

**Management Board Report
on the performance of mBank Hipoteczny S.A.
in 2017**

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1. Activity of mBank Hipoteczny S.A. in 2017

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.

In the period May – June 2017, the Bank started preparing for another change in how the strategy is implemented. The key assumptions of the strategy remain unchanged. The Bank is performing the function of financing loans secured with mortgages based on its issuing capacity as part of a wider balance sheet management strategy of the mBank Group and is gradually expanding its share in the mortgage bond market. However, a change in the model of selling retail mortgage products within the mBank Group was implemented. Starting from the end of July 2017, all sales of such products are executed solely by mBank S.A. as part of a uniform process of loan selling and post-selling activities. As a result, the sourcing of retail assets for the Bank has changed. The approach based on purchasing receivables from mBank S.A., i.e. transaction pooling, has fully replaced the previously leading model in which retail mortgage loans were sold directly by the Bank.

There are two lines of business in the Bank:

- retail, based on transaction pooling from mBank S.A., after implementation of the change;
- commercial, focused on providing the financing of commercial real estate and residential real estate to developers.

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.

Increased activity of investors within the area of commercial projects returned in the second half of the year. The stagnation in real-estate trading, resulting from the changes of tax interpretations, affected only the first half of the year.

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

- maintaining a high level of developers' activity in project execution;
- maintaining a low level of loan utilization due to an increased share of construction projects financed by the buyers of apartments;
- continuation of the liberal approach of banks to the evaluation of projects, in particular with respect to own contribution, pre-sales and withdrawal of own contribution together with a strong pressure to reduce margins.

Within the Bank, in terms of commercial and residential facilities, the levels of margins were maintained.

1.1. Key projects in 2017

The "covered bonds" project

The project of rebuilding of the balance sheet of mBank Group on the basis of long-term source of financing in a form of covered bonds issued by mBank Hipoteczny S.A. continued to be the highest priority venture in 2017. Works on the project started in August 2012, and their purpose was preparation of a comprehensive model of cooperation between a mortgage and a universal bank in terms of sales, service and management of retail mortgage loans portfolio and then issuing of covered bonds on its basis.

The implementation of the model aims at:

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

- diversification of financing sources - increasing independence of the mBank Group in terms of financing of the current portfolio of retail mortgage loans,
- improvement of long-term liquidity in the mBank Group - adaptation to the requirements of Basel III through the increase of long-term financing.

Implementation of AIRB method

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

A substantial part of the recommendations identified during the inspection was addressed by the Bank in 2017, however the mBank Group intends to fulfill all the expectations of the Supervision in 2018, which shall result in the submission in 2018 of the final Request for the application of the statistical methods for calculating the capital requirements for credit risk for the retail portfolio acquired within the scope of the cooperation with mBank S.A.

Implementation of the general Regulation on personal data protection

In connection with the entry into force of the general Regulation on personal data protection (RPDP), the RPDP Project Team was appointed by resolution of the Bank's Management Board. The Bank started cooperating with an external law firm specializing in information security. In cooperation with a law firm, the IT systems serving for the processing of personal data administered at the Bank were analysed. The purpose of the analysis was to verify the compliance of the systems with the currently applicable Act on personal data protection and with the provisions of *RPDP*. In cooperation with the law firm procedures were also prepared concerning the *Privacy by Design* and *Privacy Impact Assessment* mechanisms, which will include new processes and personal data processing systems implemented at the Bank. Further project works carried out in cooperation with mBank S.A. will be continued in 2018. In particular, the following are planned: the development of new internal procedures, as well as the preparation of a register for the personal data operations, of template agreements for entrusting personal data, of template information clauses and consent clauses.

AML Project

The Bank initiated works for the adaptation to the requirements of the future Act on counteracting money laundering and terrorist financing, which implements to Polish law Directive 2015/849 of the EU Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC (the so-called "Fourth AML Directive").

On 10 August 2017, the Project for AML was approved and the composition of the project team was decided by a resolution of the Management Board of the Bank. Further versions of the legislative bill submitted for public consultation were analysed and remarks were submitted within the scope of the works of the team operating at ZBP. Furthermore, analyses were carried out and procedures were launched aiming at the implementation of relevant changes in the systems supporting the execution of the obligations with respect to counteracting money laundering and terrorist financing. Further works from the part of the Bank will be carried on and will depend on the final formulation of the provisions implementing the Fourth AML Directive.

Implementation of the Regulation of the Minister of Development and Finance on the risk management system and the internal control system, and of Recommendation H

In connection with the entry into force of the Regulation of the Minister of Development and Finance on the risk management system and the internal control system, remuneration policy and the detailed manner of estimating the internal capital in banks of 6 March 2017 (hereinafter: the Regulation) and the publication by the Polish Financial Supervision Authority of Recommendation H relating to the internal control system in banks, work was started on the implementation of the Regulation and Recommendation H: a Project Team was appointed by resolution of the Management Board of the Bank and a gap analysis was prepared. In order to implement the aforementioned regulations new or modified applicable internal procedures were prepared, including in particular new Internal Control Rules of Procedure, Rules of Procedure for the Compliance Department, as well as regulations concerning the control functions matrix and the control functions matrix itself. Draft Rules of Procedure for the Internal Audit of Regulations were also prepared. Organisational units, including the Compliance Department continue works aiming at adapting further internal procedures to the provisions of Recommendation H.

In 2017, for the purpose of implementing the Regulation regarding the part of anonymous whistleblowing with respect to violations of provisions of law and applicable procedures and ethical standards, a respective internal procedure was introduced regulating the course of receiving and proceeding with reports. Advanced works aiming at the implementation of an information system allowing for anonymous whistleblowing are currently carried out.

IFRS 9

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

The new standard introduces provisions which require significant changes in respect of the classification and evaluation of financial instruments (in particular financial assets), a new model of financial assets impairment, as well as new approach to hedge accounting.

In order to implement IFRS 9, in January 2016, the Bank began an implementation project, by defining the areas of design work and project leaders. The structure of the project comprises the Steering Committee which consists of a Management Board Member for Retail Sales, Accounting and IT, and a Management Board Member for Risk Management. Leaders of individual project areas are selected directors of the Bank in the areas of accounting, risk and treasury. The project also involves business, IT and support departments.

As part of the project for the implementation of IFRS 9, three areas have been distinguished: classification and measurement, impairment methodology and hedge accounting.

In the area of classification and measurement, IFRS 9 introduces new classification of financial assets, distinguishing the following categories of valuation:

- financial assets stated at amortized cost;
- financial assets stated at fair value through other comprehensive income;
- financial assets stated at fair value through profit or loss.

Due to the retroactive application of the standard, in order to ensure the possibility of making the classification decision in respect of fixed assets owned (in accordance with IFRS 9) as at 1 January 2018, as part of the IFRS 9 implementation project, the Bank reviews its financial assets which will be in the Bank's possession after 31 December 2017, by:

- determining and allocating groups of financial assets to respective business models;
- determining the characteristics of contractual cash flows of financial assets, aimed at verifying whether the terms and conditions of the agreements result in cash flows on specific dates, which are only a repayment of the principal amount and interest on the outstanding principal amount (i.e. the SPPI criterion – solely payments of principal and interest).

With regard to classification and measurement, the Bank prepared and implemented a new asset classification methodology, as well as appropriate changes in the processes and IT systems.

In the impairment area, IFRS 9 replaces the impairment model applicable under IAS 39 based on the concept of an "incurred loss", with the new model based on the concept of "expected credit loss" (hereinafter: ECL). A direct consequence of this change is the need to measure impairment write-downs based on expected loan losses and to take into account forecasts and expected future economic conditions in the context of evaluating the exposure to credit risk. The new impairment model applies to the Bank's financial assets classified in accordance with IFRS 9 as financial assets stated at amortized cost or at fair value through other comprehensive income.

Pursuant to IFRS 9, instead of IBNR write-downs and non-performing exposure write-downs, the impairment write-downs will be determined in the following categories:

- Basket 1: 12-month expected loan loss – anticipated losses that may result from possible defaults within 12 months from the reporting day;
- Baskets 2 and 3: expected loan loss within the expected life of a given financial asset – anticipated losses which may result from all possible defaults in the period of life of a given financial asset.

As regards the retail part of the loans portfolio, works related to the implementation of the requirements of the new standard were carried out within the framework of a project at mBank S.A. Employees of the Bank were members of the project team and actively participated in the development of the frameworks for life-time models and of the approach to the ECL calculation. They also participated in the formulation of business requirements and implementation tests of systems, in which parameters and ECL (S1, Impairment Retail) will be calculated. Employees of the Bank also participated in the verification of parameter designation and the calculation of write-downs and provisions in the Impairment system) in test revaluations.

1.2. Financial credibility

Financial credibility of mBank Hipoteczny S.A. is assessed by an international rating agency - Fitch Ratings Ltd. As of 31 December 2017 the following ratings applied:

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

AA-(pol)(stable perspective)/F1+(pol) - long-/short-term issuer rating (in the domestic currency)

2 - support rating

A - for mortgage covered bonds

On 18 January 2017, Fitch Ratings confirmed its rating of the Bank. Moreover, the agency assigned national ratings in PLN (corresponding to international ratings) at the level of AA-(pol) stable perspective/F1+(pol) – long-/short-term national ratings in PLN.

On 23 June 2017, Fitch Ratings Ltd. confirmed the rating of mortgage bonds at "A" level with a positive outlook, indicating an improvement in the risk characteristics of the collateral register and an increase in over-collateralization.

On 8 December 2017, rating agency Fitch Ratings Ltd. confirmed the long-term rating for the Bank at the BBB level with a stable perspective.

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

- long-term international/domestic ratings: AAA, AA, A, BBB, BB, B, CCC, CC, C, RD, D
- short-term international/domestic 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 2017 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	31.12.2017	31.12.2016	Dynamics
ASSETS	12,168,169	10,649,499	14.26%
Including			
Loans granted to customers	10,766,911	9,411,505	14.40%
LIABILITIES AND EQUITY	12,168,169	10,649,499	14.26%
Including			
Debt securities in issue ¹	7,043,125	6,152,771	14.47%
Share capital	734,719	614,792	19.51%

In 2017 the Bank achieved a positive gross result in the amount of PLN 34,773 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 2017 was greatly influenced by low interest rates and strong pressure on margins. Despite this, the Bank reported a growth in the net interest income compared to 2016 (by PLN 25,868 thousand or 19.88%).

The total value of administrative expenses, amortization and depreciation increased by 2.88% compared to 2016. The cost to income ratio fell to 45.99% from 48.96% at the end of 2016.

Due to the specialization and narrow range of the products offered, the Bank is unable to compensate the effects of the bank tax. Before the tax, the Bank's operating result amounted to PLN 59,199 thousand, as compared to 46,864 thousand in 2016, which represents an increase by 26.32%. After the tax, the gross result was still significantly higher than in the previous year (by PLN 4,594 thousand or 15.22%).

In 2017 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 146,908 thousand (in 2016: PLN 134,116 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 01.01.2017 to 31.12.2017	Period from 01.01.2016 to 31.12.2016	Dynamics
Net interest income	156,009	130,141	19.88%
Net fee and commission income	(5,759)	1,526	-
Net trading income	(3,385)	1,736	-
Net impairment write-downs on loans and advances	(20,225)	(21,588)	-6.31%
Overhead costs	(64,361)	(62,472)	3.02%
Amortisation and depreciation	(3,196)	(3,197)	-0.03%
Operating result	59,199	46,864	26.32%

¹ In the first half of 2017, the Bank changed the presentation of the hedge accounting difference relating to the fair value of hedged items in such a way that the adjustment is presented jointly with the hedged item in the line "Debt securities in issue", which is consistent with IAS 39. The presentation change was applied to all comparable periods presented in the financial statements.

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Tax on the Bank's balance sheet items	(24,426)	(16,685)	46.39%
Gross profit	34,773	30,179	15.22%
Income tax	(6,944)	(6,757)	2.77%
Net profit	27,829	23,422	18.82%
Weighted average number of ordinary shares / weighted average diluted number of ordinary shares	3,191,260	3,042,186	4.90%
Net profit per ordinary share / Diluted profit per ordinary share (in PLN)	8.72	7.70	13.25%

Table 3. Effectiveness ratios

PERFORMANCE INDICATORS	31.12.2017	31.12.2016
ROA net ¹⁾	0.24%	0.24%
ROA gross ¹⁾	0.30%	0.31%
ROE net ³⁾	2.77%	2.81%
ROE gross ⁴⁾	3.46%	3.62%
Cost to income ratio (C/I) ⁵⁾	45.99%	48.96%
Net interest margin ⁶⁾	1.36%	1.37%
Cost of risk ⁷⁾	0.20%	0.26%
Total Capital Ratio	15.79%	14.54%
RATINGS Fitch Ratings Ltd		
long-term international rating	BBB	BBB
short-term international rating	F2	F2
support rating	2	2
mortgage covered bonds	A	A

OTHER		
Employment	178 employees/169 FTSE's	227 osób / 218 etatów
Average employment	208 employees	227 osób
Facilities	Headquarters + 4 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

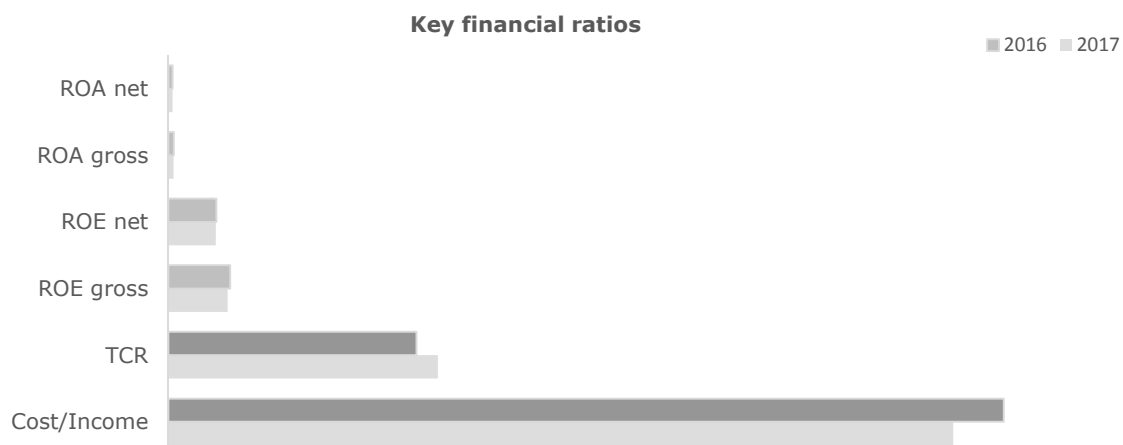
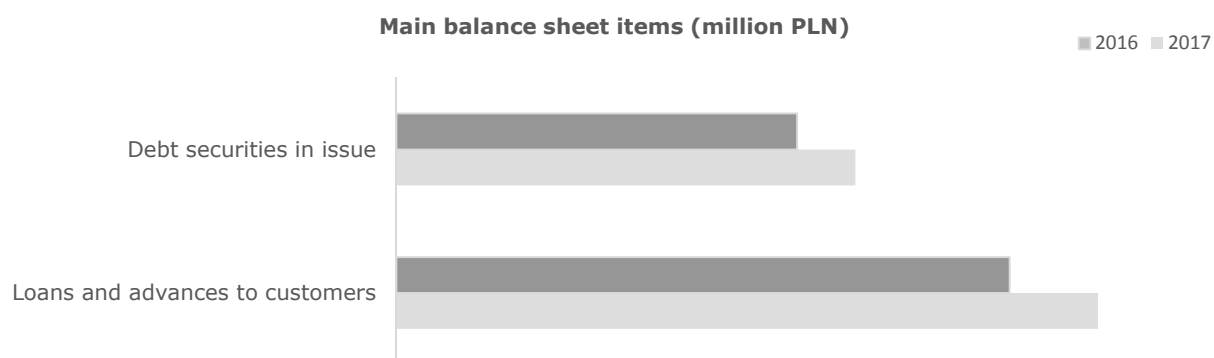


Chart 2. Main balance sheet items (in PLN million)



1.4. Lending

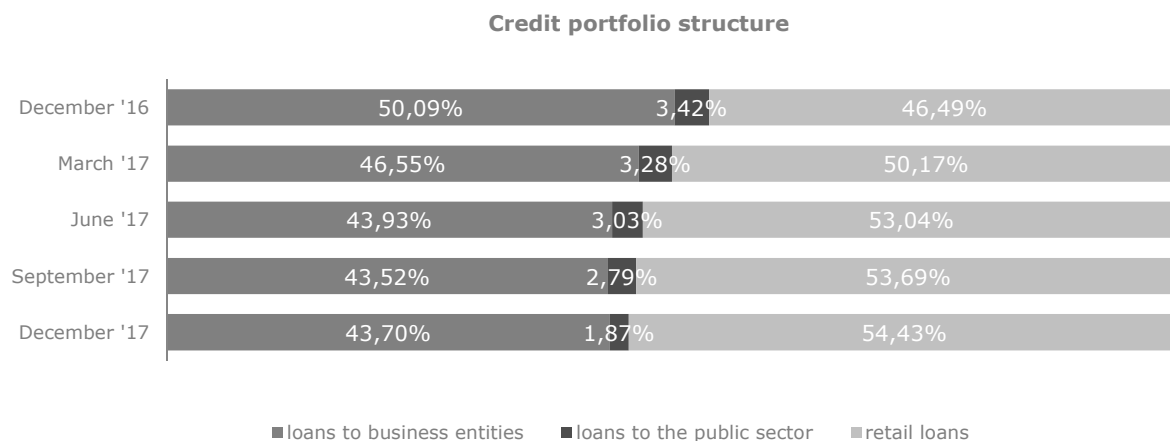
In 2017 the Bank developed its activity in both corporate and retail loan areas. The value of sales reached PLN 3,668 million and was lower by 8.1% than the value of agreements signed in 2016, due to the lower increase in the retail part, related to the transfer as of 22 July 2017 of the sales process to mBank S.A. and the planned change of the way to supply the Bank with retail assets. The net value of the whole loans portfolio, taking into account off-balance sheet liabilities, increased by the end of 2017 compared to the end of 2016 by 15.4%, reaching PLN 12.3 billion.

In the second half of 2017, a record half-year sale of commercial loans in the history of the Bank was recorded at the level of PLN 1,403 million, of which PLN 366 million accounted for housing developers, and PLN 1,037 million for the financing of commercial facilities.

During the said period, a "commercial pooling" from mBank S.A. in the amount of PLN 164.2 million was carried out. The annual sales closed with the amount of PLN 1,812 million, which is close to the previous year's result.

In the retail area, within the scope of implementation of the strategy of the mBank Group, the Bank recorded an increase of PLN 1,482 million in the retail mortgage portfolio (or 33.9%). Sales of credits in the agency model amounted to 1,855.8 million. There were no pooling transactions in 2017.

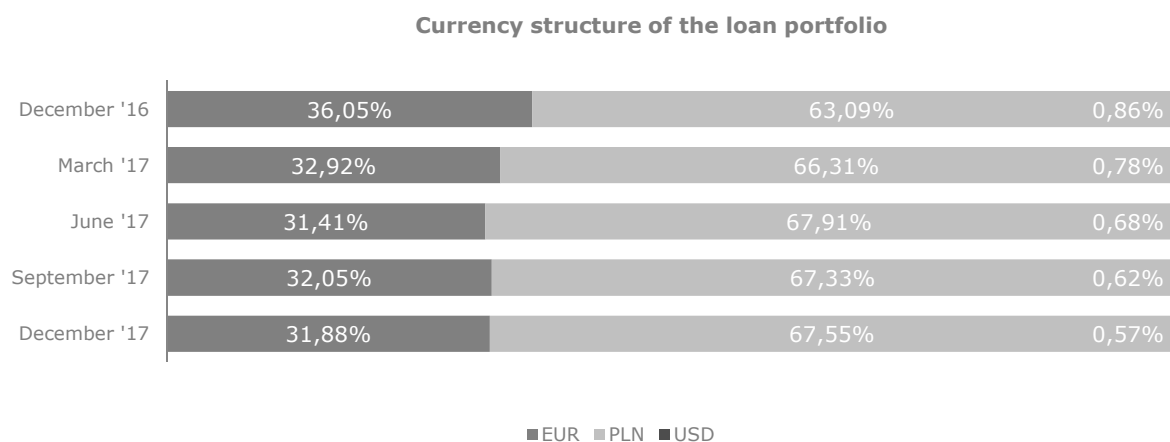
Chart 3. The structure of the loan portfolio in the period 31.12.2016 – 31.12.2017 (in PLN million)



The currency structure of the loan portfolio in 2017 was subject to change due to systematic growth of retail credit portfolio granted in PLN only. Compared to the end 2016, the share of PLN loans increased by 4.5 percentage points by the end of 2017. They constituted 67.6% of the loan portfolio. The share of EUR loans decreased to the level of 31.9%.

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

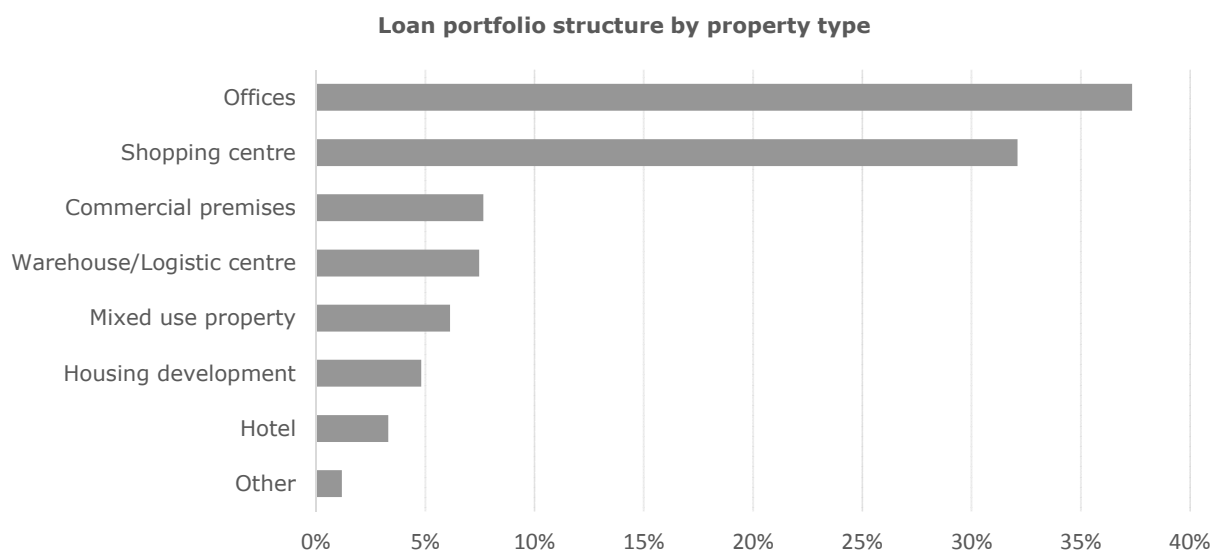
Chart 4. The currency structure of the loan portfolio in the period 31.12.2016 – 31.12.2017



Corporate loans

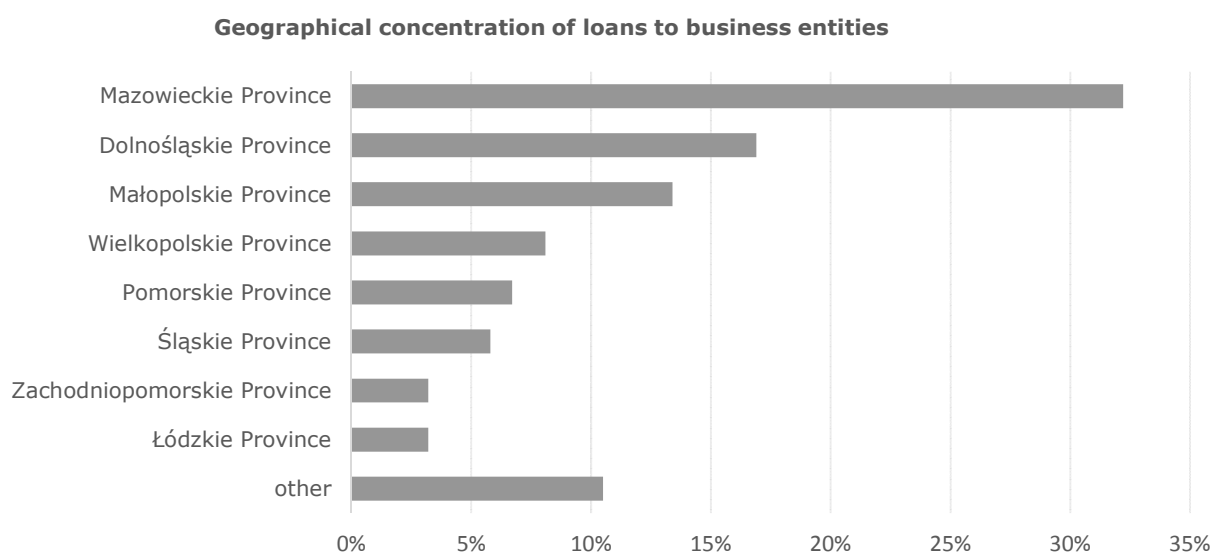
Net balance sheet exposure to business entities as of 31 December 2017 amounted to PLN 4,699 million. The dominant part (88.7%) accounted for refinancing of completed commercial facilities, the exposure in housing projects constituted 4.8%, and credits for financing of construction of commercial objects 6.5%.

Chart 5. Corporate loans by type of financed real estate as of 31 December 2017



As of the end of December 2017, 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 2017



The largest number of financed projects is concentrated in Mazowieckie province, where 32.2% of all credit resources is involved. In Dolnośląskie, Małopolskie and Wielkopolskie province the total balance sheet exposure accounts for 38.4%.

As of 31 December 2017 loans granted in EUR (72.7%) and PLN (26.1%) 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 2016, balance sheet exposure to public sector. As at 31 December 2017 the exposure was PLN 201 million (down by 37.6%).

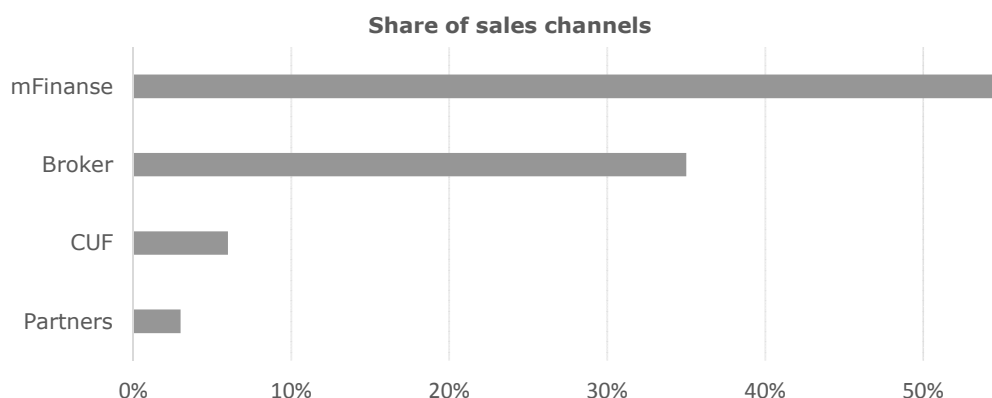
Retail loans to natural persons

The Bank continues the implementation of strategic objectives in the area of mortgage loans to natural persons in cooperation with mBank S.A.

In the second quarter of 2017, mBank S.A. decided to move sales of retail loans from mBank Hipoteczny S.A. to mBank S.A. Starting from 22 July 2017, all mortgage loans to natural persons will be processed and granted by mBank S.A.

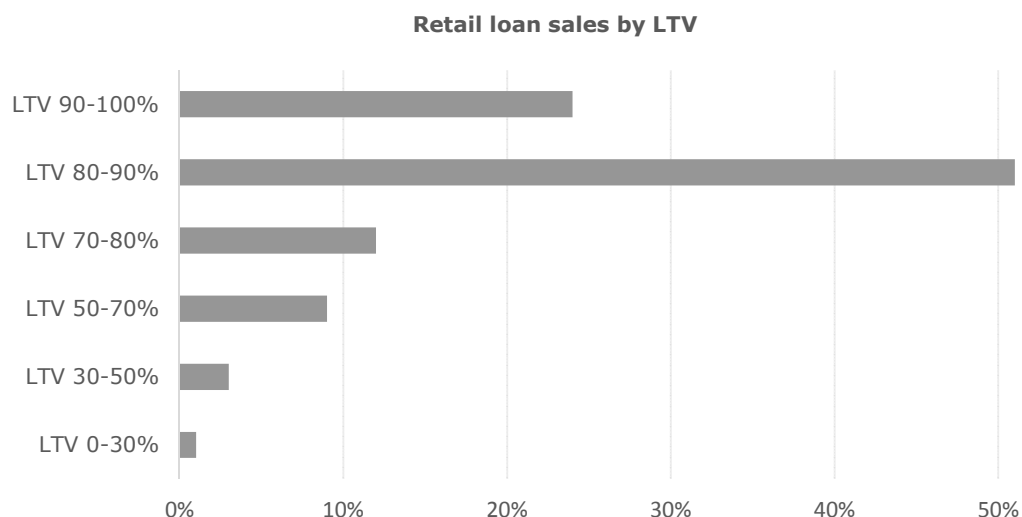
The acquisition by mBank Hipoteczny S.A. from mBank S.A. of the portfolio of receivables resulting from loans secured with a mortgage with a view to their refinancing by issuing mortgage bonds will continue to be a material component in the pursuit of strategic objectives.

Chart 7. The share of sales channels in 2017



The volume of loans disbursed in 2017 amounted to PLN 1.85 billion. The average loan amount was PLN 322 thousand. The volume-weighted average margin for the portfolio acquired in 2017 was 2.00%. The average commission weighted by the amount of credit agreement for loans disbursed in this period was 1.71%. Loans with LTV of 80-90% constituted the largest share in the sales.

Chart 8. Sales structure in 2017 divided by LTV bands.

**1.5. Refinancing and issuing of covered bonds**

In 2017, mBank Hipoteczny S.A. placed on the market six issues of mortgage covered bonds of a total nominal value of about PLN 2.73 billion as at 31 December 2017, including two private issues of a value of PLN 700 million. The value of four issues in the domestic currency amounted to PLN 2.2 billion. The value of two issues denominated in EUR amounted to EUR 124.9 million.

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It should be pointed out that the issue of a nominal value of PLN 1 billion placed on the national market in October 2017 was the largest issue not only in the history of the Bank, but also in the history of modern Polish mortgage banking.

Within the scope of debt restructuring in 2017, the Bank repurchased on the secondary market 3 series of mortgage covered bonds of private issue of a total nominal value of PLN 700 million and EUR 70 million.

The value of all mortgage covered bonds issued by the Bank and placed in organised trading as at the end of 2017 amounted to approximately PLN 6.06 billion, representing approximately 37.2% of the mortgage covered bonds market in Poland according to the Bank's estimates.

At the end of 2017, the Bank did not have any liabilities by virtue of issuing public covered bonds.

Covered bonds of mBank Hipoteczny S.A. 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 mortgage covered bonds issued by the Bank. On 23 June 2017, the rating for mortgage covered bonds was confirmed at A level.

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

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

Issue date	Redemption date	Currency	Value	Rating Fitch Ratings Ltd.
15.06.2012	15.06.2018	PLN	200,000,000	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
29.09.2017	10.09.2022	PLN	500,000,000	A
11.10.2017	15.09.2023	PLN	1,000,000,000	A
TOTAL		PLN	3,935,000,000	

Issue date	Redemption date	Currency	Value	Rating Fitch Ratings Ltd.
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
28.09.2016	20.09.2026	EUR	13,000,000	A
26.10.2016	20.09.2026	EUR	35,000,000	A
01.02.2017	01.02.2024	EUR	24,900,000	A

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30.10.2017	22.06.2022	EUR	100,000,000	A
TOTAL		EUR	504,400,000	

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

Organiser of the offering: mBank S.A.

Issue date	Redemption date	Currency	Value
22.09.2017	16.12.2019	PLN	400,000,000

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.

As of 31 December 2017 the collateral of mortgage covered bonds consisted of receivables of value PLN 8,591.7 million from total number of 18,495 loans.

Loans for commercial clients constituted 45.06% and for retail clients 54.94% of the total amount of receivables entered into the mortgage cover register. Loans granted in PLN (65.57%) dominated, loans in EUR (33.85%) and USD (0.58%) constituted the remaining part.

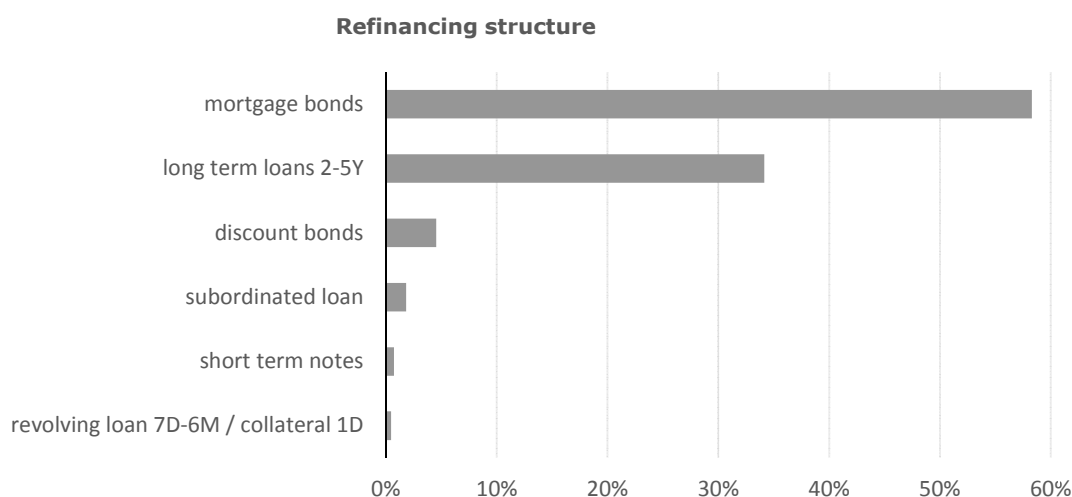
Additionally to the credit receivables, the additional collateral in a form of treasury bonds of nominal value of PLN 180 million was also entered into the mortgage cover register.

As of 31 December 2017 the level of over-collateralisation (including substitute cover) of mortgage covered bonds and public sector covered bonds amounted to 35.09%.

At the turn of 2016 and 2017, the process of entering loans in the register of mortgage bond security was modernized and restructured along with the implementation of a new IT system dedicated to this process.

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

Chart 9. The structure of refinancing of the Bank activity as of 31 December 2017

**1.6. Legal environment**

The most significant event in terms of the legal environment of the mortgage bank's activity in 2017 was the adoption on 23 March 2017 of the Act on mortgage loans, which sets out the principles and procedures for concluding a mortgage loan agreement; rights and obligations of the lender, mortgage loan intermediary and agent in terms of information provided before concluding a mortgage loan agreements, and rights and obligations of a consumer, a lender, a mortgage loan intermediary and agent with regard

to a mortgage loan agreement concluded, the results of a failure by the lender, mortgage loan intermediary or agent to fulfil their obligation, and the principles and procedures of supervision over mortgage loan intermediaries and agents. The Act implements the Directive of the European Parliament and of the Council 2014/17/UE of 4 February 2014 on credit agreements for consumers relating to residential immovable property (...). The Act on mortgage loans entered into force as of 22 July 2017, with the exception of a few provisions which have later effective dates. Due to the fact that the date of entry into force of the Act (applicable to agreements concluded after its entry into force) coincided with the date of takeover by mBank S.A. of sales of mortgage loans for consumers and the discontinuation of this activity at mBank Hipoteczny S.A., this Act in the end has limited effect on the activity of mBank Hipoteczny S.A. The Act required a certain adaptation of the internal procedures, in particular the requirements regarding loan restructuring and allowing the borrower to sell the real-estate before taking actions aiming at recovering the claim, which was done.

In 2017 works were carried out in the Bank to adjust operating procedures and IT infrastructure to the requirements of Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data (...). The works will continue in 2018. The Regulation shall apply after 25 May 2018.

In 2017, the Bank also concluded its works related to the implementation of the requirements of the Act of 9 March 2017 on the exchange of tax information with other countries, which introduces into the Polish legal order the EU provisions and facilitates the exchange of information with countries other than the EU countries based on the Common Reporting Standard procedure.

In 2017, works also focused on the entry into force of the Regulation of the Minister of Development and Finance on the risk management system and the internal control system, the remuneration policy and the detailed manner of assessing internal capital at banks of 6 March 2017 and Recommendation H, concerning the system of internal control at banks, issued on 25 April 2017 by the Polish Financial Supervision Authority.

In 2017, within the scope of analyses were the effects for the Bank of the MiFID 2/MiFIR package, i.e. Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (hereinafter referred to as "MiFID 2"), as well as of Regulation (EU) No 600/2014 of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (hereinafter referred to as "MiFIR"). The MiFID 2/MiFIR package is applicable as of 3 January 2018. The performed analyses led to the conclusion that the said rules have a limited effect on the activity of the Bank.

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.

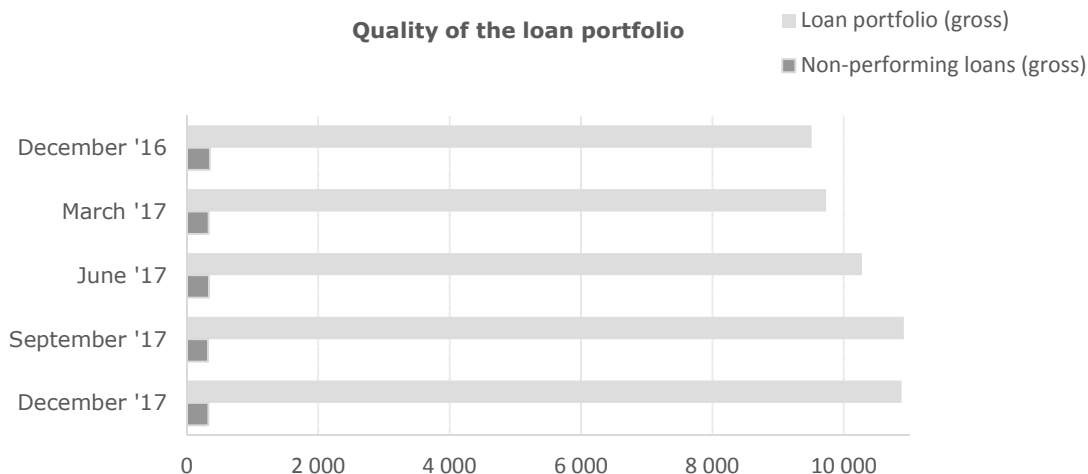
Due to the actions undertaken by the Bank within the scope of problem loans management and as a result of increasing of the loan portfolio, the share of non-performing loans in the loan portfolio decreased to the level of 2.99%. Most of the loans are repaid in a timely manner, and the borrowers of higher risk profile are subjected to a more strict monitoring. The net value of the loan portfolio in 2017 increased in relation to the end of 2016 by PLN 1,355 million, which resulted mainly from the increase of the retail portfolio (agency loans).

Impairment provisions reaching PLN 113.7 million (pursuant to IAS 39) together with mortgages on the financed real estates constitute an appropriate security against potential losses resulting from credit risk.

The main area of activity of the Bank in 2017 was refinancing of commercial real estates, especially shopping centres and offices. This activity is based on a uniform for the whole mBank S.A. group commercial real estate financing policy, including key elements of acceptance policy for individual segments of the real estate market. Drawing on past experiences in housing investments financing, the

Bank continued financing of residential construction projects focusing on selective financing of projects of the most favourable market parameters (e.g. adaptation of the offer to the needs of the market, positive history of the developer's activity, adequate level of own contribution and verified pre-sale).

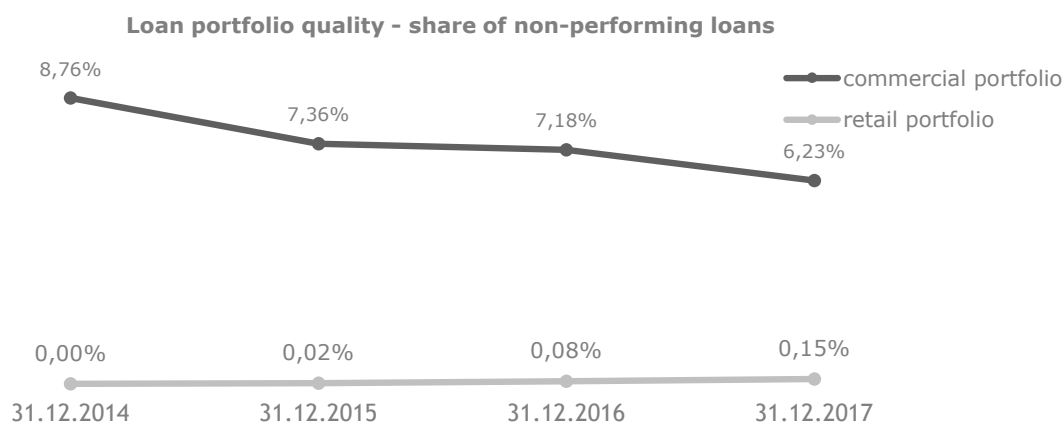
Chart 10. Non-performing loans* in the loan portfolio (gross value, in PLN million)



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

The retail portfolio is characterised by very high quality, which results from the applied credit policy (until the moment of transferring the whole process of selling retail mortgage loans to mBank S.A.) as well as the fact that this portfolio is very young. As of 31 December 2017 there were only 27 cases with reported loss of value. Loans for natural persons are monitored monthly for timely repayments and correctness in terms of established effective mortgage collaterals. Realisation of all contractual obligations of the client is verified in the same monitoring period (including insuring of the real estate and assignment of the rights under insurance policies).

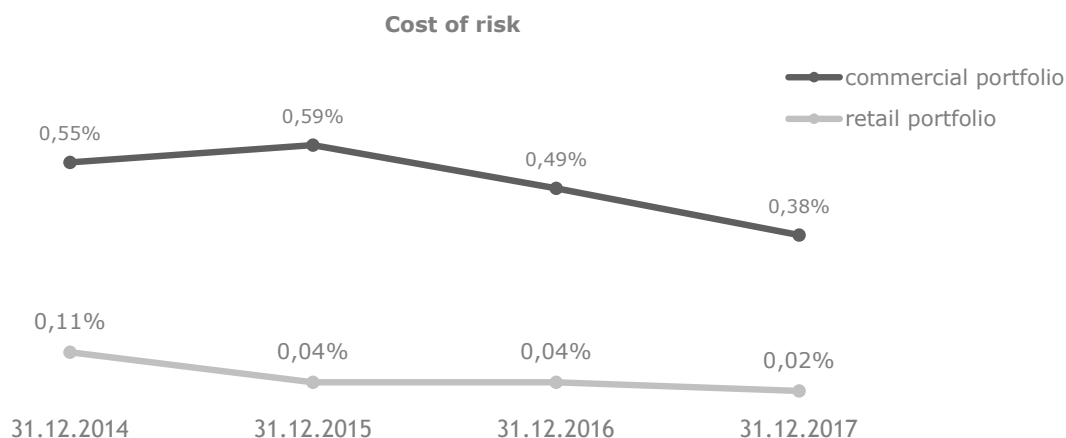
Chart 11. Share of non-performing loans by portfolio



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

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

Chart 12. Cost of risk by portfolio



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

Credit risk management

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

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

Lawsuits brought by the Bank, insolvency proceedings

In the second half of the year, on 25 July 2017, the Bank filed a motion for bankruptcy with respect to commercial receivables amounting to EUR 357.56 thousand and to PLN 0.37 thousand. As at the date of this report, the Court did not declare bankruptcy, but designated a Temporary Court Administrator.

On 19 April 2017, the Bank applied before the Court for initiating restructuring proceedings in a commercial customer case. On 20 July 2017, the Court issued an order to initiate the restructuring proceedings. The restructuring proceedings is pending

2.2. Market risk

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

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

The amount of market risk the Bank is exposed to in the day horizon is determined using Value at Risk (VaR) method at the confidence level of 97.5%. As of the end of December 2017 VaR amounted to PLN 508.9 thousand. The currency risk was PLN 61.7 thousand, the interest rate risk was PLN 129.7 thousand and the credit spread risk was PLN 567.1 thousand.

The interest rate risk results from exposure of the financial result and the Bank's capital to adverse effect of interest rates changes. The Bank manages the interest rate gap through matching the repricing dates of assets and liabilities. The sensitivity of the Bank's portfolio to interest rates fluctuations is determined on the basis of results of stress tests and scenario analyses. The interest rate risk is measured among others by using Earnings At Risk (EaR) ratio, which by the end of December 2017 reached a safe level of 4.41%. The banking books items that are exposed to interest rate risk are hedged with linear interest rate derivatives.

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

2.3. Liquidity risk

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

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

At the end of December 2017, the excess of liquid assets amounted to approx. 8.8% of the balance sheet total.

In 2017 financing of Bank's lending was performed primarily through issuing covered bonds in PLN and EUR. The long-term situation of the Bank in terms of liquidity is stable. Loans obtained from mBank S.A. have significant share in financing of long-term receivables.

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

The share of stable financing sources and liquidity reserves adequate to the scale of the Bank's activity determines meeting of long-term liquidity standard M4 required by KNF. The M4 ratio at the end of December 2017 was 1.068. M1 and M2 short-term liquidity standards were maintained at a safe level, PLN 1,482,059 thousand and 2.719 respectively. The M3 standard was 94.223.

As at the end of December 2017 the liabilities limit, resulting from Art. 15.2 of the "Act on covered bonds and mortgage banks", was used in 66.65%. In 2017 this limit was not exceeded.

As at the end of December 2017 average maturity of issued mortgage covered bonds was 4.1 of a year for mortgage covered bonds while the average maturity of loans obtained from other banks was 3.7 of a year. The margin of mortgage covered bonds issued in 2017 on average amounted to 0.80%, with average maturity of 4.9 of a year.

2.4. Operational risk

The Bank has a simplified organisational structure, and the products offered are consistent with the nature of the mortgage bank's activity. In 2017, the profile of the Bank's activity was changed. As of 22 July 2017, the sales process for retail loans was transferred to mBank S.A. This involved the transfer of operational risk related to entrusting a substantial part of the activities to external entities and the transfer of risk identified at the stage of verifying loan applications and concluding loan agreements. The indicated

factors contribute to decreasing the Bank's operational risk, yet, operations related to the maintained retail portfolio and the acquisition of loans by pooling are continuously monitored.

The transfer of the sales process for retail loans to mBank S.A. initiated in H2 2017 changes to the Bank's organisational structure, which generated elevated operational risk in that period. The Bank registered an increased employee turnover ratio, which was predominantly due to shifting positions involving the retail sales process to mBank S.A. In 2017, the Bank did not record any actual losses. The identified operational events were of non-realised effects, i.e. the Bank's results or equity not included in the statement. Based on the indicated factors, it can be stated that following the implementation of organisational changes at the end of 2017, the level of the Bank's exposure to operational risk decreased in comparison to the previous year. Any changes that could affect the operational risk portfolio view are regularly monitored and reported.

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

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

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

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

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

2.5. Covered bonds investment risk

In 2017 the investment risk profile associated with covered bonds issued by mBank Hipoteczny S.A. did not change. Those securities are a financial instrument of a low investment risk, resulting from the

requirements of multi-stage collateralisation of their issuing and trade by the issuer, accordant with the Act on covered bonds and mortgage banks. In addition to compliance with a number of statutory requirements during economic slowdown, high safety of investing in covered bonds is also a result of the Bank's conservative policy of valuation of real estates constitute their collateral, which has been applied for many years. According to the amended Act on covered bonds and mortgage banks, the minimum level of over-collateralisation of mortgage and public sector covered bonds since 1 January 2016 is 10%.

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

2.6. Internal control system

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

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

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

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

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

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

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

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

2.7. Remuneration policy

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

3. Real estate market in Poland

Housing market²

- 2017 was a period of high activity, both on the demand side and on the supply side of the residential property market.
- In total, the main cities' offer included approx. 48.2 thousand housing units at the end of 2017 (decrease by 8.5% y/y). The number of ready, unsold housing units decreased - at the end of the year, it was only 13.6% of the entire offer.
- The number of transactions of sale of housing units, calculated jointly for 6 main markets, reached a record level of 72.7 thousand units in 2017, approx. 20% more than in 2016 in which approx. 62.0 thousand housing units were sold.
- In total, 67.3 thousand new housing units were offered for sale on the main markets in 2017. Therefore, another record was broken, although in comparison to 2016, the increase was only 3.6% (2.3 thousand units).
- The highest y/y increase in offer prices was noticed in Tricity (15%). Significant changes also occurred in the market of Łódź (8.5%) and Warsaw (8.4%). In Wrocław and Poznań, the average prices grew by 4.4%.

² The analysis covers the following cities: Warsaw, Kraków, Wrocław, Poznań, Łódź, Gdańsk.

Office properties³

- At the end of 2017, the Warsaw market of office properties reached 5.28 million sq m which means that in the last year, the assets grew by another 275 thousand sq m. This supply reflects the average over the last 6 years; however, this is still by approx. 132,000 less than in the record year 2016.
- The total supply of office space in Warsaw reached 856 thousand sq m at the end of 2017; developers are active mainly in the Centre – 75% of constructed properties will be available on the market in the centre of Warsaw.
- During the analysed period, about 820 thousand sq m of office space were leased. The demand for office space in Warsaw was driven largely by financial sector companies, whose activities translated to 18% of the office space leased in the Capital.
- Good standing of the office property market in Warsaw, resulting in an increased activity of tenants, also contributed to a record level of absorption which reached 390 thousand sq m – this is an increase by 33 pp y/y.
- At the end of December 2017, the ratio of uninhabited premises in Warsaw was 11.7% (down by approx. 2.5 pp. y/y), which translated to approx. 617 thousand sq m of free space.
- Base rent for top-class office premises was adjusted to the level of EUR 20.0-23.0 per sq m per month, while the rates for locations outside the centre remained at the level of EUR 10.5–18.0 per sq m per month. Effective rent remains the same as last year, and is at the level of EUR 15.0-19.0 per sq m per month in the Centre, and EUR 9.0-13.0 per sq m per month outside the Centre.

Retail properties⁴

- The total retail space in Poland increased by further 360 thousand sq m in 2017, amounting to about 14.24 million sq m.
- Thirteen new shopping centres were opened last year. Most of the properties offered on the market were large centres (with the area of more than 40 thousand sq m). The largest commercial premises commissioned in 2017 are: Galeria Północna in Warsaw (69.3 thousand sq m), Wroclavia in Wrocław – a commercial and entertainment centre integrated with a bus station (64 thousand sq m), and Serenada in Kraków (42 thousand sq m).
- Extensions of existing projects were approx. 16% of newly supplied space in 2017, which is a decrease by 4 pp. as compared to the previous year. The greatest extension was completed at the Galaxy shopping centre in Szczecin (by approx. 17 thousand sq m).
- The level of saturation with modern spaces of shopping centres in Poland is still increasing, at the end of 2017 it reached 301 sq m /1000 residents. Among the eight main agglomerations, the highest index was noted in Wrocław (906 sq m /1000 residents), and among regional cities – in Lublin (1128 sq m /1000 residents).
- At the end of December 2017 approx. 580 thousand sq m of modern commercial space were under construction in Poland. The construction of premises such as Galeria Młociny in Warsaw (75 thousand sq m), Forum in Gdańsk (62 thousand sq m) or Galeria Libero in Katowice (42 thousand sq m) is ongoing.
- No changes in the rates of rent for commercial space were noted in the previous year. Warsaw still remains the most expensive location, where “prime” rents for the best premises of up to 100 sq m, in the most prestigious shopping centres, amount to approx. EUR 130 per sq m per month. In the remaining main agglomerations, the rent is at the level of EUR 45-60 per sq m per month.
- The level of uninhabited premises in the main agglomerations is still low – approx. 4%.

³ The analysis covers Warsaw and the following regional markets: Kraków, Wrocław, Katowice, Poznań, Gdańsk, Łódź.

⁴ The analysis covers: Warsaw, Poznań, Kraków, Wrocław, Tricity, Silesian agglomeration, Łódź.

Warehouse properties⁵

- The supply of modern warehouse space made available on the market in 2017 reached more than 2.3 million sq m (as compared to approx. 1.26 million sq m made available in 2016). The total resources of warehouse space in Poland exceeded 13.5 million sq m.
- The largest volume of new space, 478 thousand sq m, was added in the Warsaw region; Upper Silesia was second, with 320 thousand sq m, followed by Szczecin, where new supply exceeded 320 thousand sq m.
- Demand also remained high, with approx. 4.6 million sq m in 2017, i.e. by over 1.2 million sq m more than in the preceding year.
- At the end of the year, 1.39 million sq m were under construction, 30% of which were speculative developments. This result is better by 900 thousand sq m than in 2016.
- At the end of December 2017, the ratio of uninhabited premises was 5.4% and remained at the same level as in 2016.
- In the majority of markets, rent rates were stable. The highest applied in the Warsaw City zone: EUR 3.5–4.7 per sq m per month, and the lowest were in Central Poland: EUR 1.8–3.0 per sq m per month.

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

The mission of mBank Hipoteczny S.A. 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 S.A. 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 S.A. sales network. It applied 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 S.A. Two transactions of this type took place in 2014, followed by four transactions in 2015 and four transactions in 2016.

In 2017 the Bank continued actions consisting in development of the new retail mortgages portfolio acquired in cooperation with mBank S.A. and refinancing of this portfolio through issuing covered bonds. From 22 July 2017, the entire sales process for retail loans is operated by mBank S.A.

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 40 million). The priority of the Bank will be financing of commercial real estate of low investment risk, characterised by a high

⁵ The analysis covers: Warsaw City, Warsaw Suburbs, Upper Silesia, Poznań, Wrocław, Central Poland, Tricity, Kraków, Szczecin, Emerging Markets (Rzeszów, Lublin).

mBank Hipoteczny S.A.

Management Board Report on the Performance of mBank Hipoteczny S.A. in 2017

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

Starting from 22 July 2017, mBank Hipoteczny S.A. develops its activity in the retail area to build the portfolio of mortgage loans for natural persons by transfers of the existing and newly-granted loan portfolios from mBank and re-financing of that portfolio with mortgage bonds.

Refinancing strategy of mBank Hipoteczny S.A.

The activity of mBank Hipoteczny S.A. 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 S.A. 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. Issues will be offered in public or private offerings, on the domestic market and for foreign investors. Issues in public offerings will be traded on regulated markets.

5. Bank Authorities

Shareholders

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

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placement. The shares were paid-up in full on 28 February 2017. On 3 April 2017, the registry court entered the increased share capital in the registry of entrepreneurs.

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

As of 31 December 2017 the ownership structure of registered share capital of the Bank is as follows:

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

The Bank does not collaborate with international public institutions.

Management Board

As at 31 December 2017 the Management Board of mBank Hipoteczny S.A. included the following members:

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

Marcin Romanowski resigned from the position of Management Board Member as of 20 September 2017. On 21 September 2017, the Supervisory Board appointed Andrzej Kulik as a Member of the Management Board.

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

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

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

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

Rules on amending articles of association

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

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

- a company's name must include a separate word "bank" and differ from the names of other banks as well as indicate whether it is a national bank, bank in the form of a joint stock company or cooperative bank;

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- registered office, business objectives and scope of activities of a bank including activities referred to in Art 69 para. 2 item 1-7 dated 29 July 2005 on trading in financial instruments which the bank intends to perform in accordance with Art. 70 para. 2 thereof;
- bodies and their competencies with particular emphasis on competencies of members of the management board referred to in Art. 22b para. 1 banking law, as well as principles of decision-making, basic organisational structure of the bank, rules for submission of statements in the scope of rights and financial obligations, procedures of issuing internal obligations and decision-making procedures regarding commitments or disposal of assets which total value in relation to one entity exceeds 5% of own funds;
- principles of operation of the management system, including the internal audit system;
- own funds and financial management principles

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

Supervisory Board

Composition of mBank Hipoteczny S.A. Supervisory Board as at 31 December 2017:

- Cezary Kocik – Supervisory Board Chairman
- Lidia Jabłonowska-Luba - Supervisory Board Vice-Chairman
- Frank Bock – Supervisory Board Member
- Andreas Boeger – Supervisory Board Member
- Jakub Fast – Supervisory Board Member
- Paweł Graniewski – independent Supervisory Board Member
- Michał Popiołek - Supervisory Board Member
- Mariusz Tokarski – independent Supervisory Board Member

As of 7 February 2017, Dariusz Solski resigned from the position of Supervisory Board Member. The composition of the Supervisory Board was supplemented on 8 February 2017 by the Extraordinary Shareholders Meeting: Jakub Fast was appointed a Supervisory Board Member.

As of 31 March 2017, Hans Dieter Kemler resigned from the position of a Supervisory Board Member. As of 1 March 2017, the Supervisory Board appointed Cezary Kocik the Chairman of the Supervisory Board. On 29 May 2017, the Extraordinary Shareholders Meeting supplemented the composition of the Supervisory Board by appointing Frank Bock a Supervisory Board Member.

On 12 July 2017 Christoph Heins resigned from the position of a Member of the Supervisory Board and on 14 July 2017 the Extraordinary General Meeting appointed Andreas Boeger and Paweł Graniewski to join the Supervisory Board.

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

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

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

Audit Committee

As at 31 December 2017 the Audit Committee included the following members:

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

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On 16 August 2017, Jakub Fast resigned from the position of a Committee Member. On 17 August 2017, the Supervisory Board appointed Paweł Graniewski to join the Audit Committee as the Chairperson, and Andreas Boeger – as a Committee Member.

The Audit Committee operates on the basis of Article 130 of the Act of 11 May 2017 on statutory auditors, audit firms, and public oversight (Journal of Laws item 2017.1089).

In 2017 the Audit Committee held three meetings: on 27 March, 18 October and 14 December.

Risk Committee

As at 31 December 2017 the Risk Committee included the following members:

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

The tasks of the Risk Committee include:

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

In 2017 the Risk Committee held one meeting - on 13 March.

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 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.

In the first half of 2017, the composition of the Supervisory Board was changed twice, due to resignations from the position of Supervisory Board Member submitted by Dariusz Solski and Hans Dieter Kemler. On 8 February 2017, Jakub Fast and on 29 May 2017, Frank Bock, were appointed members of the Supervisory Board.

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 Note 33 to the Financial Statements.

Public aid

In 2017, 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 2017.

Events after the balance sheet date

There were no significant events after the balance sheet date.

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 S.A. as well as its financial performance,
- The report of the Management Board on activities presents a true picture of the situation of mBank Hipoteczny S.A., including a description of the main risks and threats.

The process of 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	Andrzej Kulik	Grzegorz Trawiński	Marcin Wojtachnio
President of the Management Board	Member of the Management Board	Member of the Management Board	Member of the Management Board