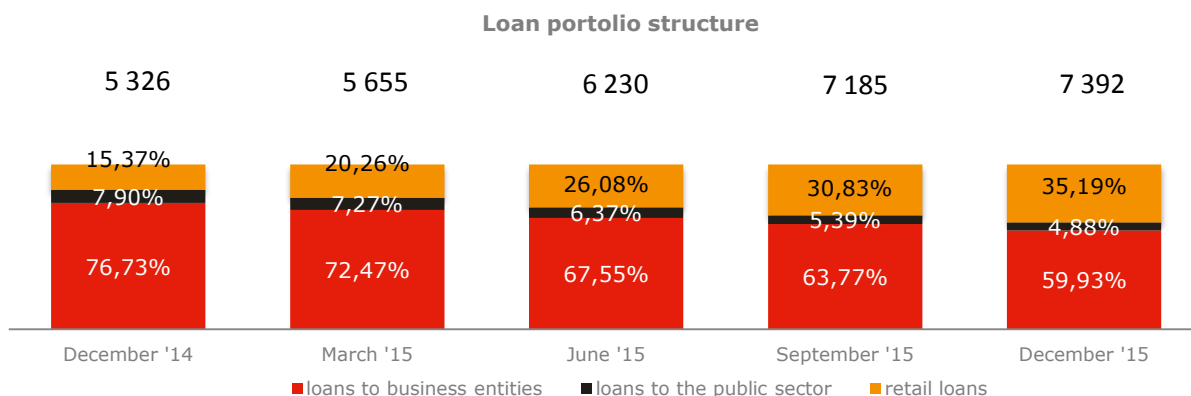
## 1.4 Lending

In 2015 the Bank developed its activity in both corporate and retail loan areas. The value of sales reached PLN 3,545 million and was higher by 47.3% than the value of agreements signed in 2014. The net value of the whole loans portfolio, taking into account "pooling" transactions and off-balance sheet liabilities, has increased by the end of 2015 compared to the end of 2014 by 30.8%, reaching PLN 8.4 billion.

Commercial sales in 2015 reached PLN 1,619.5 million, which means an increase of 2.5% in relation to 2014. The new portfolio takes into account receivables acquired from mBank of total value PLN 218.5 million. The share of financing of commercial real estate increased slightly and by the end of 2015 they constituted 63.4% of sales. 36.6% accounted for financing of residential real property.

In the retail area, within the scope of implementation of the strategy of the mBank Group, the Bank recorded nearly two times higher than in 2014 value of mortgage sales for retail clients, reaching the value of PLN 1,925.6 million. Sales of credits in the agency model (newly signed agreements of total value of PLN 1,456.9 million) was supplemented with a pooling model, in the scope of which the Bank acquires mortgages granted by mBank that can constitute the basis for issuing of covered bonds (PLN 468.7 million in 2015, in four tranches).

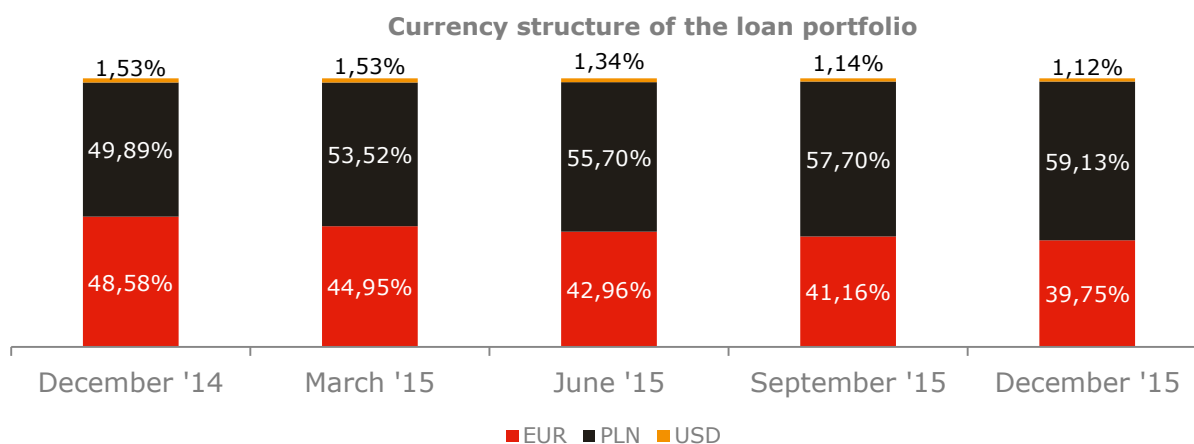
Chart 3. The structure of the loan portfolio in the period 31.12.2014 – 31.12.2015 (in PLN million)



The currency structure of the loan portfolio in 2015 was subject to change due to systematic growth of retail credit portfolio granted in PLN only. Compared with the state by the end of 2014, the share of PLN loans increased by 9.2 percentage points by the end of December 2015. They constituted nearly 60% of the loan portfolio. The share of EUR loans decreased to the level of 39.75%.

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

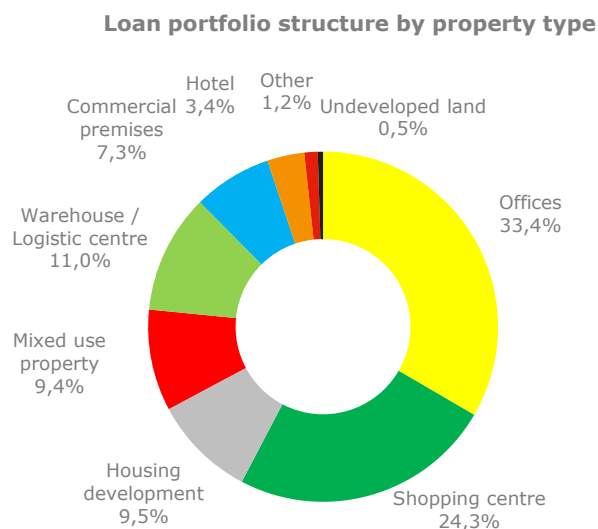
Chart 4. The currency structure of the loan portfolio in the period 31.12.2014 – 31.12.2015



### Corporate loans

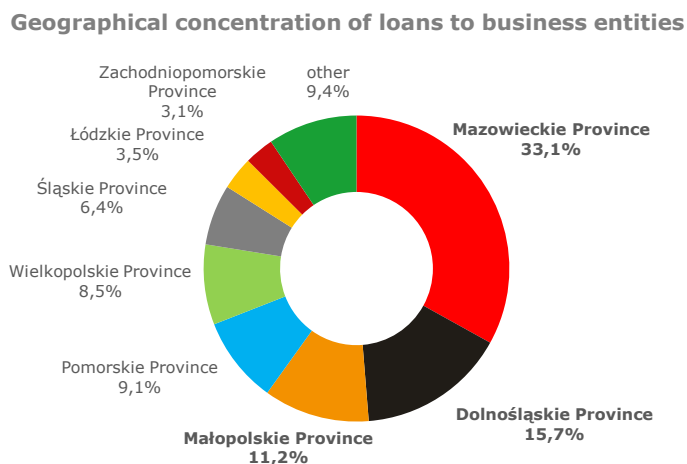
Net balance sheet exposure to business entities as of 31 December 2015 amounted to PLN 4,429.6 million. The dominant part (84.9%) accounted for refinancing of completed commercial facilities, the exposure in housing projects constituted 10.1%, and credits for financing of construction of commercial objects - 4.5%.

Chart 5. Corporate loans by type of financed real estate as of 31 December 2015



As of December 2015, in the area of commercial real estates the Bank financed in particular: office buildings and shopping centres. The Bank focused on financing of the purchase or refinancing of completed facilities of appropriate standard and financing of the construction process upon the completion of which the construction loan is converted into a long-term mortgage.

Chart 6. Geographical concentration of loan portfolio for business entities as of 31 December 2015



The largest number of financed projects is concentrated in Mazowieckie province, where 33.1% of all credit resources is involved. In Dolnośląskie, Małopolskie and Pomorskie province the total balance sheet exposure accounts for 36%.

As of 31 December 2015 loans granted in EUR (65.9%) and PLN (32.3%) dominated the corporate loans portfolio.

### Public sector loans

Due to the strategy of the Bank the portfolio does not contain new agreements, which in connection with significant prepayments is reflected in a lower, as compared to 31 December 2014, balance sheet exposure to public sector. As at 31 December 2015 the exposure was PLN 361 million (down by 14.2%)

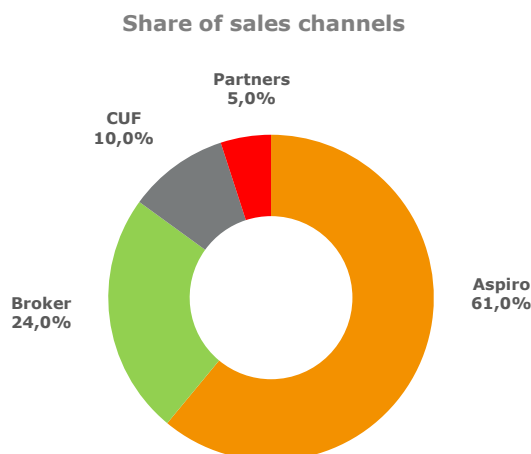
**Retail loans to natural persons**

In 2015 the Bank continued the implementation of strategic objectives in the area of mortgage loans to natural persons in cooperation with mBank S.A. In the first half of 2015 the Bank took measures aimed at the development of the share of sales of external channels, outside the mBank group, through improvement of the quality process. The scope of the above mentioned measures covers the Bank's development of professional support group for brokers and improvement of the application and communication process in the area of the so called outside facility circulation (sales channels from outside the mBank group).

Additionally to the development of the client acquisition channels, in 2015 the legal environment of the mortgage banking market was also subjected to changes which significantly influence the ability of increasing the lending scale by mortgage banks. Within the scope of amendment to the Act on Covered Bonds and Mortgage Banks the requirements regarding the establishment of security in case of crediting of premises on the primary market changed, which from January 2016 allows for active crediting of premises on the primary market by mortgage banks.

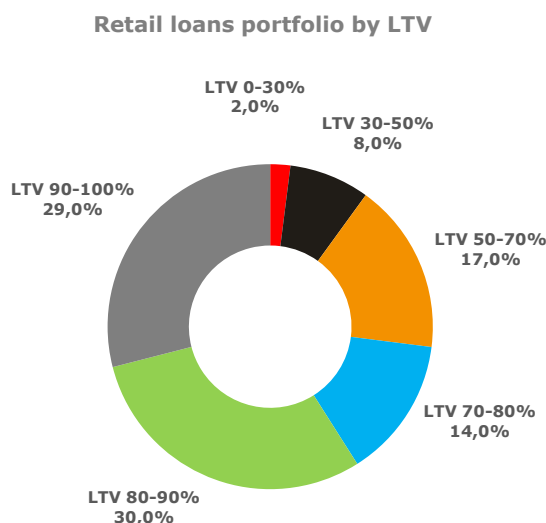
In connection with the planned amendment of the Act, in the second half of 2015 the Bank took measures aimed at the development of cooperation with credited developers within the scope of commercial activity. The new scope of cooperation aims at increasing the crediting scale for natural persons acquiring the premises of developers, whose investments were credited by the Bank.

Chart 7. The share of sales channels in 2015.



The volume of loans disbursed in 2015 amounted to PLN 1,457 million. The average loan amount was PLN 289 thousand. The volume-weighted average margin for the portfolio acquired in 2015 was 1.55%. The average commission weighted by the amount of credit agreement for loans disbursed in 2015 was 0.4%. Loans with LTV of 80-90% and clients' verified net income of PLN 8 thousand constituted the largest share in the sales.

Chart 8. Sales structure in 2015 divided into LTV limits.



### 1.5 Refinancing and issuing of covered bonds

In 2015 mBank Hipoteczny placed seven issues of mortgage covered bonds on the market. The total nominal value of the new issues as of 31 December 2015 amounted to approximately PLN 1,550 million.

The value of four issues in the national currency - including the record issue of PLN 500 million in September 2015 - amounted to PLN 1,205 million. The Bank also issued three series of mortgage bonds denominated in EUR for the amount of EUR 81 million.

The value of all outstanding covered bonds issued by the Bank as at the end of 2015 amounted to over PLN 4 billion, which according to the Bank's estimates constitutes over 75% of the market of these securities in Poland.

Covered bonds of mBank Hipoteczny are instruments characterised by a low level of investment risk as a result of statutory requirement of multi-stage collateral for the issuing and trade. It is confirmed by a rating of BBB granted by Fitch Ratings Ltd. to the mortgage and public sector covered bonds issued by the Bank.

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

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

Issue date	Redemption date	Currency	Value	Rating Fitch Ratings Ltd.
28.04.2011	20.04.2016	PLN	200 000 000	BBB
15.06.2011	16.06.2017	PLN	200 000 000	BBB
20.04.2012	20.04.2017	PLN	200 000 000	BBB
15.06.2012	15.06.2018	PLN	200 000 000	BBB
30.11.2012	15.11.2016	PLN	100 000 000	BBB
20.06.2013	21.06.2019	PLN	80 000 000	BBB
28.07.2014	28.07.2022	PLN	300 000 000	BBB
04.08.2014	20.02.2023	PLN	200 000 000	BBB
20.02.2015	28.04.2022	PLN	200 000 000	BBB
15.04.2015	16.10.2023	PLN	250 000 000	BBB
17.09.2015	10.09.2020	PLN	500 000 000	BBB
02.12.2015	20.09.2021	PLN	255 000 000	BBB
<b>TOTAL</b>		<b>PLN</b>	<b>2 685 000 000</b>	

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Issue date	Redemption date	Currency	Value	Rating Fitch Ratings Ltd.
19.10.2012	19.10.2017	EUR	10 000 000	BBB
26.07.2013	28.07.2020	EUR	30 000 000	BBB
22.11.2013	22.10.2018	EUR	50 000 000	BBB
17.02.2014	15.02.2018	EUR	7 500 000	BBB
28.02.2014	28.02.2029	EUR	8 000 000	BBB
17.03.2014	15.03.2029	EUR	15 000 000	BBB
30.05.2014	30.05.2029	EUR	20 000 000	BBB
22.10.2014	22.10.2018	EUR	20 000 000	BBB
28.11.2014	15.10.2019	EUR	50 000 000	BBB
25.02.2015	25.02.2022	EUR	20 000 000	BBB
24.04.2015	24.04.2025	EUR	11 000 000	BBB
24.06.2015	24.06.2020	EUR	50 000 000	BBB
<b>TOTAL</b>		<b>EUR</b>	<b>291 500 000</b>	

**Issues of public sector covered bonds of mBank Hipoteczny S.A. in the public offering**

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

Issue date	Redemption date	Currency	Value	Rating Fitch Ratings Ltd.
28.09.2012	28.09.2016	PLN	150 000 000	BBB
<b>TOTAL</b>		<b>PLN</b>	<b>150 000 000</b>	

**The basis for issuing of covered bonds**

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

Public sector covered bonds are secured by receivables from loans granted to local government units and loans secured by a guarantee issued by those units.

As of 31 December 2015 the collateral of:

- public sector covered bonds consisted of receivables of value PLN 361.9 million from total number of 61 loans,
- mortgage covered bonds consisted of receivables of value PLN 5,403.8 million from total number of 7,896 loans,

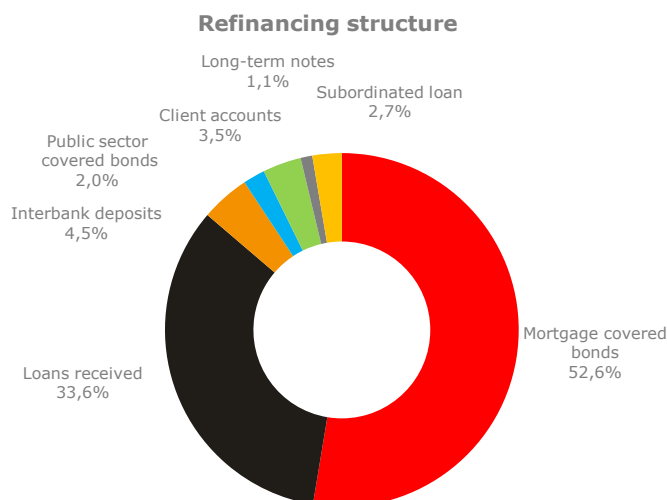
Loans for commercial clients constituted 66.43% and for retail clients 33.57% of the total amount of receivables entered into the mortgage cover register. Loans granted in PLN (53.03%) dominated, loans in EUR (45.45%) and USD (1.52%) constituted the remaining part.

Additionally to the credit receivables, the additional collateral in a form of treasury bonds of nominal value of PLN 60 million (for mortgage covered bonds) and PLN 6 million (for public sector covered bonds) was also entered into the cover register.

As of 31 December 2015 the level of over-collateralisation of mortgage covered bonds amounted to 39.13% and 145.27% in case of public sector covered bonds (including substitute cover).

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

Chart 8. The structure of refinancing of the Bank activity as of 31 December 2015



## 1.6 Legal environment

On 24 July 2015 new law was enacted amending the Act on Covered Bonds and Mortgage Banks as well as certain other acts, which significantly improves the legal framework of mortgage banking in particular through enhanced safety of mortgage banks' activity and improved rights of investors acquiring covered bonds.

Key changes include:

- 1) changes in principles of mortgage banks' activity, involving:
  - statutory 10% over-collateralisation for covered bonds in the form of assets entered into cover register,
  - statutory collateral for 6-month's interest payments on covered bonds in the form of assets entered into cover register which do not constitute the basis for covered bonds issue,
  - banks' obligation to run coverage and liquidity tests to verify if the assets in the cover register for covered bonds are still sufficient for full satisfaction of the covered bond holders,
  - cover pool monitor's obligation to notify KNF on negative test results to guarantee prompt reaction of the regulator,
  - limitation to premature redemption of covered bonds to instances where it is necessary for ensuring compliance with existing limits but also to instances where issue conditions allow for such premature redemption,
  - raised limit of refinancing of loans secured on residential real property with covered bonds, from 60% to 80% of the mortgage lending value of such property;
- 2) changes in the procedure and principles of mortgage banks' bankruptcy proceedings, involving:
  - detailed regulations on bankruptcy proceedings, dedicated to mortgage banks as well as all stages of such proceedings and competences of participants,
  - obligation imposed on an administrative receiver to run coverage tests and possible also liquidity tests the results of which would indicate the procedures to be adopted for the bankruptcy proceedings,
  - initial delay of covered bonds' redemption date by 1 year relative to the original redemption date (basic procedure if both tests' results are positive),

- introduction of pass-through procedure in case of a negative outcome of any of the tests, meaning that the covered bonds' redemption date is delayed however interest payments and, if possible, early redemptions are to be made during that time,
  - improved rights of investors in case of bankruptcy, through the right granted to covered bonds' holders to decide on specific bankruptcy procedure in each case, including a procedure for liquidation of a bankruptcy,
  - regulation on calculation of interest on covered bonds,
- 3) necessary changes in tax legislation:
- covered bonds' investors exemption from withholding tax,
  - equal tax treatment of loans acquired by a mortgage bank with loans granted by the bank (such as provisions being tax deductible costs for banks);
- 4) limit for investing in covered bonds by pension funds increased to 5%.

The above mentioned amendments came into force on 1 January 2016. On 30 December 2015 the Minister of Finance issued executive (detailed) regulations to the Act, that is the Ordinance on maintaining cover account for covered bonds and running coverage and liquidity tests.

In July 2015 also regulator's recommendations for mortgage banks changed: Recommendation F relating to the core criteria applied by KNF in approving mortgage banks' regulations used to determine the mortgage lending value of properties as well as Recommendation K on the principles of covered bonds' cover registers held by mortgage banks. The latter was amended also in February 2016 in order to adapt it to the new wording of the Act.

## **2. Risk management**

### **2.1 Credit risk**

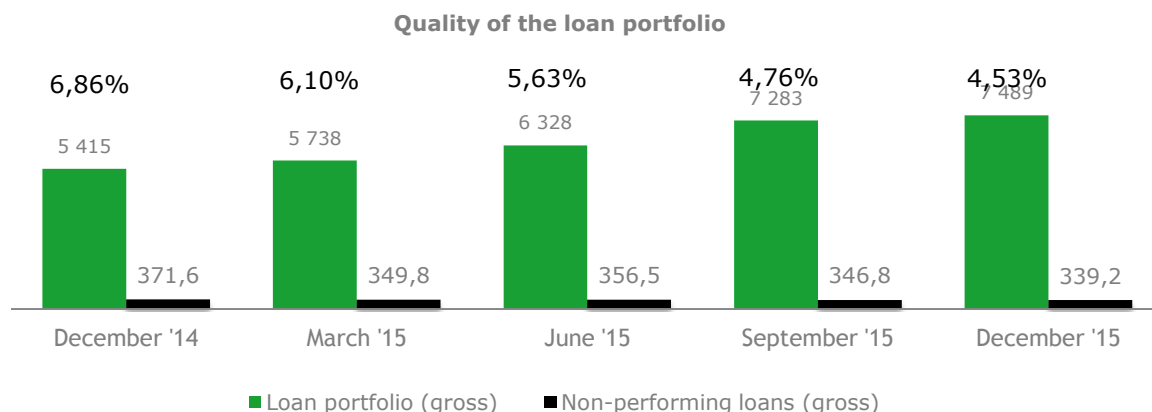
#### **Loan portfolio**

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

Due to the actions undertaken by the Bank within the scope of problem loans management and as a result of increasing of the loan portfolio, the share of non-performing loans in the loan portfolio decreased to the level of 4.53%. Most of the loans are repaid in a timely manner, and the borrowers of higher risk profile are subjected to a more strict monitoring. The net value of the loan portfolio in 2015 increased in relation to the end of 2014 by PLN 2.06 billion, which resulted mainly from the increase of the retail portfolio (agency loans and retail pooling).

Impairment provisions reaching PLN 97.4 million together with mortgages on the financed real estates constitute an appropriate security against potential losses resulting from credit risk.

Chart 9. The share of non-performing loans\* in the loan portfolio (gross value, in PLN million)



\*non-performing loans - loans for which a loss event has been identified – in accordance with IAS 39

The main area of activity of the Bank in 2015 was refinancing of commercial real estates, especially shopping centres and offices. This activity is based on a uniform for the whole mBank SA group commercial real estate financing policy, including key elements of acceptance policy for individual segments of the real estate market. Drawing on past experiences in housing investments financing, the Bank continued financing of residential construction projects focusing on selective financing of projects of the most favourable market parameters (e.g. adaptation of the offer to the needs of the market, positive history of the developer's activity, adequate level of own contribution and verified pre-sale).

The retail portfolio is characterised by very high quality, which is clearly affected by, apart from the applied credit policy, the fact that this portfolio is very young, and so far there were only three cases with reported loss of value (in the agency portfolio). Loans for natural persons are monitored monthly for timely repayments and correctness in terms of established effective mortgage collaterals. Realisation of all contractual obligations of the client is verified in the same monitoring period (including insuring of the real estate and assignment of the rights under insurance policies).

### Credit risk management

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

Within the corporate area the Bank plans to cooperate primarily with reliable customers, experienced in given segments of the real estate market (without delays in realisation of liabilities due to the Bank, borrowers who continue cooperation with the Bank on subsequent stages of project implementation, companies with recognised market position).

The priority is to increase the share of loans for purchase or refinancing of existing, new or extensively renovated commercial real estate which have universal purpose and may maintain economic value in a longer term in the total loan sales.

In 2015 the Management Board of the Bank introduced the following changes in the Credit Policy:

- on 11 May 2015 the approach to financing of CRE (commercial real estates) was uniformed. As a result of the introduced changes the Bank indicated preferred directions of acquisition and specified cases of increased risk classified as "exceptions to the policy", "outside of the policy" or excluded from financing regardless of the level on which the credit decision was made.

- on 22 December 2015 the Bank introduced provisions on maximum LTC ratio (Loan to Cost), geographical limitations and substitute investors. The changes aimed to secure the position of the Bank in the view of expected decline in availability of mortgage loans and reduction of the demand for housing in the nearest future, the strive to focus acquisition on large urban centres that ensure relative stability of the demand for housing in the foreseeable period of time, as well as necessity to specify the segment of transactions desired from the point of view of business profitability of Bank's exposure in project's financing.
- in order to limit the concentration risk, on 22 December 2015 the Management Board decided to introduce limits for new exposures, specified on the level of PLN 115 million in the CRE segment and PLN 95 million in the housing developers segment. Granting of a new exposure above the established limit constitutes an "exception to the policy" that requires the decision of the Extended Management Board Credit Committee upon obtaining of mBank Group's Credit Committee recommendation.

In the area of retail loans the Bank aims to acquire affluent customers from previously indicated target group with positively verified relationship with the banking system. The Bank intends to maximise the share of loans secured by typical residential real estates localised on markets characterised by high liquidity.

The Bank attempts to maintain a low level of loss ratio of the portfolio through application of conservative approach to the evaluation of creditworthiness and solvency of the clients. Within this area the Bank plans to base on the best market practices and take benefit from the experience of the parent company by building the foundations of credit policy and decision-making process on proven principles that function in mBank S.A.

The Bank's approach aims to eliminate the currency risk - in case of new transactions the Bank attempts to grant loans only in the currency of the customer's income.

The Bank updated the impairment measurement methodology, in particular in terms of rules of estimating the IBNR reserve. The period of loss identification, so called LIP parameter (Loss Identification Period), used for corporate exposures, was extended from six to eight months. In accordance with expectations of KNF, the Point in Time parameter of the model used to calculate the PD parameter (Probability of Default) was increased. The above changes resulted in an increase of IBNR reserve as at the end of December 2015.

### **Enforcement orders issued by the Bank**

In 2015 the issued 1 enforcement order concerning a commercial loan. The debt on the order amounted to Euro 1 975.8 thousand.

## **2.2 Market risk**

The risk of loss resulting from adverse changes of market parameters from the point of view of the term structure of items in the portfolio of the Bank is maintained as low as possible, which results from the nature of the Bank's activity, properly functioning system of risk limitation and managing of the risk at the operational level.

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

The amount of market risk the Bank is exposed to in the day horizon is determined using Value at Risk (VaR) method at the confidence level of 97.5%. As of end of December 2015 VaR amounted to PLN 100.8 thousand. The currency risk was PLN 17.8 thousand, while the interest rate risk was PLN 83 thousand.

The interest rate risk results from exposure of the financial result and the Bank's capital to adverse effect of interest rates changes. The Bank manages the interest rate gap through matching the repricing dates of assets and liabilities. The sensitivity of the Bank's portfolio to extreme interest rates fluctuations is

determined on the basis of results of stress tests and scenario analyses. The interest rate risk is measured among others by using Earnings At Risk (EaR) ratio, which by the end of December 2015 reached a safe level of 6.56%. The banking books items that are exposed to interest rate risk are hedged with linear interest rate derivatives.

The currency risk is limited through immediate closing the foreign exchange position. The measurement of scale and structure of currency risk is done on the basis of the current foreign exchange position taking into account anticipated repayments and disbursements of loans. The currency risk is limited using foreign exchange position limits for each currency as well as stop loss limit (the limit of the maximum acceptable loss) for an open intra-day position at the end of a given business day, separately for each currency.

### **2.3 Liquidity risk**

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

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

As at the end of December 2015 the liquidity reserves constituted approximately 11.3% of the balance sheet total. The Bank is not exposed to the risk of refinancing in short periods nor the risk of withdrawal of deposits by the largest depositors due to small share of the deposits from non-financial sector in the balance sheet total (3.15%).

In the first half of 2015 financing of Bank's lending was performed primarily through issuing covered bonds in PLN and EUR. The long-term situation of the Bank in terms of liquidity is stable. Loans obtained from mBank S.A. have significant share in financing of long-term receivables.

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

The share of stable financing sources and liquidity reserves adequate to the scale of the Bank's activity determines meeting of long-term liquidity standard M4 required by KNF. The M4 ratio at the end of December 2015 was 1.080. M1 and M2 short-term liquidity standards were maintained at a safe level, PLN 789,930 thousand and 3.243 respectively. The M3 standard was 51.754.

In 2015 the liabilities limit, resulting from Art. 15.2 of the "Act on covered bonds and mortgage banks", was used in 74.1% on average. In 2015 this limit was not exceeded.

At the end of December 2015 average maturity of issued covered bonds was 5.2 of a year for mortgage covered bonds and 0.8 of a year for public sector covered bonds, while the average maturity of contracted long-term deposits and loans obtained from other banks was 4.0 of a year. The margin of mortgage covered bonds issued in 2015 on average amounted to 0.66%, with average maturity of 6.9 of a year. In 2015 no public sector covered bonds were issued.

### **2.4 Operational risk**

The main factor influencing the operational risk profile in the last period is the effect of changes in the operational activity profile (extension of the scope of activity of the Bank with retail mortgages) and significant scale of activity entrusted to third parties. The Bank adapted its internal procedures and practice in order to ensure a proper control of risk categories associated with those factors. In order to properly manage the risk associated with entrusting activities, a structure that covers business units and compliance unit was implemented. Risk assessments of ordered "outsourcing" processes and risk assessments of entities implementing activities on behalf of the Bank, performed both before establishing cooperation and periodically in the course of cooperation, constitute the primary tool for monitoring of risk level associated with entrusting activities. During risk assessment the Bank takes into

account relative significance of entrusted activities and analyses the risk of failure to perform or improper performance of a service. Those analyses take into account business continuity plans of entities implementing ordered activities and potential possibility of limiting the risk through insurance.

With the introduction of retail lending, mechanisms of detection and operational risk management were launched in this area. The process of fraud detection, mechanisms of registration and analysing errors in transactions and customer complaints were launched. The Bank observes all changes that influence the operational risk profile. So far the collected data do not indicate an increase of operational risk level in the retail banking business line. As the portfolio of loans granted to natural persons develops, the increase of losses in this line may be anticipated, however, due to the nature of conducted activity it should not reach the distribution of the operational risk characteristic for commercial banks. This phenomenon is subjected to constant monitoring. Due to the nature of conducted business, despite increase of the value of retail mortgages portfolio, operational losses still burden mainly the commercial banking business line.

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

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

- numerous changes in the organisational structure,
- number of conducted undertakings and IT projects,
- high turnover of employees,
- changes in the operational activities profile, associated with development of retail mortgages portfolio on the basis of concluded outsourcing agreements in both business area and IT technology.

With the expansion of activity with sales of retail loans the Bank may expect:

- increase of number of complaints and claims of natural persons against the Bank,
- higher number of loan frauds by natural persons.

The Bank will observe and analyse any changes that influence the risk profile.

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

- operational risk management system implemented in the Bank,
- simple organisational structure, no subsidiaries,
- small scale and the degree of complexity resulting from the specificity characteristic for mortgage banks,

- no electronic banking services,
- procedures governing the process of making decisions on entrusting of activities (analysis of benefits, risks and means of their limitation, business continuity plans and insourcer's financial situation as well as the ability to implement services in a timely and qualitative manner).
- Bank's business continuity plans,
- highly qualified staff,
- efficient internal control system.

## **2.5 Covered bonds investment risk**

In 2015 the investment risk profile associated with covered bonds issued by mBank Hipoteczny did not change. Those securities are a financial instrument of a low investment risk, resulting from the requirements of multi-stage collateralisation of their issuing and trade by the issuer, accordant with the Act on covered bonds and mortgage banks. In addition to compliance with a number of statutory requirements during economic slowdown, high safety of investing in covered bonds is also a result of the Bank's conservative policy of valuation of real estates constitute their collateral, which has been applied for many years. According to the amended Act on covered bonds and mortgage banks, the minimum level of over-collateralisation of mortgage and public sector covered bonds since 1 January 2016 is 10%. The increase of investment attractiveness of such securities also results from the fact that covered bonds issued by mortgage banks may constitute a collateral for a lombard loan as well as repurchase transactions conducted with other banks.

## **2.6 Internal control system**

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

- 1) **control function** - aimed at ensuring compliance with mechanisms, in particular related to the Bank's risk management system. Internal control mechanisms constitute an integral part of the Bank's daily activities. These include:
- 2) **Compliance Department** - a compliance department whose task is to identify, assess, control and monitor the risk of the Bank's non-compliance with the provisions of law, internal regulations and market standards as well as submission of reports in this regard.

The Bank's aim in the scope of non-compliance risk management is avoiding of potential financial losses, legal sanctions, deterioration of the Bank's reputation as a result of non-compliance with law, recommendations and guidelines of supervisory authorities as well as adopted standards of conduct.

The scope of activities of the Compliance Department covers in particular:

- complex monitoring and coordination of non-compliance risk management of the Bank, including development and verification of non-compliance risk management mechanisms
- implementation of tasks regarding:
  - anti-money laundering and counter-terrorist financing
  - protection of personal data
  - banking outsourcing
  - preventing conflicts of interest, fraud and corruption
  - supervision over the process of handling of client's complaints.

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

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

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

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

## **2.7 Remuneration policy**

The Bank runs a remuneration scheme for the Bank's Management Board and employees with significant influence on Bank's risk profile, based on phantom shares settled in cash; the scheme is further referred to as the "Policy". These benefits are accounted for in accordance with IAS 19 "Employee benefits". Phantom share valuation is debited to relevant period expenses with a credit to liabilities. Costs are recognised over time during the period of the right to benefits and included in "General administrative expenses". Allocation of phantom shares results from their valuation for the assessment period. Phantom shares valuation is calculated always as at the end of a reporting period by dividing Bank's book value over the number of ordinary shares. Scheme details are presented in Note 42 to the Financial Statements.

## **3. Real estate market in Poland in 2015**

### **Housing market<sup>1</sup>**

- Transaction prices of apartments on primary and secondary markets in the largest cities of Poland showed only slight changes. Average quarter-on-quarter change of transaction prices for 1 m<sup>2</sup> on the primary market was approximately 2.7%, while on the secondary market the prices remained stable.
- Low mortgage rates along with maintenance of low interest rates and margins supported the housing demand.
- The amendment of the MdM (Apartments for the Young) programme in Q3 2015 changed the functioning of the housing market. The programme covered transactions concluded on the secondary market, the pro-family influence of the programme was increased through financing of own contribution and allowing for signing of a credit agreement with a borrower of any person.
- Indicators of housing construction in comparison to 2015 showed an increase. The number of apartments released for use increased by approximately 3.2% YoY, the number of apartments whose construction started increased by approximately 13.7% YoY, while the number of apartments for the construction of which building permits were issued increased by approximately 20.5% YoY.
- For developers the past four quarters proved to be beneficial. The number of transactions counted for a total of six markets in Q4 2015 reached a record level and amounted to nearly 14.4 thousand apartments. As a result, in the last four quarters nearly 51.8 thousand residential

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<sup>1</sup> Analysis of the housing market relates to 6 main cities: Warsaw, Kraków, Łódź, Wrocław, Poznań, Gdańsk.

premises were sold on the primary market, i.e. nearly 20% more than in the whole record 2014, when this value amounted to 43 thousand.

- In Q4 almost 11.4 thousand apartments were put on the market (down by approximately 28% q/q). In total, in the last four quarters approximately 51.9 thousand residential premises were placed on the market (up by 9.2% y/y).
- Despite good sales the residential premises offer on the primary market increased by nearly 1,7 thousand and at the end of 2015 amounted to 48.7 thousand apartments (up by 3.6% y/y). Largest increase was recorded in Poznań (16.1% y/y), Kraków (9.1% y/y) and Wrocław (4.2% y/y). In Warsaw the dynamics on the primary market remained unchanged, reduction in apartments available on this market took place in Łódź (approximately 5.1% y/y) and Trójmiasto (1.1% y/y).
- The high level of sales significantly influenced the change of the structure of the offer available on the primary housing market, especially in terms of sales of ready apartments. At the end of Q4 2015, apartments completed in 2014 which previously constituted approximately 7% of developer's offer, 12% of the offer are apartments with planned completion in 2015, approximately 43% of the projects will be completed in 2016, and 38% after 2016.
- The time needed to sell all apartments from the offer, with the current rate of sales, remained stable in the majority of analysed cities and amounted to 4 to 5 quarters. The only exception was Trójmiasto, where a clear dominance of demand over supply can be observed, and average time of sales was 3.2 of a quarter, i.e. two months faster than at the end of June 2015. We may therefore speak about relatively safe level of demand, provided that the current rate of sales will be maintained.
- Availability of an apartment for average remuneration in the majority of analysed cities remained stable, and decreased only in Poznań.

### **Commercial real estate market**

- The volume of transactions concluded in 2015 on the commercial real estate market amounted to approximately EUR 4 billion.
- The largest contribution to the total volume of transactions belonged to the commercial sector, of approximately 57%, followed by office sector with approximately 31% with warehouse sector contributing merely 11% of the total volume.
- Capitalisation rates compression for the best assets can be observed on markets. Capitalisation rates for real estates of the "prime" type on the office market vary between 6-6.5%, approximately 6% on the commercial sector, and approximately 7% on the warehouse market.

### **Office real property<sup>2</sup>**

- Warsaw remains the largest office market in Poland, complete resources at the end of Q4 2015 increased by further 278 thousand m<sup>2</sup> and amounted to nearly 4.6 million m<sup>2</sup> of surface area;
- Suspension of implementation of new investments is observable in the capital, during 12 months only approximately 102 thousand m<sup>2</sup> of office surface area was initiated, which constituted approximately 27% of the volume commenced in the same period of 2014.
- High level of new space currently under construction (approximately 1.2 million m<sup>2</sup> in major centres in Poland) may be reflected in increased coefficient of vacant spaces in 2016. Older offices (of the B class) and those of worse location will be particularly exposed to declines.
- Total volume of rental agreements signed in the capital in 2015 amounted to approximately 829 thousand m<sup>2</sup> and was comparable to the result recorded in the whole 2014;

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<sup>2</sup> Analysis of the office market relates to 7 main cities: Warsaw, Kraków, Łódź, Wrocław, Poznań, Gdańsk, Katowice.

- A positive trend on the demand side was recorded in regional markets, since the beginning of the year 549 thousand m<sup>2</sup> was rented, 36% more compared to the entire 2014;
- The asking price for space to lease remained stable. Developers are still highly flexible as far as negotiations of lease terms other than rent are concerned, such as participation in refurbishment costs or rent-free periods.

### **Retail real property**

- Total resources of retail space in Poland increased in 2015 by additional 650 thousand m<sup>2</sup> and amounted to 13.2 million m<sup>2</sup>.
- The highest growth of new supply was recorded in medium-sized cities, where nearly 35% of new space was realised.
- Among the largest projects opened in the analysed period are Sukcesja in Łódź (48 thousand m<sup>2</sup>), Tarasy Zamkowe in Lublin (38 thousand m<sup>2</sup>), Galeria Neptun in Starogard Gdański (25 thousand m<sup>2</sup>) and Supersam in Katowice (20 thousand m<sup>2</sup>).
- The trend of remodelling, re-commercialisation and expansion of older commercial facilities in order to adapt them to current conditions prevailing on the market is still maintained.
- Total surface of expanded parts of commercial facilities amounted to approximately 25% of the new supply implemented during the year.
- The largest facilities, which surface area was increased in 2015, are: Ogrody in Elbląg (22.5 thousand m<sup>2</sup>), Magnolia Park in Wrocław (20 thousand m<sup>2</sup>), Galeria Sudecka in Jelenia Góra (18.5 thousand m<sup>2</sup>) and Wola Park in Warsaw (17.6 thousand m<sup>2</sup>).
- At the end of 2015 approximately 700 thousand m<sup>2</sup> of new commercial space was under construction.
- The increase in popularity of projects of mixed-use type, which connect not only commercial, but also office and cultural functions.
- Retail parks or small commercial facilities, so called strip mall, are popular in small cities.
- In recent months no significant changes in the amount of rent prices for commercial spaces were recorded. Warsaw, in which the "prime" rents for the best premises of surfaces of up to 100 m<sup>2</sup> in the most prestigious commercial centres exceed 100 EUR/m<sup>2</sup>/month, remains the most expensive location.
- The vacancy rate remains low.

### **Warehouse space**

- Total resources of warehouse space in Poland increased at the end of 2015 by additional 970 thousand m<sup>2</sup> and amounted to 9.77 million m<sup>2</sup>.
- The highest amount of new warehouse spaces was recorded in Poznań (278 thousand m<sup>2</sup>), Upper Silesia (140 thousand m<sup>2</sup>) and in the north of Poland (136 thousand m<sup>2</sup>).
- Developers' activity remains high - currently 774 thousand m<sup>2</sup> is on the phase of implementation in the entire Poland.
- Over half of existing supply is still owned by four main market players, i.e. Prologis, SEGRO, Logisor, Goodman and their partners.
- Once again the share of speculative projects has increased - previously not secured with lease agreements (currently amounting to 35% of supply under construction).
- Projects for specific buyers (of pre-let and BTS type) continue to dominate.

- Growing popularity of small formats that connect office functions with warehouse space is noticeable.
- Tenant demand for warehouse space was focused in three regions generating nearly 61% of the total gross demand, i.e. in Central Poland (22%), areas surrounding Warsaw (25%) and Upper Silesia (15%);
- Vacancy rate decreased to record low levels. The highest vacancy rate is present on mature markets, i.e. Warsaw and its region and Upper Silesia (approximately 8%).

#### **4. Directions of development and key elements of the Bank strategy**

The mission of mBank Hipoteczny is to develop effective real property market financing through issuing long-term debt securities - covered bonds.

The Bank's vision is safe, sustained, profitable and long-term growth that leads to maintaining strong leading position on the changing and increasingly demanding covered bonds market through the best use of 15-year experience, specialist expertise and potential of the mBank brand, as well as reinforcement of the Bank's position on the growing market of commercial and housing real property financing.

In June 2015 the Bank adopted update of the strategy for subsequent years (2016-2019). Key directions of development and strategic objectives specified in the previous version of the document dated 2013 remain valid.

The business strategy formulates two main strategic objectives for the Bank in the years 2016-2019:

- building of the largest possible portfolio of real estate assets within the scope of applicable risk management strategy, which meet the collateral criteria of covered bonds,
- maximum use of covered bonds as a tool for refinancing of the portfolio of long-term mortgages.

Since 2013 the Bank has been implementing a strategic project based on cooperation with mBank in terms of development and refinancing of retail portfolio through issuing covered bonds (the agency model). In September 2013 the Bank launched mortgage lending to natural persons via mBank sales network. It applies to loans that meet the criteria of entering into the cover register for mortgage bonds and potentially constitute the basis for their issuing. In Q3 2014 the development of retail loan portfolio was additionally supported through implementation of the pooling model, which consists in acquisition of already existing retail mortgage portfolio of mBank. The first transactions of this type took place in September and October 2014.

In 2015 the Bank continued actions consisting in development of the new retail mortgages portfolio acquired in cooperation with mBank, improvement of the loan process, acquisition of retail loans portfolio from mBank within the pooling model (four subsequent pooling transactions) and refinancing of this portfolio through issuing covered bonds. Additionally, 5 loans were transferred in 2015 as part of the commercial pooling.

#### **Strategy of sales of loans for commercial real property**

In the years 2016-2019 the Bank will gradually limit financing projects with value below PLN 10 million and will focus on financing projects with value exceeding PLN 10 million (including the limit on derivative transactions) and falling below the limit of credit concentration (currently EUR 35 million). The priority of the Bank will be financing of commercial real estate of low investment risk, characterised by a high standard, located in large and medium urban centres, while in the smaller ones only in case of prime locations. The Bank will be in particular financing real property from the following segments:

- office facilities,
- storage facilities,
- retail and service facilities.

Refinancing or financing of transactions of purchasing of completed, commercialised objects will constitute the main sales objective.

Secondly, the Bank will focus on acquisition of clients from the area of commercial developers. After completion of construction phase those loans will be converted into long-term refinancing loans.

Additionally, in the years 2016-2019, drawing on past experiences in financing of housing investments, the Bank will continue crediting of housing developers' projects. Loans will be offered to successful and experienced developers with market knowledge, practice and well prepared projects adapted to the market needs. Above all the Bank will continue cooperation with developers with whom it successfully implemented housing projects in the past.

### **Retail lending strategy**

Through implementation of the strategy for the years 2016-2019 mBank Hipoteczny will develop activity in the retail area in the scope of development of mortgage loans portfolio to natural persons, both through sales of new credits and transfer of existing loan portfolio from mBank and its refinancing with covered bonds.

The Bank will draw on its past experiences and experience of mBank Group on this market, following criteria that qualify loans for issuing of covered bonds. The mBank Group will aspire to increase the share in financing of market of mortgage loans for natural persons to approximately 10% in 2019.

### **Refinancing strategy of mBank Hipoteczny**

The activity of mBank Hipoteczny in the years 2016-2019 will be financed from six main sources:

- covered bonds, including
  - secured with retail mortgages (in PLN),
  - secured with commercial mortgages (in PLN, EUR),
- own bonds,
- long-term credit lines (in PLN, EUR),
- term and current deposits,
- subordinated loan obtained from mBank S.A.,
- equity.

By increasing balance sheet total in the following years, mBank Hipoteczny will strive to build a structure of assets which within applicable law regulations will allow for issuing of the greatest possible volume of covered bonds.

Issues in PLN and denominated in EUR are planned. According to current practice the maturity dates of particular trenches will in particular be in the range of 5-10 years.

## **5. Bank Authorities**

### **Shareholders**

Total number of ordinary shares as of 31 December 2015 amounted to 2,990,000 shares (31 December 2014: 2 850 000 shares) with nominal value of PLN 100 per share (31 December 2014: PLN 100 each). The increase of number of shares in 2015 took place due to the Bank's private placement without pre-emptive rights of 100,000 ordinary registered shares of nominal value of each share of PLN 100 on the basis of resolution no. 1 of the extraordinary general meeting of shareholders which took place on 24 July 2015. On 19 August 2015 new equity increased as a result of new issuing was entered into the National Court Register.

**mBank Hipoteczny S.A.****Management Board Report on the Performance of the Bank in 2015**

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

As MLV 45 sp. z o. o. spółka komandytowa ceased its activity, mBank reorganised the mBank Group. Consequently, on 10 September 2015 an agreement on transfer of shares between MLV spółka z ograniczoną odpowiedzialnością spółka komandytowa in liquidation and mBank S.A. was concluded on the basis on which all shares held by MLV 45 sp. z o. o. spółka komandytowa in liquidation, in total 2 082 143 registered shares of mBank Hipoteczny S.A. of nominal value of PLN 100 each, constituting 69.63% of share capital, were purchased by mBank S.A.

As of 31 December 2015 the ownership structure of registered share capital of the Bank is as follows:

Name of shareholder	Registered share capital in PLN thousand	Shares		Votes at the General Meeting of Shareholders	
		Amount in thousands	%	Amount in thousand shares	%
mBank S.A.	299 000 000	2 990 000	100.00	2 990 000	100.00
<b>Total</b>	<b>299 000 000</b>	<b>2 990 000</b>	<b>100.00</b>	<b>2 990 000</b>	<b>100.00</b>

The Bank does not collaborate with international public institutions.

**Management Board**

As at 31 December 2015 the Management Board of mBank Hipoteczny included the following members:

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

Mr Grzegorz Trawiński was appointed member of the Management Board on 31 March 2015.

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

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

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

The Management Board of the Bank manages the Bank's operations and represents it, including making decisions on issuing of covered bonds and bonds, deciding on the volume of issues in the scope of operational strategy and annual financial plans approved by the Supervisory Board. The scope of activities of the Management Board of the Bank covers all matters not reserved to the competence of other authorities of the Bank, under the articles of association or provisions of law.

**Rules on amending articles of association**

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

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

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

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

### **Supervisory Board**

Composition of mBank Hipoteczny S.A. Supervisory Board as at 31 December 2015:

- Hans-Dieter Kemler – Supervisory Board Chairman (from 28.09.2015)
- Lidia Jabłowska-Luba - Supervisory Board Vice-Chairman (from 28.09.2015)
- Joerg Hessenmueller – Supervisory Board Member
- Cezary Kocik – Supervisory Board Chairman
- Michał Popiołek - Supervisory Board Member
- Dariusz Solski – Supervisory Board Member
- Mariusz Tokarski – Supervisory Board Member

The Supervisory Board in the above composition, excluding Mr Mariusz Tokarski, was appointed for the ninth term on the day of 11 April 2014 by the Annual General Meeting of mBank Hipoteczny S.A. Mr Mariusz Tokarski was appointed member of the Supervisory Board on 3 July 2014, and on 16 July 2014 also became a member of the Audit Committee.

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

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

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

### **Audit Committee**

As at 31 December 2015 the Audit Committee included the following members:

- Joerg Hessenmueller – Committee Chairman,
- Hans-Dieter Kemler - Committee Member
- Dariusz Solski - Committee Member
- Mariusz Tokarski - Committee Member

The tasks of the Audit Committee include:

- monitoring the financial reporting process,
- monitoring of the efficiency of the internal control, internal audit and risk management systems,
- monitoring the performance financial audits,
- monitoring of independence of the auditor and the entity authorised to audit financial statements.

In 2015 the Audit Committee debated three times - on 22 April, 28 September and 7 December.

### **Risk Committee**

As at 31 December 2015 the Risk Committee included the following members:

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

The tasks of the Risk Committee include:

- recommending approval or rejection of the Bank's operational strategy and principles of prudent and stable management of the Bank to the Supervisory Board,
- supervision over risk management in the Bank,
- supporting the Supervisory Board in terms of supervision over compliance of the Bank's policy in the scope of risk taking with the strategy and financial plan of the Bank,
- recommending approval or rejection of internal procedures of the Bank related to processes of estimation of equity, capital management and capital planning to the Supervisory Board,
- recommending approval or rejection of transactions between the Bank and members of the Bank's bodies to the Supervisory Board,
- supervision over cooperation of the Bank with Commerzbank AG group in terms of consolidated supervision over risk and exchange of information.

In 2015 the Risk Committee held three meeting - on 27 March, 3 June and 24 November.

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

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

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

- review and approval of the Management Board's report on Bank's activities and financial statements for the previous financial year,
- acknowledgement of the fulfilment of duties by the Bank's authorities (vote of confidence),
- Bank's profit distribution or loss coverage,
- amendments to articles of association,
- appointment and dismissal of members of the Supervisory Board and determination of their remuneration,

- increasing or decreasing Bank's share capital,
- liquidation, disposal of the entire Bank's enterprise or merger (combination) with another bank,
- appointment of receivers and determination of their remuneration,
- any decisions relating to claims for rectification of damages caused during the establishment of the company or during its management or supervision,
- decision on dividend payment date,
- disposal or establishing lien on Bank's real property being the location of Bank's authorities,
- matters submitted by the Supervisory Board,
- matters submitted by shareholders under the procedure provided for by the articles of association,
- other matter reserved under the law or the provisions of the Articles of Association.

## **6. Other information**

### **Loans, deposits and interest rates**

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

### **Transactions with affiliated entities**

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

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

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

On the day of appointing of Members of the Management Board and the Supervisory Board provisions of Art. 22aa that oblige to perform verification of candidates for members of the Management Board and the Supervisory Board were not in force.

Curricula vitae of Members of the Management Board and the Supervisory Board including information about their knowledge and experience, including education, professional career were submitted to the Financial Supervision Authority.

KNF approved the appointment of the Chairman of the Management Board and Member of the Management Board responsible for risk management.

### **Proceedings before a court, arbitration body or public administration authority**

Information on pending proceedings is provided in Note 33 to the Financial Statements

### **Public aid from public funds**

In 2015, the Bank did not received any public subsidies, in particular on the basis of the Act on the Government support for the financial institutions dated February 12, 2009 (Journal of Laws of 2014 item 158).

### **Guarantees and sureties granted by the Bank**

No guarantees or sureties were granted by the Bank in 2015.

### **Events after the balance sheet date**

- KNF decision on appropriation to Tier 2 capital of mBank Hipoteczny S.A. of the value of the funds from the new subordinated loan

The Financial Supervision Authority on 7 January 2016 approved the appropriation of funds in the amount of PLN 100,000 thousand to the Tier 2 capital of the Bank in accordance with terms and conditions of subordinate loan agreement no. 35/2015 dated 12 November 2015 concluded between mBank Hipoteczny S.A. and mBank S.A.

- Collection of receivables from a customer following his bankruptcy

As at 31 December 2015 the Bank had a receivable in the amount of PLN 1 734 thousand on which a 100% impairment write-down was created due to a client's bankruptcy, as disclosed in Note 13. On 7 January 2016, following a court's decision, dated 4 January 2016, on the final plan of distribution of the client's assets, the Bank collected a part of the receivable in the amount of PLN 906.5 thousand.

- Rating change

On 7 March 2016 Fitch Ratings Ltd. (Fitch) upgraded the long term international IDR („Issuer Default Rating”) of mBank Hipoteczny S.A. from „BBB-” (positive outlook) to „BBB” (stable outlook), which resulted directly from improved IDR of Commerzbank AG, upgraded from „BBB” to „BBB+” and of mBank S.A., upgraded from „BBB-” to „BBB”. As a result of the above rating action the short-term international IDR of the Bank was upgraded from „F3” to „F2” and its support rating was confirmed at „2”.

On 7 March 2016 Fitch Ratings Ltd. (Fitch) upgraded the rating for mortgage and public sector covered bonds issued by the Bank from „BBB” (positive outlook) to „BBB+” (positive outlook for mortgage covered bonds, stable outlook for public sector covered bonds).

- Mortgage covered bonds issue

On 9 March 2016 the Bank issued PLN 300 000 thousand 5-year floating-rate mortgage covered bonds.

## **7. Statements of the Management Board**

### **Corporate governance**

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

On 16 December 2014 the Management Board, and on 19 January 2015 the Supervisory Board accepted for application the Principles of Corporate Governance for Supervised Institutions („Principles”), adopted by the Financial Supervision Authority on 22 July 2014, with the exclusion of Principles indicated in § 8 para. 4, §25 para.1, § 29 , §53-57. Principles addressed to the shareholders will be presented during the next General Meeting by the Management Board of mBank Hipoteczny S.A.

### **True and fair picture in the presented reports**

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

- the financial statements and the comparative figures were prepared in compliance with the binding accounting principles and present a true, fair and clear picture of the financial position and the condition of the assets of mBank Hipoteczny as well as its financial performance,

- The report of the Management Board on activities presents a true picture of the situation of mBank Hipoteczny, including a description of the main 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 Department of Financial Reporting in the Department of Accounting and Settlement is responsible for preparation of financial statements in mBank Hipoteczny S.A. Financial accounting and management of standard chart of accounts lies within competencies of the Department of Accounting and Settlement.

#### **Selection of authorised entity**

The entity authorised to audit financial statements, who performs audit of annual financial statement of mBank Hipoteczny was selected in accordance with the law. This entity and auditors met the conditions of expressing an impartial and independent opinion about the audit, in accordance with appropriate provisions of the national law. Information on auditor's remuneration is provided in Note 44 to the Financial Statements.