

**Management Board Report
on the performance of mBank Hipoteczny S.A.
for the first half of 2016**

Table of content

1. Activity of mBank Hipoteczny S.A. in the first half of 2016.....	3
1.1 Key projects of 2016.....	4
1.2 Financial credibility	5
1.3 Financial results	6
1.4 Lending	9
1.5 Refinancing and issuing of covered bonds	13
1.6 Legal environment	15
2. Risk management.....	16
2.1 Credit risk.....	16
2.2 Market risk	18
2.3 Liquidity risk	18
2.4 Operational risk.....	19
2.5 Covered bonds investment risk.....	20
2.6 Internal control system	21
2.7 Remuneration policy	22
3. Real estate market in Poland in the first half of 2016	22
4. Directions of development and key elements of the Bank strategy	25
5. Bank Authorities.....	26
6. Other information	30
7. Statements of the Management Board	32

1. Activity of mBank Hipoteczny S.A. in the first half of 2016

In June 2016, mBank Hipoteczny S.A. (hereinafter the "Bank") reviewed and updated its business strategy assumptions for subsequent years (2016–2019), adopted in 2015. The aim of the update was to align the strategy to changes in legal environment and in the mBank Group's policy. The main directions of development and strategic objectives remain valid.

The Bank continued activities aimed at increasing Bank's effectiveness and dynamics of development, 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. The Bank's objective remains to achieve a secure growth 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. 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 2016-2019. 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 the first half of 2016 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:

- maintenance of increased investor activity in real property trading,
- 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 in the first half of 2016

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 the first half of 2016. 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, one loan was transferred by the Bank in the first half of 2016 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 the internal ratings-based (IRB) approach. It is a task of high priority and long-term nature. In June 2016, the Bank received a final decision on the positive verification of the fulfillment of conditions for portfolios covered with the gradual implementation plan. Following that decision, all internal rating models in the commercial area for specialised lending within real estate financing received an approval of the supervision authority for the application of the IRB method (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.

Intensive works are also aimed at covering the retail portfolio, acquired in cooperation with mBank S.A., with the A-IRB method, on the basis of adaptation of models applied in mBank S.A. Key areas that require major involvement within the project include the verification of proper operation of group models for the Bank's exposures, approach to outsourcing of business services as well as issues from the area of data quality management. The Bank intends to file a pre-validation application in the second half of 2016 and, in the first quarter of 2017, the final Application for the use of statistical methods to calculate capital requirements for credit risk with respect to the retail portfolio acquired in cooperation with mBank S.A.

Implementation of Recommendation W

At the end of June 2016, the Bank has completed most of the works related to the implementation of Recommendation W concerning model risk management in the banks. In the first half of 2016, works ensuring general compliance with the provisions of Recommendation W were conducted. The Bank carried out the gap analysis, updated the Model Management Policy at mBank Hipoteczny S.A. together with other key regulations from the model management area and defined the model list, assigning the level of materiality, level of risk exposure and level of model risk. The Bank also developed the *Model registry* application for keeping model registry and logs. The process of appointing the Model Risk Committee is underway. This Committee will act as a body responsible for approving material aspects of the functioning of models, as delegated by the Management Board of the Bank. A detailed schedule of tasks that remain to be implemented, including mainly the clarification of provisions in operating regulations, was developed. According to the schedule, all tasks are to be completed in the second half of 2016. The Committee was appointed on 12 July 2016.

Implementation of IFRS 9

In mBank Hipoteczny, the IFRS 9 project is being implemented in two areas:

- for portfolios acquired in cooperation with mBank (i.e. retail portfolio), mBank Hipoteczny participates in project works carried out within the mBank Group,
- for commercial lending, comprising mainly specialised lending, mBank Hipoteczny commenced project works in the fourth quarter of 2015.

In the implementation of the requirements of IFRS 9, both mBank and mBank Hipoteczny collaborate with the same advisory company, which ensures, among other things, consistent approach to the implementation of the aforesaid guidelines.

For the purposes of the implementation of IFRS 9 at mBank Hipoteczny, three areas were identified: classification and measurement, impairment methodology and hedge accounting.

In the area of classification and measurement, the Bank has carried out a preliminary analysis covering two main aspects that determine the new asset classification method prescribed by IFRS 9, i.e. assessment of the business model and analysis aimed at identifying changes in the classification and measurement of individual financial assets of the Bank. Further project works in the area of classification and measurement include, among others, accounting implementation, including implementation of necessary changes in IT systems, changes in the accounting policy or development of disclosures to be included in the financial statements, as required by IFRS 9.

At the same time, the Bank is working on the methodology for estimating parameters (PD, EAD, LGD) in the horizon to the maturity of a transaction. The Bank's representatives take an active part in works carried out by mBank and aimed at developing a methodology for the retail portfolio acquired in cooperation with mBank.

1.2. Financial credibility

Financial credibility of mBank Hipoteczny is assessed by an international rating agency - Fitch Ratings Ltd. As of 30 June 2016 the following ratings applied:

BBB-/F2 - long- and short-term international rating

2 - support rating

BBB+ - for public sector covered bonds

BBB+ - for mortgage covered bonds (as of 1 July 2016, rating upgraded to **A**)

On 7 January 2016, Fitch Ratings Ltd. placed the rating of mortgage covered bonds issued by the Issuer on the "BBB" level (positive outlook), on a watch list with positive indication, following the entry into force of amendments to mortgage bond regulations on 1 January 2016.

mBank Hipoteczny S.A.

Management Board Report on the Performance of mBank Hipoteczny S.A. for the first half of 2016

On 7 March 2016, Fitch Ratings Ltd. upgraded mBank Hipoteczny's international long-term IDR rating ("Issuer Default Rating") from "BBB-" (positive outlook) to "BBB" (stable outlook), following the upgrade of the IDR rating for Commerzbank AG from "BBB" to "BBB+" and for mBank S.A. from "BBB-" to "BBB". As a consequence, the international short-term IDR rating of the Bank was also upgraded from "F3" to "F2", while the support rating was confirmed at level "2".

On 7 March 2016, Fitch Ratings Ltd. also upgraded the rating for, respectively, mortgage and public sector covered bonds issued by the Bank from "BBB" (stable outlook) to "BBB+" (positive outlook for mortgage covered bonds, stable outlook for public sector covered bonds). The change of the ratings for the Bank's covered bonds resulted from the upgrade of the international long-term IDR rating ("Issuer Default Rating") of the Issuer and from the fact that Fitch Ratings Ltd.'s assessment took account of the statutory requirement imposed on the Bank to maintain the over-collateralisation of covered bonds at the minimum level of 10%.

On 4 and 20 May 2016, the rating agency Fitch Ratings Ltd. confirmed the ratings for, respectively, public sector covered bonds issued by the Bank — at "BBB+" level (stable outlook) and mortgage covered bonds issued by the Bank — at "BBB+" level (positive outlook).

On 1 July 2016, the rating agency Fitch Ratings Ltd. published a decision on upgrading the rating for mortgage covered bonds issued by the Bank from "BBB+" to "A" (positive outlook). The rating was upgraded following the amendments to the Act on covered bonds, which entered into force on 1 January 2016. The positive outlook for the mortgage covered bond rating reflects the Fitch agency's expectations concerning the reduction, on a year-to-year basis, of credit and currency risk of credit receivables of the Bank from mortgage loans granted and acquired, entered in the register of mortgage covered bonds collateral.

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 the first half of 2016 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	30.06.2016	31.12.2015	Dynamics
ASSETS	9 672 321	8 419 125	14.89%
including			
Loans granted to customers	8 391 043	7 391 743	13.52%
LIABILITIES AND EQUITY	9 672 321	8 419 125	14.89%

mBank Hipoteczny S.A.**Management Board Report on the Performance of mBank Hipoteczny S.A. for the first half of 2016**

including			
Debt securities in issue	5 287 777	4 164 902	26.96%
Amounts due to customers	295 296	265 509	11.22%
Share capital	614 792	514 856	19.41%

In the first half of 2016 the Bank achieved a positive gross result in the amount of PLN 13,387 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 the first half of 2016 was greatly influenced by low interest rates. Despite this, the Bank reported a growth in the net interest income compared to the first half of 2015 (PLN 8,886 thousand or 17.35%).

The net trading income, which includes the result on swaps, other net trading income and result on hedge accounting was above the line in the first half of 2016 (PLN 2,024 thousand) with important contribution to the gross result, while in the first half of 2015 a corresponding result was below the line (PLN - 1,881 thousand).

Introduction of the banking tax on 1 February 2016 had a material impact on the results recorded by the Bank. Before the tax, the Bank's operating result amounted to PLN 19,835 thousand, as compared to 8,305 thousand in the first half of 2015, which represents an increase by 138.83%. After the tax, the gross result was still significantly higher than in the previous year (by PLN 5,082 thousand or 61.19%).

In the first half of 2016 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 63,022 thousand (the first half of 2015: PLN 50,955 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 01.01.2016 to 30.06.2016	Period from 01.01.2015 to 30.06.2015	Dynamics
Net interest income	60 090	51 204	17.35%
Net fee and commission income	1 367	3 965	-65.52%
Net trading income	2 024	(1 881)	-
Net impairment write-downs on loans and advances	(10 351)	(13 608)	-23.93%
Overhead costs	(31 191)	(26 766)	16.53%
Amortisation and depreciation	(1 645)	(2 276)	-27.72%
Operating result	19 835	8 305	138.83%
Tax on the Bank's balance sheet items	(6 448)	-	-
Gross profit	13 387	8 305	61.19%
Income tax	379	(3 349)	-
Net profit	13 766	4 956	177.76%
Weighted average number of ordinary shares / weighted average diluted number of ordinary shares	2 993 846	2 850 000	4.91%
Net profit per ordinary share / Diluted profit per ordinary share (in PLN)	4.60	1.74	164.37%

Table 3. Effectiveness ratios

PERFORMANCE INDICATORS	30.06.2016	31.12.2015
ROA net ¹⁾	0.31%	0.26%
ROA gross ¹⁾	0.30%	0.37%

mBank Hipoteczny S.A.

Management Board Report on the Performance of mBank Hipoteczny S.A. for the first half of 2016

ROE net ³⁾	3.49%	2.74%
ROE gross ⁴⁾	3.39%	3.91%
Cost to income ratio (C/I) ⁵⁾	52.10%	54.82%
Net interest margin ⁶⁾	1.37%	1.55%
Cost of risk ⁷⁾	0.27%	0.39%
Total Capital Ratio	14.32%	13.81%
RATINGS Fitch Ratings Ltd		
long-term international rating	BBB-	BBB-
short-term international rating	F2	F3
support rating	2	2
public sector covered bonds	BBB+	BBB
mortgage covered bonds	BBB+ A (since / from 01.07.2016)	BBB
OTHER		
Employment	228 employees / 215 FTE's	222 employees / 212 FTE's
Average employment	226 employees / 215 FTE's	218 employees / 207 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) / total income (defined as net interest income + net fee and commission income + net trading income + other operating income - other operating expenses)

6) interest income / average earning assets

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

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

Chart 1. Key financial ratios

■ 12.2015 ■ 06.2016

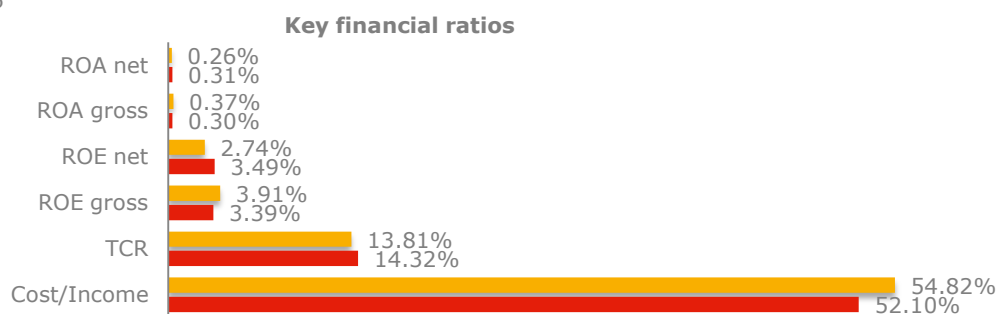
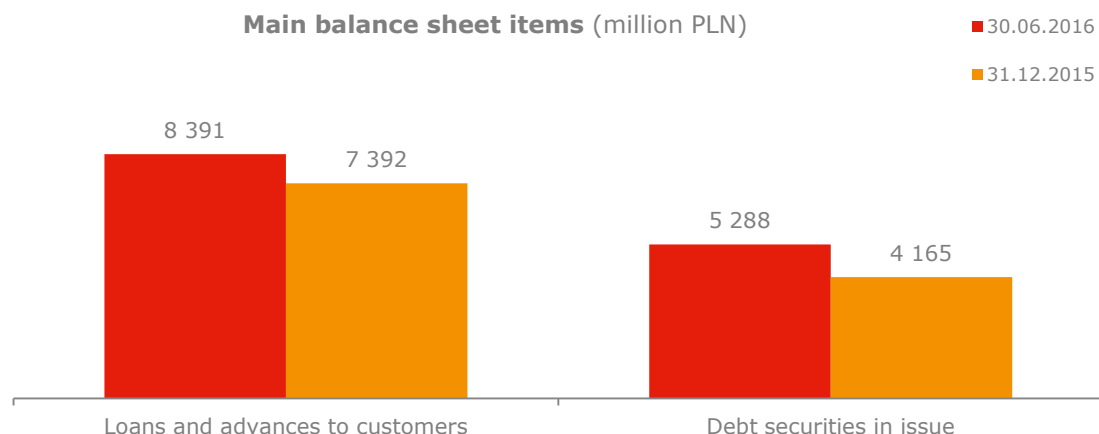


Chart 2. Main balance sheet items (in PLN million)



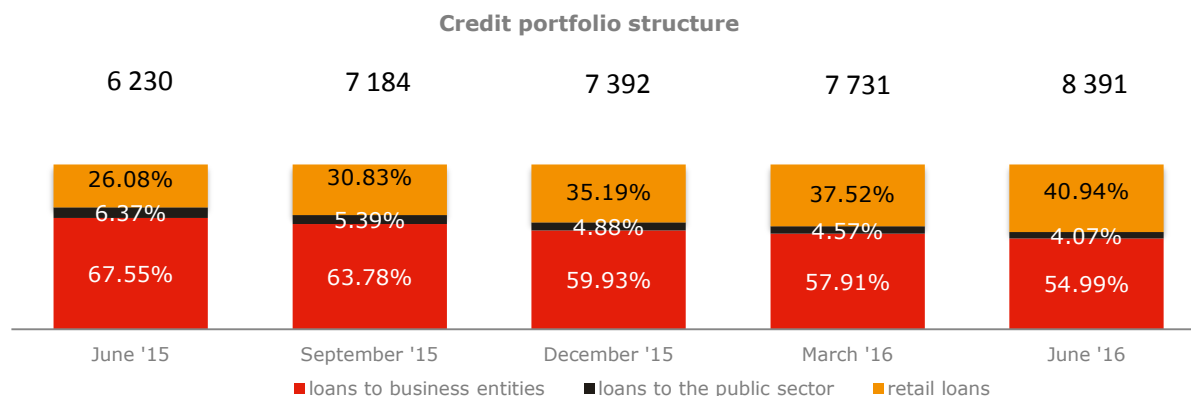
1.4. Lending

In the first half of 2016 the Bank developed its activity in both corporate and retail loan areas. The value of sales reached PLN 2,253.5 million and was higher by 55.4% than the value of agreements signed in the first half of 2015. The net value of the whole loans portfolio, taking into account "pooling" transactions and off-balance sheet liabilities, increased by the end of the first half of 2016 compared to the end of 2015 by 16.3%, reaching PLN 9.7 billion.

In the first six months of 2016, sales of commercial loans amounted to PLN 1,279 million, which is a record high result for the first half-year in the sixteen years of the Bank's history. As compared to the first six months of 2015, the current figure represents 216%. As regards the sales structure, 33% of financing accounted for the construction of commercial facilities. The share of new financing for housing developers amounted to 26% in the first half of the year. The housing developers market is a very dynamic market and the large number of apartments sold resulted in short periods for project financing. In the previous year, the portfolio of apartments financed by the Bank was sold over 7 quarters, whereas at the end of 2015 this period was reduced to 3–4 quarters. This pace is currently affecting the reduction of balance-sheet and off-balance sheet balances. One commercial pooling transaction was executed. This transaction will cover the shortfall resulting from the total repayment of three loans acquired from mBank as part of the commercial pooling arrangement in 2015.

In the retail area, within the scope of implementation of the strategy of the mBank Group, the Bank recorded an increase of PLN 973.7 million in the retail mortgage portfolio. Sales of credits in the agency model (newly signed agreements of total value of PLN 605.1 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 368.6 million in three tranches).

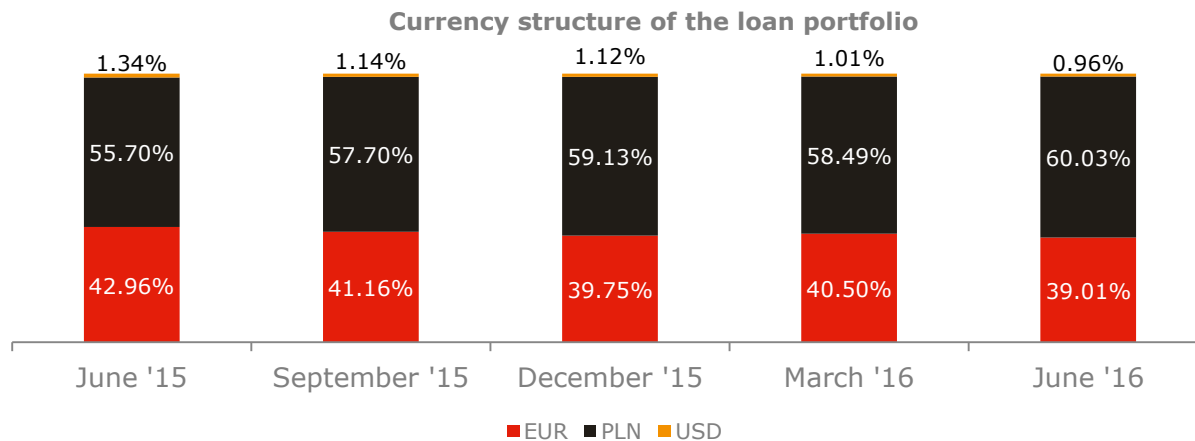
Chart 3. The structure of the loan portfolio in the period 30.06.2015 – 30.06.2016 (in PLN million)



The currency structure of the loan portfolio in the first half of 2016 was subject to change due to systematic growth of retail credit portfolio granted in PLN only. Compared with the state by the end of June 2015, the share of PLN loans increased by 4.3 percentage points by the end of June 2016. They constituted 60% of the loan portfolio. The share of EUR loans decreased to the level of 39%.

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

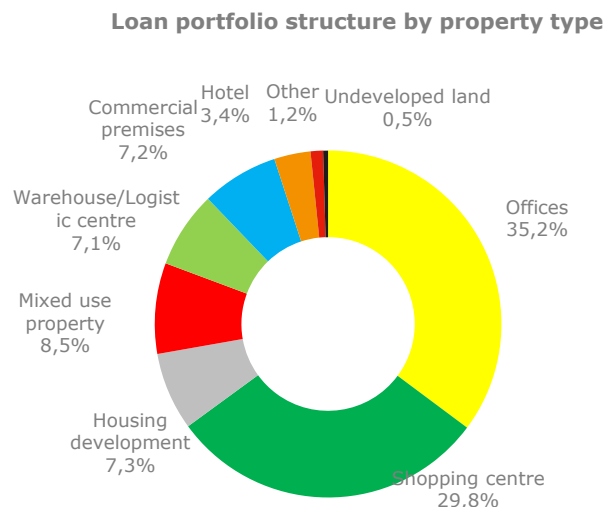
Chart 4. The currency structure of the loan portfolio in the period 30.06.2015 – 30.06.2016



Corporate loans

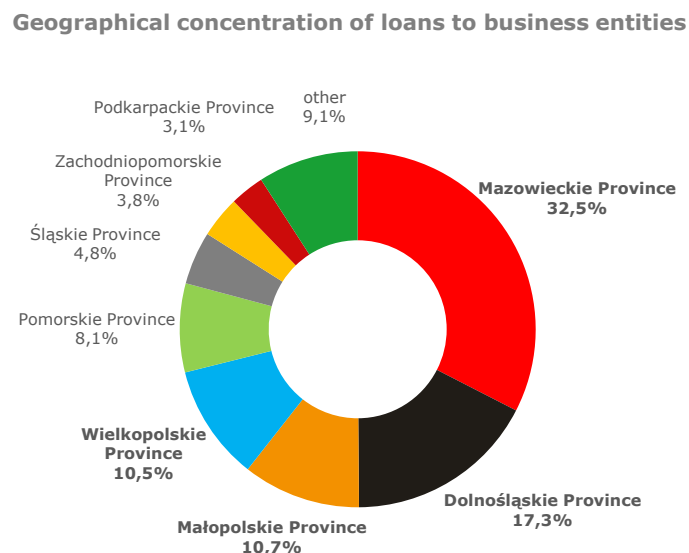
Net balance sheet exposure to business entities as of 30 June 2016 amounted to PLN 4,613.8 million. The dominant part (83.4%) accounted for refinancing of completed commercial facilities, the exposure in housing projects constituted 7.5%, and credits for financing of construction of commercial objects - 8.7%.

Chart 5. Corporate loans by type of financed real estate as of 30 June 2016



As of June 2016, 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 30 June 2016



The largest number of financed projects is concentrated in Mazowieckie province, where 32.5% of all credit resources is involved. In Dolnośląskie, Małopolskie and Wielkopolskie province the total balance sheet exposure accounts for 38.6%.

As of 30 June 2016 loans granted in EUR (70.5%) and PLN (27.8%) 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 30 June 2015, balance sheet exposure to public sector. As at 30 June 2016 the exposure was PLN 342 million (down by 13.9%)

Retail loans to natural persons

The Bank continues the implementation of strategic objectives in the area of mortgage loans to natural persons in cooperation with mBank S.A. Following the amendment to the Act on Covered Bonds and Mortgage Banks, which enables less stringent lending by mortgage banks for the purchase of premises on the primary market, the Bank has intensified its activities in this area. The Bank also continues measures aimed at the development of cooperation with developers credited within the scope of the Bank's commercial activities. In the first half of 2016, the Bank took a number of initiatives aimed at developing the offer for customers and available distribution channels. In response to the growing threat of increase in interest rates, the Bank develops an offer of a loan based on a fixed interest rate for the first five years of the loan agreement (with the option for a renewal on new terms). In addition, the Bank is changing the offer as regards additional products that are required to obtain promotional terms of the loan. The works on changing the insurance product that is a condition for the promotion are carried out in cooperation with AXA Życie TU S.A. and AXA Ubezpieczenia TUiR S.A. The change is expected to be introduced to the offer in the third quarter of 2016. The expected result is an increase in the product's value for the customer and, at the same time, improved positioning of the loan offered by mBank Hipoteczny among competitor's offers.

Chart 7. The share of sales channels in 2016.

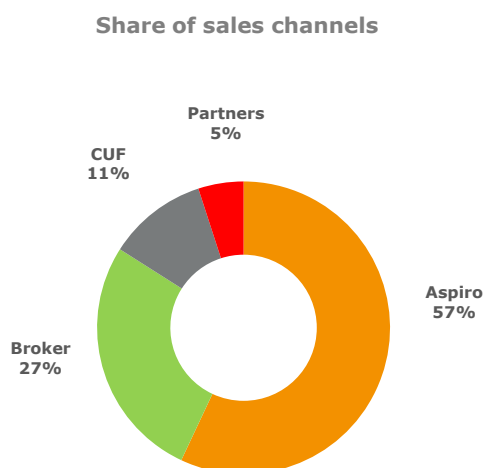
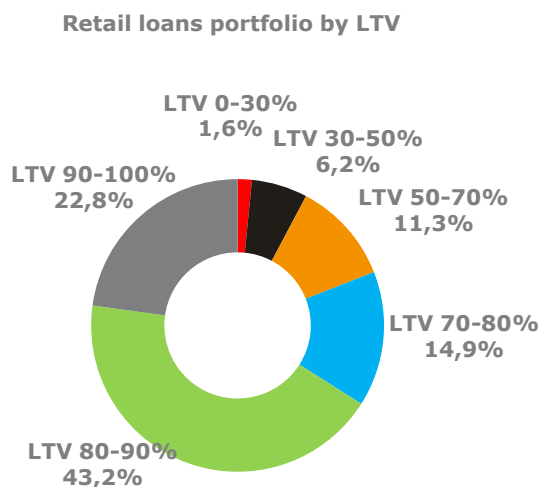


Chart 8. Sales structure in 2016 divided into LTV limits.



The volume of loans disbursed in the first half of 2016 amounted to PLN 0.6 billion. The average loan amount was PLN 302 thousand. The volume-weighted average margin for the portfolio acquired in the first half of 2016 was 2.13%. The average commission weighted by the amount of credit agreement for loans disbursed in this period 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.

1.5. Refinancing and issuing of covered bonds

In the first half of 2016, mBank Hipoteczny successfully placed on the market four issues of mortgage covered bonds with a total nominal value of approx. PLN 670 million as at 30 June 2016. The value of three issues in domestic currency amounted to PLN 450 million. The value of euro-denominated issue amounted to EUR 50 million. Two of the said issues — issue amounting to PLN 50 million of 28 April 2016 and issue amounting to PLN 100 million of 11 May 2016 — were characterised by fixed interest rate. Both issues were the first transactions of this kind in the history of Polish mortgage banking.

The value of all covered bonds issued by the Bank and outstanding as at the end of the first half of 2016 amounted to approx. PLN 4.6 billion, representing more than 66% of the covered bonds market in Poland according to the Bank's estimates.

Covered bonds of mBank Hipoteczny are instruments characterised by a low level of investment risk as a result of the statutory requirement of multi-stage collateral for the issuing and trade. It is confirmed by the ratings assigned by Fitch Ratings Ltd. to covered bonds issued by the Bank: BBB+ rating assigned to public sector covered bonds and A rating assigned to mortgage covered bonds (as of 1 July 2016). On 1 July 2016, the rating for mortgage covered bonds was upgraded from BBB+ to A.

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.
15.06.2011	16.06.2017	PLN	200 000 000	A
20.04.2012	20.04.2017	PLN	200 000 000	A
15.06.2012	15.06.2018	PLN	200 000 000	A

mBank Hipoteczny S.A.**Management Board Report on the Performance of mBank Hipoteczny S.A. for the first half of 2016**

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
20.02.2015	28.04.2022	PLN	200 000 000	A
15.04.2015	16.10.2023	PLN	250 000 000	A
17.09.2015	10.09.2020	PLN	500 000 000	A
02.12.2015	20.09.2021	PLN	255 000 000	A
09.03.2016	05.03.2021	PLN	300 000 000	A
28.04.2016	28.04.2020	PLN	50 000 000	A
11.05.2016	28.04.2020	PLN	100 000 000	A
TOTAL		PLN	2 935 000 000	

Issue date	Redemption date	Currency	Value	Rating 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
25.02.2015	25.02.2022	EUR	20 000 000	A
24.04.2015	24.04.2025	EUR	11 000 000	A
24.06.2015	24.06.2020	EUR	50 000 000	A
23.03.2016	21.06.2021	EUR	50 000 000	A
TOTAL		EUR	341 500 000	

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+
TOTAL		PLN	150 000 000	

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 30 June 2016 the collateral of:

- public sector covered bonds consisted of receivables of value PLN 342.7 million from total number of 56 loans,
- mortgage covered bonds consisted of receivables of value PLN 6,606.1 million from total number of 11,152 loans,

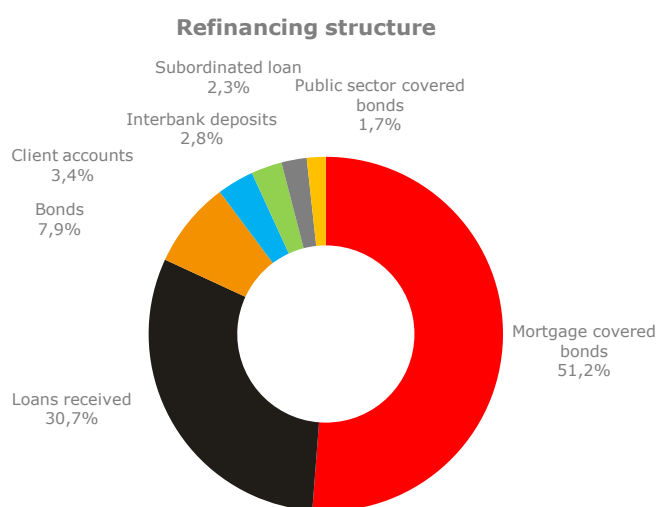
Loans for commercial clients constituted 59.7% and for retail clients 40.3% of the total amount of receivables entered into the mortgage cover register. Loans granted in PLN (55.8%) dominated, loans in EUR (43.0%) and USD (1.2%) constituted the remaining part.

Additionally to the credit receivables, the additional collateral in a form of treasury bonds of nominal value of PLN 90 million (for mortgage covered bonds) and PLN 6 million (for public sector covered bonds) was also entered into the cover register.

As of 30 June 2016 the level of over-collateralisation (including substitute cover) of mortgage covered bonds and public sector covered bonds amounted to 49.5% and 130.7% respectively.

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 30 June 2016



1.6. Legal environment

On 1 January 2016 new law amending the Act on Covered Bonds and Mortgage Banks as well as certain other acts, came into force. The legal framework of mortgage banking was significantly improved 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%.

On 30 December 2015 the Minister of Finance issued executive (detailed) regulations to the Act on Covered Bonds and Mortgage Banks, that is the Ordinance on maintaining cover account for covered bonds and running coverage and liquidity tests. In February 2016 Recommendation K on the principles of covered bonds' cover registers held by mortgage banks was amended in order to adapt it to the new wording of the Act.

2. Risk management

2.1. Credit risk

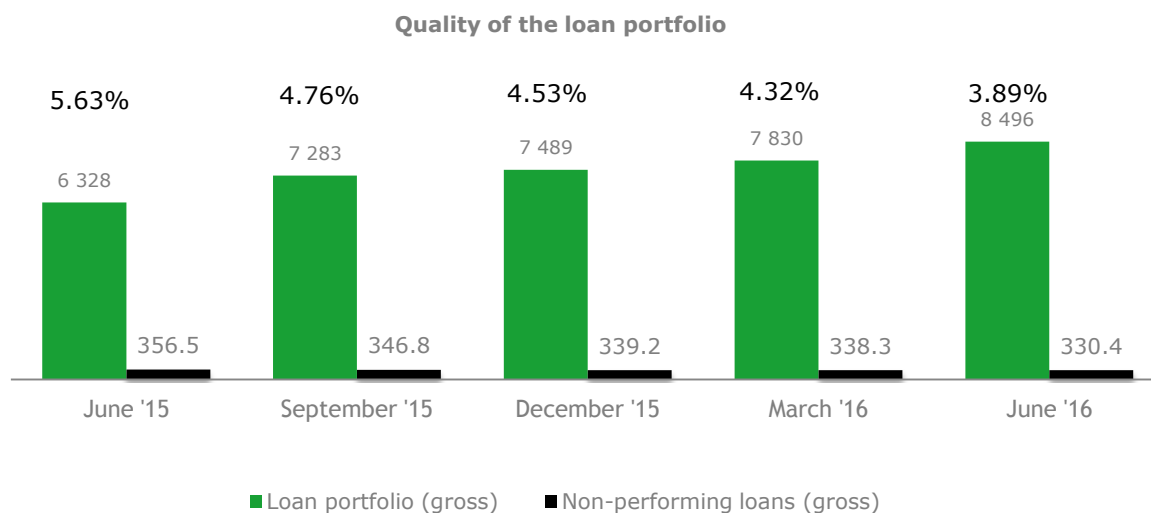
Loan portfolio

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 3.89%. 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 the first half of 2016 increased in relation to the end of 2015 by PLN 980 million, which resulted mainly from the increase of the retail portfolio (agency loans and retail pooling).

Impairment provisions reaching PLN 106.8 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 the first half of 2016 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, which is growing strongly, 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 six cases with reported loss of value. Loans for natural persons are monitored monthly for timely repayments and correctness in terms of established effective mortgage collaterals. Realisation of all contractual obligations of the client is verified in the same monitoring period (including insuring of the real estate and assignment of the rights under insurance policies).

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 the first half of 2016 the Management Board of the Bank did not introduce any changes to the Credit Policy.

On 30 June 2016, the Bank updated the internal limits of the Bank's exposure in relation to the annual review of internal concentration limits of the Bank's exposure.

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 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.

Enforcement orders issued by the Bank

In the first half of 2016, the Bank filed 1 lawsuit for issuing a payment order for the amount of EUR 849.5 thousand, relating to a commercial loan. The court issued the payment order and the Bank waits for the order to become valid.

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 June 2016 VaR amounted to PLN 217.8 thousand. The currency risk was PLN 21.1 thousand, while the interest rate risk was PLN 196.7 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 repicing 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 June 2016 reached a safe level of 5.11%. 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 June 2016 the liquidity reserves constituted approximately 12.3% 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 (3.01%).

In the first half of 2016 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 June 2016 was 1.080. M1 and M2 short-term liquidity standards were maintained at a safe level, PLN 1,055,929 thousand and 2.868 respectively. The M3 standard was 83.000.

As at the end of June 2016 the liabilities limit, resulting from Art. 15.2 of the "Act on covered bonds and mortgage banks", was used in 75.5%. In the first half of 2016 this limit was not exceeded.

As at the end of June 2016 average maturity of issued covered bonds was 4.9 of a year for mortgage covered bonds and 0.2 of a year for public sector covered bonds, while the average maturity of contracted long-term deposits and loans obtained from other banks was 3.9 of a year. The margin of mortgage covered bonds issued in the first half of 2016 on average amounted to 0.52%, with average maturity of 4.6 of a year. In 2016 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:

- changes in the organisational structure,
- number of conducted undertakings and IT projects,
- 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 the first half of 2016 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.
- 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
 - Inside information according to Market Abuse Regulation

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

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

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

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

2.7. Remuneration policy

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

3. Real estate market in Poland in the first half of 2016

Housing market¹

- The first two quarters of 2016 have brought a record-breaking level of apartment sales in the primary market. The total number of transactions for six markets amounted to 29.4 thousand apartments, which represents an increase as compared to the total sales recorded in the second half of 2015 by over 6.5%.
- In the first and second quarter 31.4 thousand apartments were placed on the market (increase in the first half of 2016 by approx. 14.6% as compared with the second half of 2015). In total, in the last four quarters approximately 58.8 thousand residential premises were placed on the market (up by approx 21.2% y/y).
- The residential premises offer on the primary market increased by approx. 2.5 thousand and at the end of the first half of 2016 amounted to approx. 51.0 thousand (up by 5.2% y/y). The highest increase was recorded in Lodz (16.1% y/y), Wroclaw (12.3% y/y) and Warsaw (10.1% y/y). In Krakow, the offer remained at a stable level, and a decrease in the number of apartments offered on the primary market was recorded in Poznań (approx. 7.0% y/y) and Tricity (2.7% y/y).
- 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 m2 on the primary market was approximately 1.7%, while on the secondary market the prices dropped by approximately 1.6%.
- The historically high level of sales significantly affected the structure of the offer available on the primary housing market, particularly in the context of the sales of finished apartments. At the end of the second quarter of 2016, apartments handed over to users in 2014 and earlier accounted for approx. 4% of the developers' offers, 5% of apartments on offer are those handed over in

¹ Analysis of the housing market relates to 6 main cities: Warsaw, Krakow, Lodz, Wroclaw, Poznań, Gdańsk.

2015, approx. 25% of projects were or will be handed over in 2016, and 66% will be handed over in 2017 or later;

- Interest in purchasing apartments for rent remained at a relatively high level. The lowest level of interest rates on bank deposits since 1990, the continuing deflation and stable rental rates contributed to the attractiveness of rental investments.
- Availability of an apartment for average remuneration in the majority of analysed cities remained stable.
- The act regulating the trade in agricultural land, adopted on 14 April, can have a significant impact on the functioning of the housing market. The regulations introduced have caused far-reaching changes in lending to natural and legal persons who apply for financing for the purchase and development of agricultural real property.
- In June, the government also presented the "Mieszkanie plus" ("Home Plus") programme. The programme will be based on three pillars: the National Housing Fund holding the land owned by the State Treasury, support to social and cooperative housing and on Individual Housing Accounts, on which Polish citizens will be able to save for the purchase or renovation of their own apartment.

Commercial real estate market

- The volume of transactions concluded in the first half of 2016 on the commercial real estate market amounted to approximately EUR 2 billion.
- Capitalisation rates compression for the best assets can be observed on markets. Capitalisation rates for real estates of the "prime" type are approximately 6% on the office market, 5.5% on the commercial sector and 7% on the warehouse market.

Office real property²

- Warsaw remains the largest office market in Poland, complete resources at the end of Q2 2016 increased by further 350 thousand m² and amounted to nearly 5.0 million m² of surface area.
- In the Warsaw market, approximately 550 thousand m² of new office space is currently under construction.
- Total volume of rental agreements signed in the capital in the first half of 2016 amounted to approximately 360 thousand m² and was 7.7% lower than the result recorded in the first half of 2015.
- The largest projects completed in Warsaw included the office buildings Warsaw Spire A (59 thousand m²) and Q22 (46 thousand m²). Never before in the history of the Polish office market have office buildings with such large leasable area been put on the market in a single year.
- At the end of the first half of 2016, total modern office in stock in regional cities amounted to approx. 3,665,200 m². The largest volume of space is located in Krakow (almost 832,900 m²), Wroclaw (757,100m²) and the Tricity (629,300 m²).
- In the first half of 2016, projects with the total space of more than 219,500 m² were completed. The majority of the new space – nearly 66,500 m² – was completed in Kraków and Tricity (52,700 m²).
- In the major regional markets, 395,700 m² of office space were available for immediate lease. The highest vacancy rate was noted in Szczecin – 17.7%, the lowest in Krakow – 6.0%.

² Analysis of the office market relates to 7 main cities: Warsaw, Krakow, Lodz, Wroclaw, Poznań, Gdańsk, Katowice.

- 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 the first half of 2016 by additional 117 thousand m² and amounted to 13.3 million m².
- The highest growth of new supply was recorded in major agglomerations, where nearly 65% of new space was realised.
- The largest projects opened in the analysed period include Galeria Karuzela in Września (12 thousand m²) and Galeria Awangarda in Bartoszyce (6 thousand m²).
- 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. One of the most recent examples is the shopping centre Galeria Zaspa in Gdańsk. This 23-year-old facility, previously operating as ETC Gdańsk, has been fully modernised and re-opened in the second quarter of 2016.
- At the end of the first half of 2016, approx. 610 thousand m² of new retail space was under construction, with the largest facilities located in major agglomerations: Posnania in Poznań (98 thousand m²), Wroclavia in Wroclaw (64 thousand m²), Forum Gdańsk (62 thousand m²), Galeria Północna in Warsaw (64 thousand m²), Serenada in Krakow (42 thousand m²).
- The increase in popularity of projects of mixed-use type, which connect not only commercial, but also office and cultural functions.
- The total volume of retail investment transactions in the second quarter of 2016 is estimated at approx. EUR 893 million, which is eight times higher than the value recorded in the corresponding period of the previous year (EUR 106 million). This high volume is mainly attributable to the completion of Redefine's acquisition of a 75% stake in Echo Investment's commercial property portfolio in Poland.
- 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 m² in the most prestigious commercial centres exceed 100 EUR/m²/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 the first half of 2016 by additional 660 thousand m² and amounted to 10.4 million m².
- The majority of new warehouse space was developed in Warsaw suburbs (144 thousand m²), in Poznań (122 thousand m²) and in Central Poland (115 thousand m²).
- Developers' activity remains high - currently 856 thousand m² is on the phase of implementation in the entire Poland.
- At the end of June 2016, 563 thousand m² of warehouse space in the analysed markets remained vacant. The vacancy rate was 5.3%.
- Over half of existing supply is still owned by four main market players, i.e. Prologis, SEGRO, Logisor, Goodman and their partners.
- Increased share of investments of a speculative nature.
- A stabilisation of rental rates can be observed. However, a slight increase of rental rates is projected for markets with a low vacancy rate.

- Increased interest of both developers and tenants in smaller warehousing markets (Szczecin, Rzeszow).

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 2016, the Bank completed a review and update of the strategy for subsequent years (2016-2019) (adopted in 2015). Key directions of development and strategic objectives 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. Two transactions of this type took place in 2014, followed by four transactions in 2015.

In 2016 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 (three subsequent pooling transactions) and refinancing of this portfolio through issuing covered bonds.

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 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 five main sources:

- covered bonds, including:
 - bonds secured with retail mortgages (in PLN),
 - bonds secured with commercial mortgages (in PLN, EUR),
- own bonds,
- long-term credit lines (in PLN, EUR),
- 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

As at 30 June 2016, the total number of ordinary shares was 2,990,000 shares with a nominal value of PLN 100 per share. On 2 June 2016, the Extraordinary General Meeting adopted resolution on the increase of the share capital and the exclusion of the shareholder from the pre-emptive right to shares, under which the share capital will be increased to the amount of PLN 309,000,000.00 by way of issuing 100,000 series G ordinary registered shares with a nominal value of PLN 100.00 each and the issue price of PLN 1,000.00 each. The new shares were offered for subscription to mBank S.A. through private placement. The shares were paid-up in full on 24 June 2016. On 1 August 2016, the registry court entered the increased share capital in the registry of entrepreneurs.

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

mBank Hipoteczny S.A.

Management Board Report on the Performance of mBank Hipoteczny S.A. for the first half of 2016

As of 30 June 2016 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
Total	299 000 000	2 990 000	100.00	2 990 000	100.00

The Bank does not collaborate with international public institutions.

Management Board

As at 30 June 2016 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

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 30 June 2016:

- Hans-Dieter Kemler – Supervisory Board Chairman
- Lidia Jabłonowska-Luba - Supervisory Board Vice-Chairman
- Joerg Hessenmueller – Supervisory Board Member (resigned from his position as of 30 June 2016)
- Cezary Kocik – Supervisory Board Member
- Michał Popiołek - Supervisory Board Member
- Dariusz Solski – Supervisory Board Member
- Mariusz Tokarski – Supervisory Board Member

The Supervisory Board in the above composition was appointed for the tenth term of office on 19 April 2016 by the Annual General Meeting of mBank Hipoteczny S.A. The composition of the Supervisory Board was supplemented on 6 July 2016 by the Extraordinary General Meeting — Mr Christoph Heins was appointed a Member of the Supervisory Board.

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 30 June 2016 the Audit Committee included the following members:

- Joerg Hessenmueller - Committee Chairman (resignation as of 30 June 2016)
- 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 the first half of 2016 the Audit Committee debated one time - on 18 April.

Risk Committee

As at 30 June 2016 the Risk Committee included the following members:

- Lidia Jabłonowska-Luba – Chairwoman of the Committee
- Joerg Hessenmueller - Committee Member (resignation as of 30 June 2016)
- Hans-Dieter Kemler – Committee Member
- Michał Popiołek – Committee Member

The tasks of the Risk Committee include:

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

In the first half of 2016 the Risk Committee held one meeting - on 15 April.

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

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

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

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

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

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 19 April 2016, the Annual General Meeting of mBank Hipoteczny S.A. appointed the Supervisory Board for the tenth term of office, composed of the following Members: Hans-Dieter Kemler, Lidia Jabłonowska-Luba, Joerg Hessenmueller, Cezary Kocik, Michał Popiołek, Dariusz Solski, Mariusz Tokarski.

On 6 July 2016, another Member of the Supervisory Board was appointed — Christoph Heins — due to the resignation of Joerg Hessenmueller from his position as a Member of the Supervisory Board as of 30 June 2016.

The General Meeting conducted a verification and concluded that the candidates for Members of the Supervisory Board comply with the requirements set out in Article 22aa of the Banking Law.

On 18 April 2016, the Supervisory Board appointed the Management Board for the next term of office in the following composition: Piotr Cyburt, Marcin Romanowski, Grzegorz Trawiński, Marcin Wojtachnio. The Supervisory Board conducted a verification and concluded that the appointed Members of the Management Board comply with the requirements set out in Article 22aa of the Banking Law.

Proceedings before a court, arbitration body or public administration authority

Information on pending proceedings is provided in selected explanatory information to the Financial Statements.

Public aid from public funds

In the first half of 2016, the Bank did not receive any public subsidies, in particular on the basis of the Act on the Government support for the financial institutions dated February 12, 2009 (Journal of Laws of 2014 item 158).

Guarantees and sureties granted by the Bank

No guarantees or sureties were granted by the Bank in the first half of 2016.

Events after the balance sheet date

■ Rating change

On 1 July 2016, the rating agency Fitch Ratings Ltd. published a decision on upgrading the rating for mortgage covered bonds issued by the Bank from "BBB+" to "A" (positive outlook).

The rating was upgraded following the amendments to the Act on covered bonds, which entered into force on 1 January 2016. The positive outlook for the mortgage covered bond rating reflects Fitch agency's expectations concerning the reduction, on a year-to-year basis, of credit and currency risk of credit receivables of the Bank from mortgage loans granted and acquired, entered in the register of mortgage covered bonds collateral.

As a result of the aforementioned change, the rating of mortgage covered bonds issued by the Bank is classified under category "A" of the investment scale, which represents high creditworthiness.

■ Decision of the Management Board on transferring bank accounts to mBank S.A.

In connection with the signing by the President of the Republic of Poland on 30 June 2016 of the Act of 10 June 2016 on Bank Guarantee Fund, Deposit Guarantee Scheme and Mandatory Restructuring, repealing, in Article 348, the legal basis for maintaining bank accounts by mortgage banks, the Management Board of mBank Hipoteczny S.A., by way of Resolution No 85/2016 adopted on 12 July 2016, decided to transfer services provided to the Bank's customers as regards maintaining escrow accounts and closed trust accounts to mBank by way of jointly offering mBank S.A.'s products that comply with specific functionality requirements to the customers.

■ Signing of a deposit agreement

On 25 July 2016, a deposit agreement was signed between mBank S.A. and mBank Hipoteczny S.A., according to which mBank S.A. will place a deposit at mBank Hipoteczny S.A., the value of which will not exceed PLN 150,000 thousand.

■ Registration of the increased share capital

On 1 August 2016, the amount of share capital of mBank Hipoteczny S.A. increased, as a result of the new issue, described in detail in Point 22 of Selected explanatory information, which was entered in the National Court Register. As at 1 August 2016, the share capital of mBank Hipoteczny S.A. (fully paid-up) amounts to PLN 309,000,000.

■ Bank acquisition of mortgage loans portfolio granted by mBank S.A.

Under a framework agreement on the acquisition of portfolios of receivables in respect of mortgage-backed loans in order to refinance them through the issue of mortgage covered bonds and on entrusting mBank S.A. with further servicing of the acquired portfolios by mBank Hipoteczny S.A. signed on 28 August 2014, another portfolio transfer agreement was concluded on 29 July 2016 between mBank S.A. and mBank Hipoteczny S.A. Under this agreement, mBank Hipoteczny S.A. acquired a retail portfolio of mortgage-backed loans with the total fair value of PLN 152,641 thousand from mBank S.A.

■ New issue of covered bonds

On 19 August 2016, the Bank issued, by way of a private placement, mortgage covered bonds with a nominal value of EUR 70 million, maturing on 28 August 2019, with floating interest rate. The issue was carried out under a programme for private placement of covered bonds with the value of up to PLN 2 billion, organised by mBank S.A.

7. Statements of the Management Board

Corporate governance

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

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

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.

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