

**mBank Hipoteczny S.A.
Directors' Report
for the first half of 2014**

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1. Operations of mBank Hipoteczny in the first half of 2014

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

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

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

In the first half of 2014, the Bank carried out its tasks in the conditions of increased competition on the commercial real estate financing market, dominated by strong universal banks.

Major trends observable in this market include:

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

As regards the financing of residential construction for commercial purposes:

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

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

Since 2010, when Poland started leaving the global economic crisis behind, the real estate market has been subject to systematic growth, expressed in a greater number of new projects, more new space available, and higher volume of transactions executed on this market. The residential real estate market is more predictable and more stable than at the time of the 2006–2008 boom, and the existing surplus in apartment supply is being gradually reduced. In the last quarter, the sales volume of flats was relatively high.

1.1. Key projects in 2014

“Covered Bonds” Project

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

The implementation of the model is aimed at:

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

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

Implementation of the IRB approach

The Bank is working on the implementation of the integral ratings-based (IRB) approach, as a matter of high priority and long-term nature. Seven internal models in the commercial area were conditionally approved by the PFSA on 27 August 2012. Three further rating models for hotels and utility premises obtained the approval of the Federal Financial Supervisory Authority (BaFin) and the PFSA on 10 April 2014. A positive conditional decision on expanding the application scope of the IRB approach for the aforementioned models enabled immediate application of the IRB approach (slotting approach) to calculate capital requirements with respect to credit risk on a consolidated (the Commerzbank Group), subconsolidated (the mBank Group) and individual (mBank Hipoteczny S.A.) basis.

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

IT projects

Implementation of Recommendation D

Implementation of Recommendation D is one of the key tasks and projects implemented by the Bank. It comprises 43 initiatives, of which 29 had been completed as at the end of the second quarter of 2014, which made it possible to implement 75 out of 110 specific recommendations. Other specific recommendations are implemented under initiatives whose completion is expected to take place in the last quarter of 2014.

Modification of the Bank's Business Continuity Plan

In view of the Gap Analysis under Recommendation D, internal audit recommendations and the expansion of business activity relating to the Covered Bonds project, it was necessary to modify and update the Bank's existing Business Continuity Plan, taking into account the identified critical processes and the Bank's new business needs.

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As at the end of the first half of 2014, the Bank's Viability Strategy was developed, including critical processes adopted by way of a decision issued by the Management Board. During the last stage of the project, the entire Bank's Business Continuity Plan Management Process has been implemented, together with the operational test for this Plan concluded on the 2nd of August 2014.

Implementation of a Service Model for IT Management

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

1.2. Financial credibility

The financial credibility of mBank Hipoteczny is assessed by an international rating agency — Fitch Ratings Ltd. As at 30 June 2014, the following ratings were applicable:

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

1 – support rating

A – for public covered bonds

A – for mortgage covered bonds

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

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

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

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

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

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

1.3. Financial results

The Bank's financial statements for the first half of 2014 are prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union. Data presented in the Director's Report are presented according to the management approach and do not always have to be consistent with data contained in the financial statements.

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

Key balance sheet items	30.06.2014	31.12.2013	Dynamics
ASSETS	4,706,601	4,782,443	-1.59%
including			
Loans and advances to customers	4,119,202	4,045,000	1.83%
EQUITY AND LIABILITIES	4,706,601	4,782,443	-1.59%
including			
Debt securities in issue	2,817,776	2,661,407	5.88%
Amounts due to customers	255,269	295,167	-13.52%
Share capital	275,000	275,000	-

*The item "loans and advances to customers" includes "other receivables from customers" in the amount of PLN 2 209 thousand as at the end of June 2014.

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

Table 2. Dynamics of selected elements of the income statement (in PLN '000)

Income statement	Period from 01.01.2014 to 30.06.2014	Period from 01.01.2013 to 30.06.2013	Dynamics
Net interest income	41,711	37,118	12.37%
Net fee and commission income	3,113	1,714	81.62%
Net impairment write-downs on loans and advances	-9,099	-12,696	-28.33%
Overhead costs	-21,699	-19,824	9.46%
Amortisation and depreciation	-2,330	-1,950	19.48%
Profit before income tax	18,589	7,465	149.02%
Net profit	13,816	4,634	198.14%
Weighted average number of ordinary shares/diluted weighted average number of ordinary shares (in '000)	2,750	2,750	0.00%
Earnings per ordinary share/Diluted earnings per ordinary share (in PLN)	5.02	1.69	197.04%

As at the end of the first half of 2014, the Bank achieved a positive gross result amounting to PLN 18.6 million, exceeding the adopted plan almost twice and at the same time, reaching a result almost 150% higher than that achieved in the corresponding period in the previous year. Good performance is primarily attributable to the significantly higher than expected net trading income (high valuation of hedging instruments) and a much better net commission income than it was anticipated. A lower than planned value of revaluation write-downs on loans (28% less in comparison with the write-downs established at the end of the six-month period in 2013) also contributed to the achieved results.

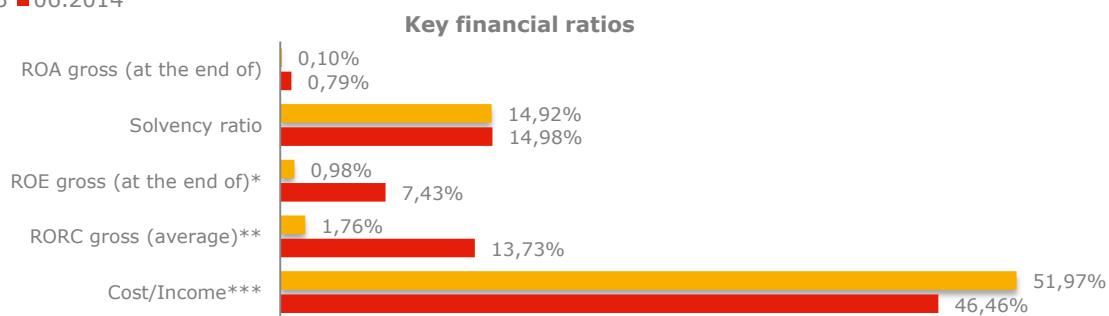
Table 3. Business effectiveness ratios

BUSINESS EFFECTIVENESS RATIOS	06.2014	2013
Gross ROE (as at the end of the period)	7.43%	0.98%
Gross ROA (as at the end of the period)	0.79%	0.10%
Cost/income*	46.46%	51.97%
Capital adequacy ratio	14.98%	14.92%
RATINGS of Fitch Ratings Ltd		
international long-term rating	A	A
international short-term rating	F1	F1
support rating	1	1
public covered bonds	A	A
mortgage covered bonds	A	A
OTHER		
Average employment	171 persons	144 persons
Branches	Head Office + 6 branch offices	Head Office + 6 branch offices

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

Chart 1. Key financial ratios

■ 12.2013 ■ 06.2014



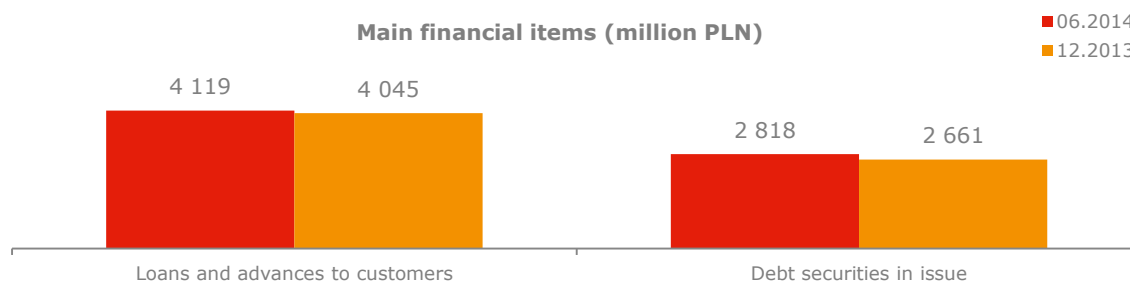
* gross result / (share capital + financial result from the previous years)

** gross result / average regulatory capital

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

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

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



* The item "loans and advances to customers" includes "other receivables from customers" in the amount of PLN 2 209 thousand as at the end of June 2014.

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

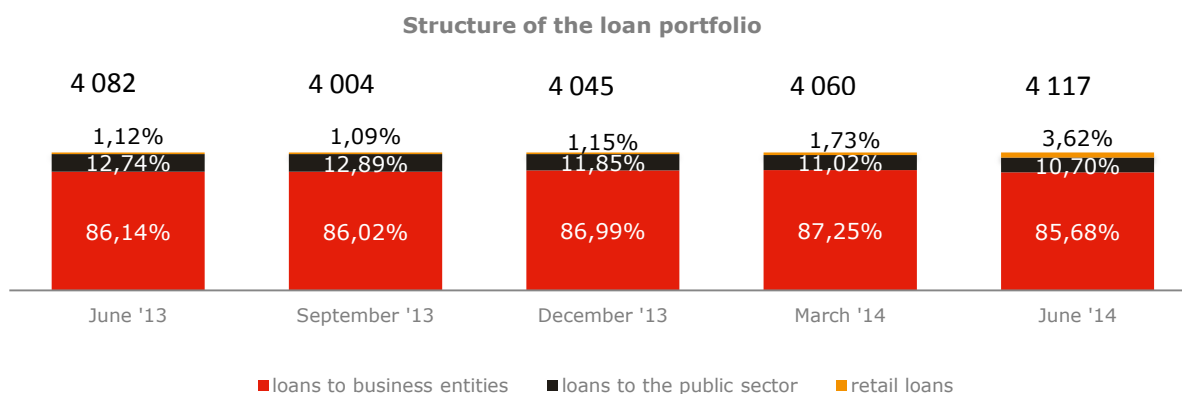
In the first half of 2014, the value of loans granted reached PLN 649.8 million (the value of the signed agreement) and was 160% higher than the value of agreements signed in the corresponding period in the previous year. Over PLN 120 million of this year's sales refers to lending activity in the retail area, which was resumed last year. The net value of the entire loan portfolio, taking into account off-balance sheet exposure, increased by 3.9% in comparison with the end of 2013, reaching the level of PLN 5.2 billion.

1.4. Lending activity

In the course of 15 years of its operations, the Bank has secured a strong position in the commercial real estate financing sector that guarantees its presence among the top lenders in this market. The Bank is committed to expand its sales network as part of the cooperation with Aspiro and to open further corporate branches of mBank.

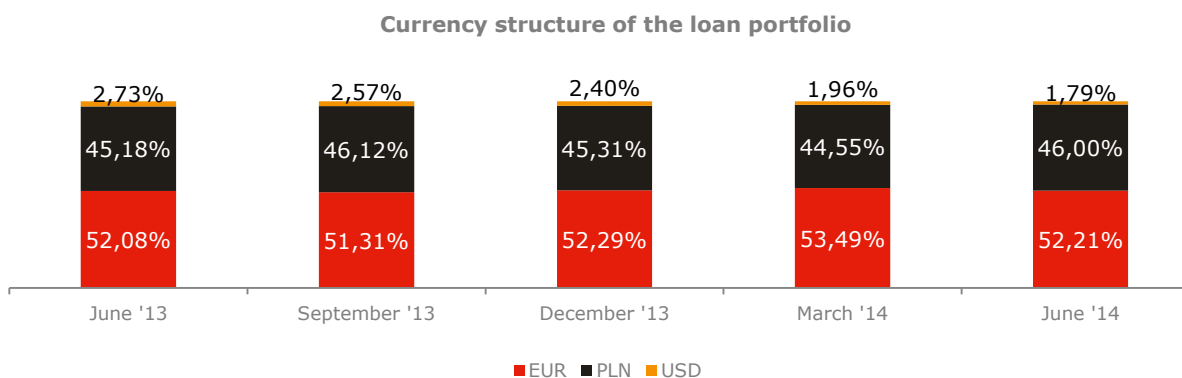
Since September 2013, as part of the project involving the reconstruction of the mBank Group's balance sheet, the Bank's offer also includes retail loans.

Chart 3. Structure of the loan portfolio in the period 30.06.2013–30.06.2014 (in PLN million).



Currency structure of the loan portfolio remains at a similar level. For the last 12 months, loans in EUR continue to constitute the largest portion of the loan portfolio, which is characteristic of commercial investments. Nevertheless, the systematic growth of the portfolio of retail loans, granted only in PLN, contributed to the increase of the share of the Polish currency in the Bank's loan portfolio.

Chart 4. Currency structure of the loan portfolio in the period 30.06.2013–30.06.2014.



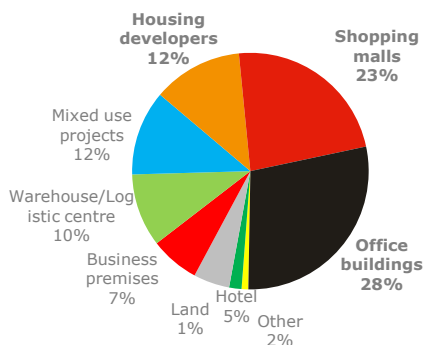
Loans to business entities

As at 30 June 2014, net balance sheet exposure towards business entities amounted to PLN 3,527.4 million. In the first half of 2014, loan agreements for the total of PLN 529.1 million were signed (the value of the signed agreement). The largest share in sales was that of loans to housing developers (48.0%),

followed by the refinancing of completed commercial premises (34.9%). Loans for commercial construction projects, with a share of 17.1%, accounted for the smallest portion of the newly signed loan agreements in 2014.

Chart 5. Loans to business entities by type of real estate financed as at 30 June 2014.

Loans to business entities by type of real estate financed

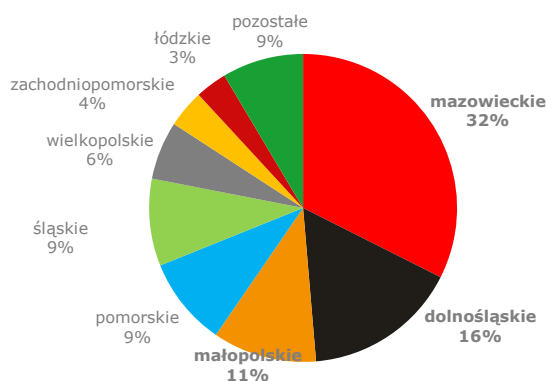


As at the end of June 2014, within the area of commercial real estate, the Bank particularly financed office buildings and shopping centers.

The Bank focused on the financing of purchases or refinancing of completed facilities with the relevant standard, as well as the financing of the construction process after which the construction loan is converted into a long-term mortgage loan. In the field of loans to housing developers, the Bank's purpose was to finance medium size projects (up to 100 apartments) located in attractive areas.

Chart 6. Geographical concentration of loans to business entities as at 30 June 2014.

Geographical concentration of loans to business entities



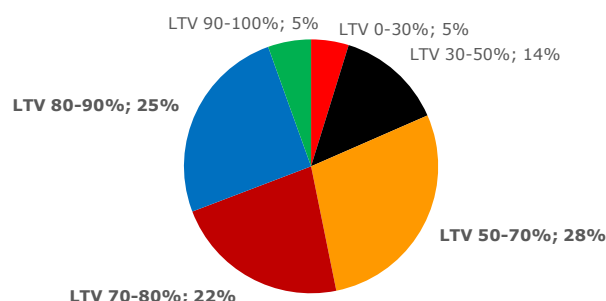
The largest number of financed projects is concentrated within the Mazowieckie province, where the exposure amounts to 32.4% of all credit funds. In the provinces of Dolnośląskie, Małopolskie and Pomorskie, the total balance sheet exposure amounts to 36.5%. As at 30 June 2014, the portfolio of loans to business entities is dominated by loans in EUR (60.3%) and PLN (37.7%).

Loans to the public sector

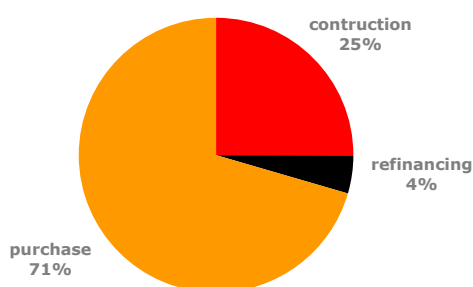
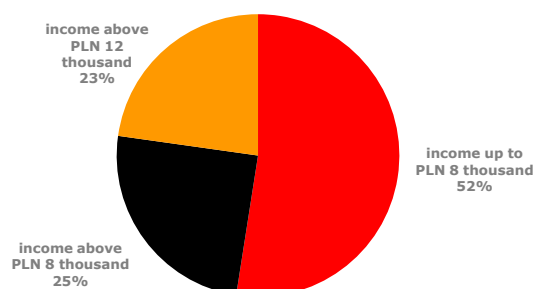
In the first half of 2014, the Bank ceased to provide financing to local government units. The lack of new agreements in 2014, coinciding with a substantial volume of early repayments, is reflected in a lower (as compared to the end of 2013) balance sheet exposure for such loans (-8.1%).

Retail loans to individual customers

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

Loan portfolio structure

As at the end of the six-month period, the net value of the portfolio exposure (retail loans – agency model) amounts to approx. PLN 110.5 million. The average amount of loan was PLN 214 thousand. In 2014, the average margin weighted by the portfolio volume amounted to 1.54%. The largest share in sales is that of loans with LTV of 50–70% and verified Customer net income at the level of up to PLN 8 thousand.

Loan portfolio structure according purpose of loan**mBH's Customer net income**

The net exposure of loans from the Bank's old portfolio granted to individuals shows a decline, reaching approx. PLN 38.6 million at the end of the first half of 2014.

1.5th Refinancing and issues of covered bonds

In the first half of 2014, mBank Hipoteczny successfully placed on the market 4 issues of mortgage covered bonds in EUR. The value of the said issues was EUR 50.5 million, and three of them were distinguished by an exceptionally long, i.e. amounting to 15 years, maturity period.

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The value of all covered bonds issued by the Bank and outstanding as at the end of the first half of 2014 was over PLN 2.5 billion, representing approx. 71% of the market of such bonds according to the Bank's estimates.

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

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

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

Date of issue	Date of redemption	Currency	Value	Fitch Rating
28.07.2010	28.07.2014	PLN	200,000,000	A
28.09.2010	28.09.2015	PLN	100,000,000	A
29.11.2010	28.11.2014	PLN	100,000,000	A
28.04.2011	20.04.2016	PLN	200,000,000	A
16.05.2011	15.05.2015	PLN	100,000,000	A
15.06.2011	16.06.2017	PLN	200,000,000	A
07.07.2011	07.07.2015	PLN	100,000,000	A
20.04.2012	20.04.2017	PLN	200,000,000	A
15.06.2012	15.06.2018	PLN	200,000,000	A
30.11.2012	15.11.2016	PLN	100,000,000	A
20.06.2013	21.06.2019	PLN	80,000,000	A
TOTAL		PLN	1,580,000,000	

Date of issue	Date of redemption	Currency	Value	Fitch Rating
19.10.2012	19.10.2017	EUR	10,000,000	A
26.07.2013	28.07.2020	EUR	30,000,000	A
22.11.2013	22.10.2018	EUR	50,000,000	A
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
TOTAL		EUR	140,500,000	

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

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

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

Basis for issuing covered bonds

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

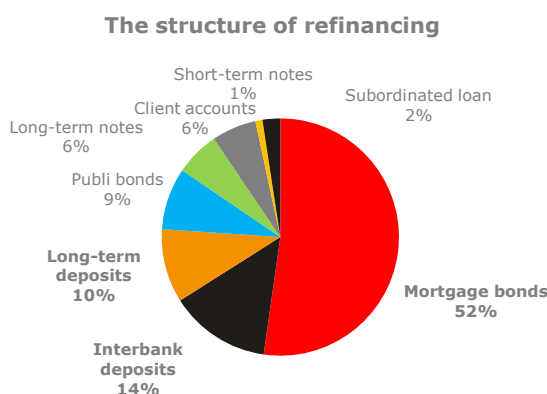
Public covered bonds are backed with receivables in respect of loans granted to local government units and loans secured with guarantees or warranties of local government units.

As at 30 June 2014, the collaterals of:

- public covered bonds comprised receivables of PLN 441,027 thousand relating to 74 loans in total
- mortgage covered bonds comprised receivables of PLN 2,765,397 thousand relating to 555 loans in total.

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

Chart 7. The structure of refinancing of the Bank's operations as at 30 June 2014.



2. Risk management

2.1. Credit risk

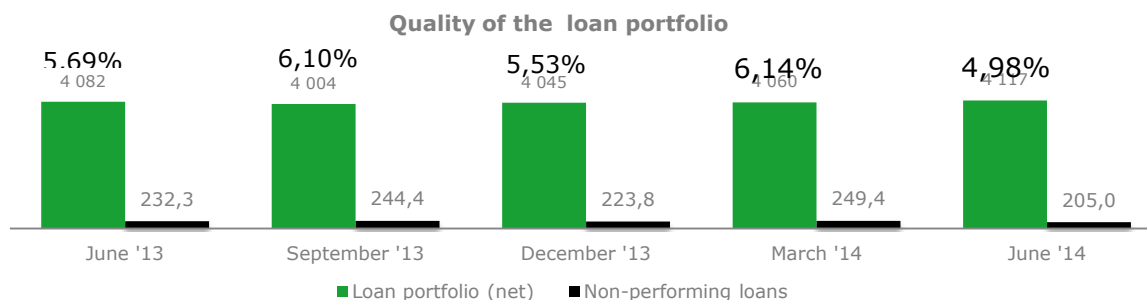
Loan portfolio

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

Due to actions taken by the Bank in the area of problem loans management, the share of non-performing loans in the Bank's loan portfolio decreased to the level of 4.98%. Most liabilities are repaid in a timely manner, but borrowers with a higher risk profile have been subjected to intensified monitoring. In 2014, the net value of the loan portfolio increased by PLN 69.5 million in comparison with the end of 2013. In the first half of 2014, the commercial portfolio remained at a stable level. However, the retail portfolio recorded a significant increase by PLN 104.4 million.

Impairment write-downs in the amount of PLN 79,585.9 thousand as well as collateral in the form of mortgages on financed properties comprise the relevant collateral against potential losses resulting from credit risk.

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



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

The Bank has been observing a sustained increased level of credit risk for portfolios of loans granted to purchase land for housing developments and to finance developers' housing projects, in particular in tourist towns and cities. In the first half of 2014, on the basis of the previous experience in the financing of residential projects, the Bank continued to finance projects in the field of housing development. In this area, the Bank focused on the selective financing of projects with the most favourable market parameters (the offer's adjustment to the market needs, positive history of the developer's activity, adequate level of own shares, as well as verified pre-sales).

Credit risk management

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

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

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

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

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

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

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

Enforcement titles issued by the Bank

In the first half of 2014, the Bank issued 2 banking enforcement titles (BTEs), both referring to commercial loans. The total amount of debt covered by the BTEs was EUR 7,199.3 thousand, whereby after issuing the BTEs, this receivable was sold, and PLN 10,804.3 thousand – the value of the collateral (the current market value of properties) amounts to PLN 9,990.0 thousand – impairment write-down on an asset was established.

2.2. Market risk

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

In order to mitigate market risk, the Bank adjusts the currency structure and the structure of revaluation of its sources of financing to the structure of loan liabilities held, uses linear derivatives, and concludes spot or forward currency purchase/sale transactions and FX SWAP transactions.

The amount of market risk to which the Bank is exposed daily, is determined using the Value at Risk (VaR) method at the 99% confidence level. As at the end of June 2014, VaR amounted to PLN 113.9 thousand. The currency risk amounted to PLN 34.9 thousand, and the interest rate risk amounted to PLN 79.0 thousand.

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

of June 2014 reached a safe level of 5.75%. The Bank's portfolio components which are exposed to interest rate risk are hedged with linear interest rate derivatives.

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

2.3. Liquidity risk

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

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

At the end of June 2014, liquidity reserves represented approx. 10.94% of the balance sheet total. The Bank is not exposed to the risk of short-term refinancing to maturity or to the risk of withdrawal of deposits by the largest deposit holders due to a small share of deposits from the non-financial sector in the balance sheet total (5.24%).

In the first half of 2014, the financing of the Bank's lending activities was performed through obtaining short-term deposits in EUR, PLN and USD from the main shareholder, as well as issues of short- and medium-term uncovered bonds in PLN and covered bonds in EUR. The Bank's long-term liquidity is stable. Short-term deposits obtained from mBank S.A. under the available Money Market credit line constitute a significant share in the financing of long-term credit receivables.

With the need to preserve liquidity ratios at the appropriate level, the need to minimize the mismatch of the structure of assets to financing them liabilities, and the need to increase the stability of financing sources, mBank Hipoteczny will seek to replace short-term financing with financing in the form of new issues of covered bonds with maturities of 5 years and more.

The share of stable sources of financing and liquidity reserves adequate to the scale of the Bank's operations enables the Bank to meet the M4 long-term liquidity standard set by the Polish Financial Supervision Authority. M4 ratio as at the end of June 2014 amounted to 1.053. M1 and M2 short-term liquidity standards were maintained at a safe level of PLN 341,083 thousand and 1.508 respectively. The M3 standard amounted to 32.148.

Over the first half of 2014, the limit of liabilities arising from Article 15.2 of the "Act on covered bonds and mortgage banks" was utilised in 55.9% (on average). In the analysed period, this limit was not exceeded.

As at the end of June 2014, the average maturity of covered bonds issued amounted to 3.64 years for mortgage covered bonds and to 1.68 years for public covered bonds, whereas the average maturity of long-term deposits from other banks amounted to 1.36 years. The margin on mortgage covered bonds issued in the first half of 2014 was 1.25%, with an average maturity of 12.3 years. No public covered bonds were issued in the first half of 2014.

2.4. Operational risk

The process of operational risk mitigation within mBank Hipoteczny is carried out through the implemented control mechanisms, risk transfers, contingency plans, business continuity plans and outsourcing. Operational risk measurement is performed by using both the qualitative and quantitative methods, which complement each other in assessing the risk profile of the Bank. The risk is monitored through the implemented mechanisms and internal control procedures, based on the Key Risk Indicators (KRIs) and the statistics of operating loss events.

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

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

- highly qualified staff,
- effective system of internal control.

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

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

The Bank monitors, analyses and reports any changes affecting the operational risk profile. After the first half of 2014, the operational risk profile remains unchanged as compared to the previous year.

2.5th Risk of investing in covered bonds

In the first half of 2014, the risk profile of investments in covered bonds issued by mBank Hipoteczny did not change. These securities constitute financial instruments with a low investment risk, resulting from the required multi-level collateralisation of their issue and trading by the issuer in accordance with the Act on covered bonds and mortgage banks. In addition to ensuring that the Bank meets a number of statutory requirements, taking into account the security of investments in covered bonds under the conditions of slower economic growth, the fact that for many years the Bank has followed a conservative policy of real estate valuation on which the bonds are secured also contributes to high security of this investment. The minimum level of overcollateralization with regard to mortgage covered bonds amounts to 10%, and to 6% with regard to public covered bonds.

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

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

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

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

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

Implementation of the project comprises 2 stages:

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

As part of the project, in 2013, the Bank implemented the agency model, which, in the second half of 2014, will be supplemented with a pooling model, involving the acquisition of the existing retail mortgage loan portfolio from mBank to refinance it by issuing mortgage covered bonds.

In addition, the objectives of the Bank include:

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

The refinancing or crediting of the purchase of completed, commercialised facilities, particularly office buildings, retail space and warehouse space will continue to be the Bank's main sales objective. The Bank intends to be an active creditor operating in the segment of prestigious medium-scale commercial projects financed with loans of up to EUR 25 million.

The purpose of the Bank is to maintain the leading position on the market of mortgage banking for business entities and strengthening the role of the leader in the area of covered bonds, by increasing the scale of their issues.

4. The Bank's authorities

Shareholders

Shareholding structure of mBank Hipoteczny

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

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

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

The Bank does not cooperate with international public institutions.

Management Board

As at 30 June 2014, the composition of the Management Board of mBank Hipoteczny was as follows:

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

Information on the remuneration of the members of the Management Board is disclosed in the Financial Statements.

Supervisory Board

In 2014, the composition of the Supervisory Board changed. As at 30 June 2014, it was composed of:

- Cezary Kocik – Chairman of the Supervisory Board
- Hans-Dieter Kemler – Deputy Chairman of the Supervisory Board
- Joerg Hessenmueller – Member of the Supervisory Board
- Lidia Jabłonowska-Luba – Member of the Supervisory Board
- Michał Popiołek – Member of the Supervisory Board
- Dariusz Solski – Member of the Supervisory Board

On 3 July 2014, Mariusz Tokarski was appointed a member of the Supervisory Board of mBank Hipoteczny S.A.

Information on the remuneration of the members of the Supervisory Board is disclosed in the Financial Statements.

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

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

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

As at 30 June 2014, the composition of the Audit Committee was as follows:

- Joerg Hessenmueller – Chairman of the Committee
- Dariusz Solski – Member of the Committee

On 2 July 2014 and 16 July 2014, respectively, Hans-Dieter Kemler and Mariusz Tokarski were appointed to the Audit Committee.

Duties of the Audit Committee include:

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

In the first half of 2014, one meeting of the Audit Committee took place – on 10 April 2014.

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

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

Duties of the Risk Committee include:

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

In the first half of 2014, one meeting of the Risk Committee took place – on 26 March 2014.

5. Other information

Related party transactions

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

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

Post balance-sheet events

On 3 July 2014, Mariusz Tokarski was appointed a member of the Supervisory Board of mBank Hipoteczny S.A.

On 28 July 2014, the Bank issued mortgage covered bonds with a total nominal value of PLN 300,000 thousand with the maturity date on 28 July 2022 and a variable interest rate coupon.

On 4 August 2014, the Bank issued mortgage covered bonds with a total nominal value of PLN 200,000 thousand with the maturity date on 20 February 2023 and a variable interest rate coupon.

6. Management representations

Corporate governance

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

Correctness and fairness of the presented financial statements

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

- financial statements and comparable data have been drawn up in accordance with the applicable accounting principles and reflect truly, fairly and clearly the assets and the financial position of mBank Hipoteczny as well as its financial results,
- the Director's report on the operations for the first half of 2014 presents a true picture of the situation of mBank Hipoteczny, including a description of basic risks and threats.

Appointment of the registered audit company

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

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Piotr Cyburt

President of the Management Board

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Marcin Romanowski

Member of the Management Board

.....

Marcin Wojtachnio

Member of the Management Board