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Bank Hipoteczny

PKO Bank Hipoteczny SA
Directors' Report
for the six-month period ended
30 June 2018

TABLE OF CONTENTS

1. Introduction ... 3
2. External operating conditions ... 4
2.1. Macroeconomic environment ... 4
2.2. Residential real estate market ... 4
2.3. Residential lending market ... 5
2.4. Covered bond market ... 6
2.5. Regulatory and legal environment ... 6
3. Financial performance and capital adequacy ... 8
3.1. Key financial ratios of PKO Bank Hipoteczny ... 8
3.2. Statement of financial position of PKO Bank Hipoteczny SA ... 8
3.3. Profit and loss account of PKO Bank Hipoteczny SA ... 9
3.4. Own funds requirements (Pillar I) ... 10
3.5. Internal capital (Pillar II) ... 12
3.6. Disclosures (Pillar III) ... 12
4. Business and development of PKO Bank Hipoteczny SA ... 14
4.1. Sales of mortgage home loans under the agency model ... 14
4.2. Acquisition of receivables under residential loans ... 14
4.3. Structure of the mortgage home loan portfolio ... 15
4.4. Covered bonds ... 16
4.5. Financial market operations ... 18
4.6. Short-term bonds ... 19
4.7. Ratings of the Bank and its covered bonds ... 19
4.8. Development of PKO Bank Hipoteczny SA ... 19
5. Internal operating conditions ... 21
5.1. Qualified management team ... 21
5.2. Lending process and relationship with PKO Bank Polski SA ... 21
5.3. Internal control system ... 21
5.4. Risk management ... 22
5.5. Measurement of mortgage loan collaterals ... 24
5.6. The cover pool for covered bonds ... 25
5.7. The Cover Pool Monitor ... 26
5.8. Statutory limits ... 26
6. Structure and governing bodies of PKO Bank Hipoteczny SA ... 29
6.1. Organisational structure of PKO Bank Hipoteczny SA ... 29
6.2. Powers of the governing bodies and committees of PKO Bank Hipoteczny SA ... 29
6.3. The Management Board of PKO Bank Hipoteczny SA ... 33
6.4. The Supervisory Board of Bank Hipoteczny SA ... 35
7. Corporate governance and information for investors ... 37
7.1. Representation on compliance with the rules for corporate governance ... 37
7.2. Entity authorised to audit financial statements ... 39
7.3. Other information ... 40
8. Statement of the Management Board of PKO Bank Hipoteczny SA ... 44

1. INTRODUCTION

PKO Bank Hipoteczny SA (Bank) specialises in granting residential mortgage loans to individual customers and purchasing receivables in respect of such loans from PKO Bank Polski SA. The Bank purchases loans for its portfolio based on its strategic cooperation with PKO Bank Polski SA.

PKO Bank Hipoteczny SA is the leader of the Polish mortgage bank market in terms of total assets and the balance of mortgage home loans. The Bank is Poland's largest regular issuer of covered bonds on Polish and international markets. It was the only bank in Poland to carry out benchmark issues of euro-denominated covered bonds, four issues in total. The outstanding covered bonds issued by the Bank account for more than one half of the total value of outstanding covered bonds issued by Polish mortgage banks.

The Bank's fast growth was made possible by granting both new residential mortgage loans and the purchase of such loans from PKO Bank Polski. In the first six months of 2018, the Bank's total assets exceeded PLN 20 billion, of which over PLN 19 billion were a high quality portfolio of home loans. This means that there was a 20% increase in total assets compared with the end of 2017, while at the same time maintaining the stability and safety of operations.

STRATEGY OF PKO BANK HIPOTECZNY SA

In December 2016, the Management Board of PKO Bank Hipoteczny SA adopted, and the Supervisory Board of PKO Bank Hipoteczny SA approved, the strategy of PKO Bank Hipoteczny SA for the years 2017 to 2020.

The mission of the Bank is to responsibly promote the interests of its stakeholders by ensuring:

- for customers – loan products tailored to their needs, for the financing of real estate;
- for investors – long-term covered bonds providing a high level of safety.

PKO Bank Hipoteczny SA's strategy for the years 2017–2020 calls for:

- diversification of financing sources by obtaining long-term financing in the form of covered bonds intended for real-estate financing;
- achieving and maintaining the leading position on the Polish market for covered bond issues while at the same time maintaining a high level of safety of such covered bonds;
- establishing a centre of competence of the PKO Bank Polski SA Group in the area of real-estate valuation and residential loans, with the optimal use of PKO Bank Polski SA's assets, for the purpose of achieving synergies within the PKO Bank Polski SA Group.

2. EXTERNAL OPERATING CONDITIONS

Macroeconomic environment
Residential real estate market
Home loan market
Covered bond market
Regulatory and legal environment

2.1. MACROECONOMIC ENVIRONMENT

The macroeconomic factors affecting the Polish economy in the first six months of 2018:

GROSS DOMESTIC PRODUCT

The GDP growth rate affects both the residential real estate market and the mortgage loan market. A sufficiently high GDP growth rate translates into new jobs and higher wages, and, consequently, into consumers' purchasing power and creditworthiness. The data published by the Central Statistical Office of Poland (GUS) in May 2018 show that Poland's GDP grew by 5.2% in Q1 2018 compared with Q1 2017. The European Commission's forecast published in July 2018 assumes that Poland's GDP will grow by 4.6% in 2018, and by another 3.7% in 2019. The high GDP growth rate may have a favourable effect on the employment level and consumers' wages. As a result, it may contribute to generating an increased demand for home loans granted by banks to finance residential real estate purchases.

UNEMPLOYMENT AND WAGES

Based on the data published by GUS, the number of unemployed registered with unemployment offices in Poland stood at 967.9 thousand at the end of June 2018, down 183.7 thousand, or 16.0%, compared with June 2017. The unemployment rate at the end of June 2018 was 5.9%, compared with 7.0% at the end of June 2017. The number of people employed at the end of the first quarter of 2018 was 16,344 thousand, up 0.5% y/y, according to GUS's Labour Force Survey (BAEL). Whereas, the average monthly wage in the enterprise sector in Q2 2018 was PLN 4,795.06, up 7.4% y/y, based on GUS data. The increase in the number of professionally active people and the increase in the wage level contribute to the development of the residential real estate market, and thus increases demand for home loans.

INFLATION

Price changes affect consumers' purchasing power and the level of interest rates. A low inflation rate has a favourable effect on banking customers' creditworthiness, which in turn affects the value of home loans granted. Based on GUS data, the Consumer Price Index (CPI) for June 2018 was 2.0% y/y.

INTEREST RATES

Low interest rates translate into reduced credit costs and increased consumer creditworthiness. As at the date of this Report, the National Bank of Poland's (NBP) reference rate was 1.5%, the lowest on record. Maintaining interest rates at the current level may contribute to a further increase in the Bank's lending. It should also favourably influence the meeting of payment obligations by borrowers as and when they fall due.

2.2. RESIDENTIAL REAL ESTATE MARKET

The first six months of 2018 was yet another period of prosperity on the residential real estate market. However, compared with 2017, there are signs of a slowdown on both the demand and supply side of the market.

Based on REAS data, prices on the primary market rose by 5.3% in Krakow, 4.9% in Warsaw and 1.6% to 3.1% in other cities in Q2 2018 on a quarter-on-quarter basis. Compared with the second quarter of 2017, prices in the

Tricity are 16.4% higher, in Warsaw 13.3% higher, in Poznań and Wrocław slightly more than 10% higher, in Krakow 8.2% higher and in Łódź 6.9% higher.

Based on NBP data, in the first quarter of 2018, on a quarter-on-quarter basis, prices on the secondary market rose by 1% in Warsaw, did not change in the six large cities, and rose by 2% in the medium-sized cities. Compared with the first quarter of 2017, the average prices in Warsaw were 3% higher, in the six large cities 9% higher, and in the medium-sized cities 8% higher.

Based on REAS data about the developer market, there was a slowdown both in terms of the number of apartments offered for sale and apartments actually sold by developers on the six markets with the highest turnover (Warsaw, Kraków, Wrocław, the Gdańsk-Gdynia-Sopot Tricity, Poznań and Łódź) in the first six months of 2018. The data for the majority of the large cities indicate that sales are falling while house and apartment prices continue to rise. As at the end of the second quarter of 2018, the volume of the offer was 8% lower than as at the end of 2017 (and it amounted to 44.4 thousand apartments). The next quarters of 2018 will show how developers will cope with the emerging supply barriers – especially in the area of construction (rising prices of workmanship and finishing materials and decreasing resources of employees in the construction industry cause problems with contracting construction projects at the envisaged margins) and in connection with the difficulties with the purchase of land for new projects. If the weakening of the supply proves to be permanent, it will stimulate growth of residential property prices at the current level of demand.

However, the decrease in the number of new apartments offered for sale by developers reported by REAS in the first six months of 2018 may be a temporary phenomenon, as the number of commenced development projects is growing. GUS data for the first six months of 2018 point to a continuation of the growing activity of investors (in particular developers) on the residential real estate market:

- a record number of 132,000 permits issued for apartments construction was reported, including 83,000 permits for apartments under construction by developers (an increase of 16% compared with the corresponding period of 2017);
- construction of 114,000 new apartments began, including 66,000 apartments under construction by developers (an increase of 23% compared with the corresponding period of 2017).

Based on NBP data, in Q1 2018 the average availability of apartments in the large cities (a measure defining the number of square meters of housing available for an average one-month salary in the enterprise sector assuming the average transaction price of a flat) improved slightly compared with Q4 2017 (0.87 sq m, compared with 0.84 sq m). The current apartment availability indicator is 0.38 sq m higher than the minimum level reported in Q3 2007.

The demand for apartments generated by the Apartments for Young People (MdM) scheme came to an end. The remaining funds were fully committed in the first days of January 2018, and the continuation of the scheme in subsequent years is not contemplated.

The Mieszkanie Plus (Apartment Plus) scheme, which is currently undergoing modification, is neutral for the market. With the limited possibilities of building low-cost apartments for rent, the Housing Board has decided to subsidize rents up to 30% of their amount. Such subsidies are to come into force in January 2019.

Based on NBP data, the estimated share of cash purchases of apartments on the primary market in the seven largest cities was 71% in Q1 2018. Over the last year it fluctuated within a range of 67% to 74%, with a slightly upward trend occurring since Q3 2012.

2.3. RESIDENTIAL LENDING MARKET

Based on NBP data, banks' receivables from residential loans in Poland were PLN 403.7 billion at 30 June 2018, up 3.3% y/y. Loans denominated in PLN were PLN 271.4 billion as at 30 June 2018 (67% of the total banks' receivables from residential loans in Poland) and was 10.6% higher y/y.

The total balance of residential loans in relation to gross domestic product expressed at market prices stood at 19.6% at the end of December 2017. That is significantly lower than the average for the European Union, which, according to 2016 data, was nearly 47.1%. This indicates a great potential for further growth of the home loan market in Poland.

2.4. COVERED BOND MARKET

As at the date of this Report, three mortgage banks were operating in Poland, namely:

- PKO Bank Hipoteczny SA,
- mBank Hipoteczny SA,
- Pekao Bank Hipoteczny SA.

The Polish covered bond market is relatively small and moderately liquid. At the end of June 2018, the total value of outstanding covered bonds issued by Polish mortgage banks amounted to about PLN 20.9 billion, i.e. PLN 4.4 billion more than at 31 December 2017. As at 30 June 2018, outstanding covered bonds issued by Polish banks corresponded to 5.2% of the amount of mortgage loans granted by banks. For comparison, in 2016 this ratio was around 15.6% in Germany and around 37.4% in the Czech Republic.

PKO Bank Hipoteczny SA is the largest issuer of mortgage covered bonds in Poland. As at 30 June 2018, the value of outstanding mortgage covered bonds issued by PKO Bank Hipoteczny SA amounted to PLN 12.2 billion, which accounted for approx. 58% of the total value of outstanding covered bonds issued by Polish mortgage banks. The value of mortgage covered bonds issued by PKO Bank Hipoteczny SA in the first six months of 2018 accounted for 73% of the value of mortgage covered bonds issued by Polish mortgage banks in that period.

2.5. REGULATORY AND LEGAL ENVIRONMENT

In the first six months of 2018, legal and regulatory solutions affecting the operations of PKO Bank Hipoteczny SA came into force, including:

PRUDENTIAL AND CAPITAL REQUIREMENTS	• Regulation of the Minister of Development and Finance of 1 September 2017 on the systemic risk buffer (Official Journal 2017.1776), introducing the systemic risk buffer of 3% of the total risk exposure on individual and consolidated basis; • Act of 5 August 2015 on Macroprudential Supervision over the Financial System and on Crisis Management in the Financial System (Official Journal 2017.1934) introducing an increase of the capital conservation buffer from 1.25% to 1.875%. These regulations affect the minimum capital base of banks and the level of capital adequacy.
ACCOUNTING STANDARDS	The financial reporting standard IFRS 9 introducing, *inter alia*, changes to the method of calculating and recording of impairment losses and classification of financial instruments – the standard affects the classification and measurement of financial assets and financial liabilities in banks.
INTERNAL CONTROL SYSTEM	Recommendation H of the Polish Financial Supervision Authority concerning the system of internal control in banks, introducing changes to the organization of the internal control system, including the control function, the compliance function and the internal audit function – the regulation has an impact on the way the internal control system in banks is organized.
PERSONAL DATA	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, and repealing Directive 95/46/EC (GDPR) – the regulation has an impact on banks' operations in the area of internal processes and customer relations.
REPORTING OBLIGATIONS OF ISSUERS	Regulation of the Minister of Finance of 29 March 2018 on current and periodic information submitted by issuers of securities and on the conditions for recognizing information required by law of a non-member state as equivalent information – which affects the scope and frequency of discharge of issuers' reporting obligations.
TAXES	Act of 27 October 2017 amending the Personal Income Tax Act, the Corporate Income Tax Act, and the Act on Flat-Rate Tax Chargeable on Certain Revenues Earned by Natural Persons, introducing, *inter alia*, regulations on restricting the recognition of expenditures on intangible services as costs of earning revenues and amendments adapting regulations on account of the entry into force of IFRS 9 – the regulations affect the manner and outcome of income tax

	computations.
BENCHMARKS	Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 – the regulation affects banks' operations in the area of customer and counterparty relations, and risk management.

3. FINANCIAL PERFORMANCE AND CAPITAL ADEQUACY

Key financial ratios of PKO Bank Hipoteczny
Balance sheet of PKO Bank Hipoteczny SA
Profit and loss account of PKO Bank Hipoteczny SA
Own funds requirements (pillar I)
Internal capital (pillar II)
Disclosures (pillar III)

3.1. KEY FINANCIAL RATIOS OF PKO BANK HIPOTECZNY

	30.06.2018	31.12.2017	30.06.2017
Total assets (in PLN millions)	20,267.7	16,902.6	12,134.5
ROA[1]	0.5%	0.4%	0.5%
ROE[2]	7.0%	5.3%	5.9%
Capital adequacy ratio	14.2%	15.2%	16.7%
Leverage ratio	6.1%	6.9%	7.6%
Cost to income ratio (C/I)[3]	24.6%	27.8%	35.8%

3.2. STATEMENT OF FINANCIAL POSITION OF PKO BANK HIPOTECZNY SA

in PLN millions	30.06.2018	31.12.2017	30.06.2017
Cash and balances with the Central Bank	0.0	0.6	0.0
Amounts due from banks	122.2	5.4	7.6
Derivative financial instruments	214.7	0.3	0.2
Loans and advances to customers	19,065.8	16,042.5	11,538.6
Securities	842.7	830.5	563.1
Other assets	22.3	23.3	25.0
TOTAL ASSETS	**20 267.7**	**16 902.6**	**12 134.5**

in PLN millions	30.06.2018	31.12.2017	30.06.2017
Line of credit liabilities	1,505.8	1,627.5	1,244.8
Amounts due to PKO Bank Polski SA for purchased receivables	2,205.7	2,497.9	1,786.5
Other amounts due to banks	146.8	0.0	0.0
Mortgage covered bonds issued	12,168.0	8,883.2	6,116.8
Unsecured bonds issued	2,899.0	2,428.0	1,912.5
Derivative financial instruments	0.2	217.8	103.6
Other liabilities	49.3	26.4	21.8
Equity	1,292.9	1,221.8	948.5
TOTAL LIABILITIES AND EQUITY	**20,267.7**	**16,902.6**	**12,134.5**

[1] Annualized ratio expressed as the quotient of the net profit (loss) for the year and the average level of assets at the beginning and end of the reporting period and of the interim monthly periods
[2] Annualised ratio calculated by dividing the net profit (loss) for the year by the average level of equity at the beginning and end of the reporting period and of the interim monthly periods
[3] Annualised ratio excluding tax on certain financial institutions

As at 30 June 2018, the total assets of PKO Bank Hipoteczny SA were PLN 20,267.7 million, up 20% compared with the end of 2017. Mortgage loans were the key component of the Bank's assets. Their carrying amount, taking into account impairment losses recognized as at 30 June 2018, amounted to PLN 19,065.8 million, of which new loans amounted to PLN 6,875.6 million, whereas loans purchased from PKO Bank Polski SA amounted to PLN 12,190.2 million.

As far as liabilities and equity are concerned, the share of covered bonds rose significantly, to 60% thereof as at the end of June 2018. In the first six months of 2018, PKO Bank Hipoteczny SA carried out:

- one benchmark issue of euro-denominated covered bonds of EUR 500 million;
- two issues of zloty-denominated covered bonds of PLN 700 million and PLN 100 million, respectively.

Consequently, the carrying amount of covered bonds was PLN 12,168.0 million at the end of June 2018.

As at 30 June 2018, financial liabilities to PKO Bank Polski SA in the form of revolving lines of credit and liabilities for the acquisition of loan receivables were a significant item in the Bank's liabilities and equity. The total amount of these liabilities was PLN 3,611.5 million. Short-term bonds issued by the Bank were also a significant source of funding the Bank's operations. Their total amount as at 30 June 2018 was PLN 2,899.0 million, up 19% compared with the end of 2017.

3.3. PROFIT AND LOSS ACCOUNT OF PKO BANK HIPOTECZNY SA

in PLN millions	01.01.2018 – 30.06.2018	01.01.2017 – 30.06.2017	Change y/y (in PLN millions)
Net interest income	119.5	62.2	57.3
Net fee and commission income/(expense)	(2.3)	(2.1)	(0.2)
Net income/(expense) from financial instruments measured at fair value	0.0	(0.2)	0.2
Net foreign exchange gains/(losses)	4.0	6.5	(2.5)
Other operating income and expenses	0.0	0.0	-
Net income/(expense) on modification	(0.3)	0.0	(0.3)
Net impairment losses and provisions	(4.4)	(1.5)	(2.9)
General administrative expenses	(28.2)	(19.6)	(8.6)
Tax on certain financial institutions	(27.4)	(11.3)	(16.1)
Operating profit	**60.8**	**34.0**	**26.8**
Profit before tax	60.8	34.0	26.8
Tax	(18.2)	(8.9)	(9.3)
Net profit	**42.6**	**25.1**	**17.5**

In the first six months of 2018, PKO Bank Hipoteczny SA generated a net profit of PLN 42.6 million, up PLN 17.5 million compared with the corresponding period of 2017. The most important driver of this increase was the improvement in net interest income caused by an increase in the scale of the Bank's operations, with a limited increase in costs.

In the analysed period, the Bank generated interest income of PLN 306.9 million, comprising primarily income from mortgage loans in the amount of PLN 298.3 million, and income from securities. In the same period, the Bank incurred interest expense of PLN 187.4 million. Interest expense resulted mainly from covered bonds issued (including costs of hedging transactions). The related interest expense was PLN 119.2 million. The Bank also incurred interest expense of PLN 14.8 million on revolving lines of credit, interest expense of PLN 25.8 million on the liability for the purchase of receivables from PKO Bank Polski SA, and interest expense of PLN 27.6 million on bonds issued.

In the first six months of 2018, the Bank incurred a net fee and commission loss of PLN 2.3 million. This item comprised, *inter alia*, costs of expert valuations of the mortgage lending value of real estate (MLV), as prepared by real estate appraisers, in the amount of PLN 4.5 million, costs of the bond issue programme of PLN 1.8 million, costs of insuring loans of PLN 1.2 million, and costs of lines of credit of PLN 1.1 million, as well as income from customers for real estate valuations performed by the Bank, in the amount of PLN 6.9 million.

In the first six months of 2018, the Bank incurred general administrative expenses of PLN 28.2 million. Non-personnel expenses of PLN 12.7 million, including costs related to services rendered by PKO Bank Polski SA in the amount of PLN 9.0 million under an outsourcing agreement, were a significant component of administrative expenses. Costs of employee benefits, whose amount during the reporting period was PLN 8.0 million, were also a significant component of administrative expenses. The increase in administrative expenses compared with the corresponding period of 2017 was mainly caused by

- an increase in costs of related to contribution to Bank Guarantee Fund Resolution Fund (up PLN 4,6 million),
- an increase in costs of services provided by PKO Bank Polski SA (up PLN 3.2 million), which resulted from an increase in the value of the loan portfolio in the Bank's balance sheet.

Tax on certain financial institutions, which amounted to PLN 27.4 million in the reporting period, was a significant cost of the Bank's activities.

Thanks to a faster growth of income than costs, the Bank reported an improved C/I ratio, whose annualized level was 24.6% as at 30 June 2018 (excluding tax on certain financial institutions), down 11.2 pp compared with the corresponding period of 2017.

The Bank's net impairment losses and provisions amounted to PLN (4.4) million in the first six months of 2018.

3.4. Own funds requirements (Pillar I)

General information

In accordance with the CRR Regulation, the Bank calculates own funds requirements for the following risks:

- credit risk – using the Standardised Approach;
- credit valuation adjustment risk (CVA) – using the Standardised Approach;
- settlement and delivery risk – using the Standardised Approach;
- operational risk – using the Basic Indicator Approach (BIA);
- market risk (foreign-exchange risk only) – using basic methods.

At 30 June 2018, the own funds requirements concerning the credit valuation adjustment, settlement and delivery, and market risk were nil, therefore the total own funds requirement was comprised of the requirements for credit and operational risks.

Own funds requirements	**30.06.2018**	**31.12.2017**
Credit risk (in PLN millions)	690.2	611.9
Operational risk (in PLN millions)	15.7	15.1
Total own funds requirement (in PLN millions)	705.9	626.9
Common Equity Tier 1 capital ratio (CET1)	14.2%	15.2%
Tier 1 capital ratio (T1)	14.2%	15.2%
Total capital ratio (TCR)	**14.2%**	15.2%

The tables below present the values of exposures, risk-weighted assets and own funds requirements by exposure class:

30/06/2018	Gross exposure	Exposure value[4]	Risk-weighted assets (RWA)	Own funds requirement
Retail exposures[5]	4,833.7	4,479.1	3,359.3	268.7
Exposures secured by mortgages on immovable property	15,036.6	14,991.2	5,246.9	419.8
Exposures to central governments or central banks	842.7	842.7	0.0	0.0
Exposures to institutions	903.9	903.9	0.0	0.0
Exposures in default	4.3	3.8	4.3	0.3
Other items	17.2	17.2	17.2	1.4
Total	**21,638.4**	**21,238.0**	**8,627.7**	**690.2**

31/12/2017	Gross exposure	Exposure value[4]	Risk-weighted assets (RWA)	Own funds requirement
Retail exposures[5]	5,043.0	4,730.7	3,548.0	283.8
Exposures secured by mortgages on immovable property	11,684.6	11,654.3	4,079.0	326.3
Exposures to central governments or central banks	831.1	831.1	0.0	0.0
Exposures to institutions	455.1	455.1	0.0	0.0
Exposures in default	2.8	2.8	3.5	0.3
Other items	17.7	17.7	17.7	1.4
Total	**18,034.4**	**17,691.6**	**7,648.2**	**611.9**

CREDIT RISK ADJUSTMENTS

For the purpose of specific credit risk adjustments, the Bank uses impairment loss, which was recognised in the Bank's Tier 1 capital in accordance with the CRR Regulation and the implementing legislation.

The approach applied by the Bank to identifying exposures at risk of impairment and methods of estimating impairment losses and provisions for contingent liabilities are described in Note 39.3 "Impairment loss on credit exposures" of the abbreviated interim financial statements of PKO Bank Hipoteczny SA as at and for the six months ended 30 June 2018.

USE OF CREDIT RISK MITIGATION TECHNIQUES

The Bank uses mortgage collateral for the classification of exposures to classes of exposures secured by mortgages on immovable property and the use of preferential risk weighting. Detailed information about the main types of collateral adopted by the Bank and the method of determining the mortgage lending value is presented in Note 41 "Residual risk management" of the condensed interim financial statements of PKO Bank Hipoteczny SA for the six months ended 30 June 2018.

[4] The value of balance-sheet exposures and the balance-sheet equivalent of contingent liabilities and transactions, taking into account specific credit risk adjustments and the CCF (Credit Conversion Factor).
[5] These result from that part of the exposure which is not fully and completely secured, i.e. which exceeds an MLV of 80% or is in a transitional period, i.e. until collateral has been put up.

3.5. Internal capital (Pillar II)

Internal capital is the estimated amount of capital required to cover all identified material risks in the Bank's activities, as well as the effect of changes in the business environment, taking into account the expected level of risk.

PKO Bank Hipoteczny SA regularly monitors the materiality of different risks involved in the Bank's operations.

The Bank separately assesses its internal capital for the following risks considered as material:

- credit risk;
- liquidity risk;
- operational risk;
- business risk;
- model risk;
- interest rate risk.

The internal capital to cover the risks is determined in accordance with the methods set out in the Bank's internal regulations. The total internal capital is the sum of internal capital amounts necessary to cover all the risks material for the Bank. The Bank has adopted a prudent approach to risk aggregation and does not take advantage of the diversification effect.

Structure of internal capital	30.06.2018	31.12.2017
For credit risk	93.9%	90.7%
For operational risk	2.1%	2.2%
For liquidity risk	1.5%	4.4%
For interest rate risk	1.9%	1.9%
For business risk	0.4%	0.5%
For model risk	0.2%	0.2%
Total	100.0%	100.0%

As at 30 June 2018, the relationship between the Bank's own funds and internal capital remained above the statutory and internal limits.

In order to estimate the amount of capital necessary to operate safely in recessionary conditions, the Bank conducts stress tests.

3.6. Disclosures (Pillar III)

Considering the scale and specific nature of the Bank's operations, the Bank discloses, in the financial statements and in the Directors' Report, the following information:

- risk management objectives and strategies;
- own funds for capital adequacy purposes;
- capital buffers;
- leverage ratio;
- capital requirements;
- credit risk adjustments;
- credit risk mitigation techniques used;

- remuneration policy for those categories of personnel whose professional activities have a material impact on the Bank's risk profile;
- requirements referred to in Article 111a of the Banking Act and Recommendation H;
- operational risk in accordance with Recommendation M;
- liquidity risk management system and the liquidity position, in accordance with Recommendation P.

Being part of the PKO Bank Polski Group, the Bank also supplies information to the parent company for consolidation purposes.

Details of the disclosures made, the methods of their verification and publication are presented in the *Information policy of PKO Bank Hipoteczny SA on capital adequacy and other information to be published*, which is available on the Bank's website (www.pkobh.pl).

4. BUSINESS AND DEVELOPMENT OF PKO BANK HIPOTECZNY SA

Sales of mortgage home loans under the agency model
Acquisition of receivables under mortgage home loans
Structure of the mortgage home loan portfolio
Covered bonds
Financial market operations
Short-term bonds
Ratings of the Bank and its covered bonds
Development of PKO Bank Hipoteczny SA

4.1. SALES OF MORTGAGE HOME LOANS UNDER THE AGENCY MODEL

PKO Bank Hipoteczny SA has been granting residential loans in Polish zlotys since 1 April 2015. New residential loans are sold under the agency model, through Poland's largest network of branches, agents and intermediaries, organized by PKO Bank Polski SA. The Bank accepts apartments and single-family homes as collateral.

The first six months of 2018 saw record sales of residential loans. In that period, the Bank granted PLN 1,890.2 million worth of home loans, which is an increase of 21.9% compared with the first six months of 2017.

In accordance with Recommendation S of the Polish Financial Supervision Authority, in the first six months of 2018, the Bank granted only loans for which the loan-to-value ratio did not exceed 80%. Where a low down payment insurance policy was used, the Bank approved loans for which this ratio was not higher than 90%.

Moreover, in compliance with the Polish Act on Covered Bonds and Mortgage Banks, the Bank only grants loans whose value in relation to the mortgage lending value of the real estate does not exceed 100%.

The following table shows the main criteria applied by PKO Bank Hipoteczny SA in the process of granting loans secured by mortgages.

CRITERIA	AGENCY MODEL
Loan amount/market value of the real estate	Max 80%[6]
Loan amount/mortgage lending value of the property	Max 100%
Legal form of real estate	Ownership or public lease
Loan collateral	Mortgage recorded as the first in Section IV of the Land and Mortgage Register
Currency	PLN
Purpose	Residential

In the first six months of 2018, the Bank worked on the implementation of a new product – a residential mortgage loan with an interest rate based on a 5-year fixed base rate.

4.2. ACQUISITION OF RECEIVABLES UNDER RESIDENTIAL LOANS

Purchase of receivables for residential loans from PKO Bank Polski SA under a framework agreement is an important element of business of PKO Bank Hipoteczny SA

In the first six months of 2018, PKO Bank Hipoteczny SA acquired from PKO Bank Polski SA a portfolio of receivables for residential loans secured by mortgages in the total amount of PLN 1,878.4 million. The following

[6] Where a low down payment insurance policy is used, the Bank approves loans for which this ratio is not higher than 90%

table shows the main criteria applied by PKO Bank Hipoteczny SA in the process of acquiring loans secured by mortgages.

CRITERIA	POOLING MODEL
Loan amount/mortgage lending value of the property	Max 100%
Legal form of real estate	Ownership or public lease
Loan collateral	Mortgage recorded as the first in Section IV of the Land and Mortgage Register
Currency	PLN
Days past due or impairment indicators	None
Purpose	Residential

4.3. STRUCTURE OF THE MORTGAGE HOME LOAN PORTFOLIO

The structure of the gross loan portfolio on the balance sheet of PKO Bank Hipoteczny SA according to the LtV ratio based on market valuation[7] and the LtV ratio based on the mortgage lending value is presented in the following tables.

Gross loans at LtV based on market valuation	30.06.2018	31.12.2017	30.06.2017
below 50%	28%	28%	29%
51% – 60%	16%	16%	16%
61% – 70%	22%	21%	18%
71% – 80%	23%	23%	23%
80% – 90%	11%	12%	14%
above 90%	0%	0%	0%
Total, gross	**100%**	**100%**	**100%**
Average LtV based on market valuation	60.1%	60.3%	60.9%

Gross loans at LtV based on MLV	30.06.2018	31.12.2017	30.06.2017
below 50%	14%	15%	16%
51% – 60%	10%	10%	10%
61% – 70%	13%	13%	13%
71% – 80%	18%	18%	17%
80% – 90%	23%	22%	21%
above 90%	22%	22%	23%
Total, gross	**100%**	**100%**	**100%**
Average LtV based on MLV	72.9%	72.5%	72.2%

The main interest rate applied by the Bank to loans was WIBOR 3M, whose average value was as follows in the first six months of 2018: 1.71%.

[7] The current LtV level, based on the value of the real estate at the moment the loan is granted, updated using statistical methods on the basis of a real estate market analysis.

4.4. COVERED BONDS

The key objective of PKO Bank Hipoteczny SA is the issuance of covered bonds which are the main source of long-term financing for loans secured with immovable property.

POLISH ISSUES OF COVERED BONDS

On 27 April 2018, PKO Bank Hipoteczny SA carried out its fifth benchmark issue of Series 7 zloty-denominated mortgage covered bonds, which was yet another issue carried out under the firm commitment underwriting procedure. The Bank offered securities of PLN 700 million to institutional investors. During the book-building process, the spread on the Series 7 covered bonds was set at 0.49% above WIBOR 3M. The period from the date of issue to redemption of the covered bonds was set at 5 years, 11 months and 28 days, and the maturity date was set at 25 April 2024.

The Series 7 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the BondSpot OTC market on 8 May 2018. Since 22 May 2018, they have also been accepted in repo transactions by the National Bank of Poland. ,

On 18 May 2018, PKO Bank Hipoteczny SA carried out an issue of Series 8 zloty-denominated covered bonds. The Bank offered securities of PLN 100 million to institutional investors. The spread on the Series 8 covered bonds was set at 0.32% above WIBOR 3M. The period from the date of issue to redemption of the covered bonds was set at 3 years, 11 months and 11 days, and the maturity date was set at 29 April 2022.

The Series 8 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the BondSpot OTC market on 28 May 2018. Since 4 July 2018, they have also been accepted in repo transactions by the National Bank of Poland.

Zloty-denominated issues of mortgage covered bonds of PKO Bank Hipoteczny SA carried out up to and including 30 June 2018:

Series	Covered bond number (ISIN)	Issue date	Redemption date	Value (PLN millions)	Interest rate	Currency	Rating	Listing
1	PLPKOHP00017	11.12.2015	11.12.2020	30	WIBOR 3M + 0.75%	PLN	Aa3	BondSpot, WSE parallel market
2	PLPKOHP00025	27.04.2016	28.04.2021	500	WIBOR 3M + 0.65%	PLN	Aa3	BondSpot, WSE parallel market
3	PLPKOHP00033	17.06.2016	18.06.2021	500	WIBOR 3M	PLN	Aa3	BondSpot, WSE

					+ 0.59%			parallel market
4	PLPKOHP00041	28.04.2017	18.05.2022	500	WIBOR 3M + 0.69%	PLN	Aa3	BondSpot, WSE parallel market
5	PLPKOHP00058	22.06.2017	10.09.2021	265	2.69%	PLN	Aa3	BondSpot, WSE parallel market
6	PLPKOHP00066	27.10.2017	27.06.2023	500	WIBOR 3M + 0.60%	PLN	Aa3	BondSpot, WSE parallel market
7	PLPKOHP00074	27.04.2018	25.04.2024	700	WIBOR 3M + 0.49%	PLN	Aa3	BondSpot, WSE parallel market
8	PLPKOHP00082	18.05.2018	29.04.2022	100	WIBOR 3M + 0.32%	PLN	Aa3	BondSpot, WSE parallel market

INTERNATIONAL ISSUES OF COVERED BONDS

On 22 March 2018, PKO Bank Hipoteczny SA carried out its fourth benchmark issue of Series 6 euro-denominated covered bonds. The Bank offered fixed-rate instruments of EUR 500 million to institutional investors. During the book-building process, the spread was set at 0.769% (and the coupon at 0.75%). In the process, investors expressed interest in purchasing securities for a total of about EUR 850 million. The period from the date of issue to redemption of the covered bonds was set at 5 years, 10 months and 2 days, and the maturity date was set at 24 January 2024.

Chart: Purchasers of EUR-denominated covered bonds of PKO Bank Hipoteczny in the years 2016-2018

Series 6 euro-denominated covered bonds of PKO Bank Hipoteczny SA were listed on the Luxembourg Stock Exchange and the Warsaw Stock Exchange (parallel market) on 27 March 2018 and 10 April 2018, respectively. Since 27 March 2018, they have also been accepted in repo transactions by the European Central Bank.

Chart: Geographical distribution of purchasers of EUR-denominated covered bonds of PKO Bank Hipoteczny in 2016-2018

Euro-denominated issues of mortgage covered bonds of PKO Bank Hipoteczny SA carried out up to and including 30 June 2018:

Series	Covered bond number (ISIN)	Issue date	Redemption date	Value (EUR millions)	Coupon	Price	Currency	Rating	Listing
1	XS1508351357	24.10.2016	24.06.2022	500	0.125%	99.702%	(EUR)	Aa3	LuxSE, WSE parallel market
2	XS1559882821	02.02.2017	02.02.2024	25	0.82%	100.00%	(EUR)	Aa3	LuxSE
3	XS1588411188	30.03.2017	24.01.2023	500	0.625%	99.972%	(EUR)	Aa3	LuxSE, WSE parallel market
4	XS1690669574	27.09.2017	27.08.2024	500	0.75%	99.906%	(EUR)	Aa3	LuxSE, WSE parallel market
5	XS1709552696	02.11.2017	03.11.2022	54	0.467%	100.00%	(EUR)	Aa3	LuxSE
6	XS1795407979	22.03.2018	24.01.2024	500	0.75%	99.892%	(EUR)	Aa3	LuxSE, WSE parallel market

The funds raised from the issues of covered bonds have been used by PKO Bank Hipoteczny SA to grant residential loans and to acquire receivables for such loans from PKO Bank Polski SA.

THE COVERED BOND LABEL

On 6 February 2018, PKO Bank Hipoteczny, as the first issuer of covered bonds from Poland, joined The Covered Bond Label. The Covered Bond Label is a quality certificate, whose purpose is to build awareness among investors of the safety and high quality of assets such as covered bonds.

4.5. FINANCIAL MARKET OPERATIONS

PKO Bank Hipoteczny SA executes treasury transactions on the wholesale financial market. The purpose of the transactions is to manage liquidity (over short-, mid- and long-term time horizons) and the Bank's foreign-currency position. Additionally, the Act on Covered Bonds and Mortgage Banks imposes an obligation on PKO Bank Hipoteczny SA to mitigate the risk caused by fluctuations in exchange rates.

For the purpose of financing the granting of home loans and purchase of receivables for home loans granted by PKO Bank Polski SA, PKO Bank Hipoteczny SA issues mortgage covered bonds, short-term bonds, and takes out lines of credit and assumes liabilities for purchased receivables. However, in accordance with the Act on Covered Bonds and Mortgage Banks, the level of liabilities arising from the taking out of loans and advances (including liabilities for purchased receivables) and issuing bonds cannot exceed in aggregate ten times the Bank's own funds over the first five years of operating activities or six times the Bank's own funds after that period.

In the Management Board's opinion, as at 30 June 2018, there were no indicators of a risk of late payment of the liabilities incurred by the Bank. In the first six months of 2018, the Bank did not exceed any of the liquidity limits. Details of the levels of the Bank's liquidity limits are provided in Note 42 to the condensed interim financial statements of PKO Bank Hipoteczny SA as at and for the six months ended 30 June 2018.

As far as the issue of euro-denominated covered bonds is concerned, for the purpose of hedging interest-rate risk and currency risk, PKO Bank Hipoteczny SA entered into Cross-Currency Interest Rate Swap (CIRS) transactions, under which the Bank pays a coupon in the Polish zloty based on a variable interest rate, and receives a coupon based on a fixed interest rate for euro. If a court declares PKO Bank Hipoteczny SA bankrupt, the CIRS transactions will automatically be extended by 12 months on the terms set on the transaction date and indicated in the Final Terms of issue of mortgage covered bonds. Additionally, the Bank has executed a series of forward contracts, which constitute a hedge of currency exposure with maturities on the payment dates of the coupons for the euro-denominated covered bonds.

As far as the issue of fixed-interest rate covered bonds in PLN is concerned, the Bank entered into an IRS transaction to hedge interest rate risk in 2017. Under the IRS transaction, the Bank pays a coupon based on a floating PLN rate, and receives a coupon based on a fixed PLN rate.

PKO Bank Hipoteczny SA is and intends to continue being a regular issuer of covered bonds both on the Polish and international market.

4.6. SHORT-TERM BONDS

On 30 September 2015, PKO Bank Hipoteczny SA established a non-public short-term bond issue programme. In the first half of 2018, the Bank issued a total of PLN 3 783.2 million worth of bonds under the programme. The balance of issued bonds was PLN 2 899.0 million as at 30 June 2018. The Bank also intends to continue seeking financing in the form of short-term bond issues.

4.7. RATINGS OF THE BANK AND ITS COVERED BONDS

As at the date of this Report, PKO Bank Hipoteczny SA had the following ratings assigned by Moody's:

	Rating	Outlook	Rating assignment / rating confirmation date
Long-term issuer rating	Baa1	Stable	19.12.2017
Short-term issuer rating	P-2	n/a	19.12.2017
Long-term Counterparty Risk Rating	A3	n/a	18.06.2018
Short-term Counterparty Risk Rating	P-2	n/a	18.06.2018
Long-term Counterparty Risk (CR) Assessment	A3(cr)	n/a	19.12.2017
Short-term Counterparty Risk (CR) Assessment	P-2(cr)	n/a	19.12.2017

As at the date of this Report, the covered bonds of PKO Bank Hipoteczny SA had the following ratings assigned by Moody's:

	Rating	Date of initial rating	Rating confirmation date
Covered bonds denominated in PLN	Aa3	08.09.2015	12.12.2015
Covered bonds denominated in EUR	Aa3	29.09.2016	24.10.2016

The rating assigned to the covered bonds of PKO Bank Hipoteczny SA is the highest rating achievable for Polish securities. The rating of Polish securities is limited by Poland's country ceiling for debt instruments, which is currently at the Aa3 level.

4.8. DEVELOPMENT OF PKO BANK HIPOTECZNY SA

The strategy adopted by PKO Bank Hipoteczny SA calls for:

- diversification of financing sources by obtaining long-term financing in the form of covered bonds intended for real-estate financing;
- achieving and maintaining the leading position on the Polish market for covered bond issues while at the same time maintaining a high level of safety of such covered bonds;

- establishment of a centre of competence of the PKO Bank Polski SA Group in the area of real-estate valuation and residential loans, with the optimal use of PKO Bank Polski SA's assets, for the purpose of achieving synergies within the PKO Bank Polski SA Group.

5. INTERNAL OPERATING CONDITIONS

Qualified management team
Lending process and relationship with PKO Bank Polski SA
Internal control system
Risk management
Valuation of home loan collaterals
Cover pool for mortgage covered bonds
Cover Pool Monitor
Statutory limits

5.1. QUALIFIED MANAGEMENT TEAM

The Bank implements mechanisms and procedures to guarantee that managers employed in the Bank have the highest qualifications in key business areas. The Bank constantly improves the qualifications of its employees, and makes efforts to ensure the stability and continuity of the management. These factors have an important influence on the implementation of the Bank's strategy and business goals and, consequently, on its operations and results of operations.

5.2. LENDING PROCESS AND RELATIONSHIP WITH PKO BANK POLSKI SA

PKO Bank Hipoteczny SA acquires home loans for its portfolio as part of its strategic relationship with PKO Bank Polski. The banks work together under two models:

- agency model;
- pooling model.

The relationship with PKO Bank Polski SA is governed in detail by an outsourcing agreement signed on 16 January 2015. The agreement governs the scope of the relationship and describes in detail the method of performing the outsourced functions, first and foremost in the area of offering and administering home loans and performing support functions for PKO Bank Hipoteczny SA. Additionally, the agreement imposes obligations on PKO Bank Polski SA to properly perform the functions entrusted to it, as well as broad reporting and controlling obligations towards PKO Bank Hipoteczny SA.

On 17 November 2015, the Receivables Sale Framework Agreement was signed with PKO Bank Polski SA. On the basis thereof, the Bank has been acquiring from PKO Bank Polski SA portfolios of receivables for residential mortgage loans since December 2015.

PKO Bank Polski SA, as part of the regulatory approval process for establishing a mortgage bank before the Polish Financial Supervision Authority, undertook to ensure that, if necessary and if PKO Bank Hipoteczny SA's capital or liquidity ratios fall below the level required by law or by other regulations of relevant domestic banking supervision authorities that are applicable to PKO Bank Hipoteczny SA, PKO Bank Polski SA will immediately provide PKO Bank Hipoteczny SA with appropriate financial support.

5.3. INTERNAL CONTROL SYSTEM

The internal control system in PKO Bank Hipoteczny SA is one of the elements of managing the Bank. The objective of the internal control system is to support the Bank's decision-making processes to ensure:

- effectiveness of the Bank's operations;
- reliability and accuracy of financial reporting, administrative and accounting procedures, and reliable internal and external reporting;
- compliance with the risk management policy;

- compliance of the Bank's operations with the generally applicable laws, internal regulations and market standards adopted by the Bank, taking into account regulatory recommendations, if any.

The Bank's internal control system includes:

- the control function designed to ensure compliance with controls relating, in particular, to risk management; this function covers all of the Bank's and the Head Office's business units which are responsible for carrying out the tasks assigned to this function;
- the compliance function, which, together with the Bank's and the Head Office's business units, is responsible for identifying, assessing, controlling and monitoring the risk of the Bank's non-compliance with the generally applicable laws and with the Bank's internal regulations and market standards adopted by the Bank, taking into account regulatory recommendations, and for the submission of the relevant reports;
- the independent internal audit function to evaluate and assess, independently and objectively, the adequacy and effectiveness of the risk management system and the internal control system, except for the aspects relating to the internal audit function itself.

The internal control system is arranged at the Bank on three independent levels (lines):

- the first level (line) consists of organizational structures that perform risk-generating operational tasks and operate under internal regulations;
- the second level (line) is composed of specialized organizational structures operating under applicable policies, methodologies and procedures; the purpose of these structures is to ensure that the activities implemented at the first level are properly designed and effectively reduce the risk, support risk measurement and analysis and business effectiveness. This level comprises the activities of the compliance function, as well as identification, measurement or estimation, control, monitoring and reporting of risks material to the Bank, and identified threats and irregularities;
- the third level (line) is internal audit, which carries out independent audits of elements of the Bank's management system, including the risk management system and the internal control system. The internal audit operates separately from, and can support the activities carried out by, the first and second level. The support involves consultation without affecting the decisions made.

The Bank's Management Board ensures the continuity of operation of the internal control system and proper cooperation of all business units within the internal control system in place. The Management Board also identifies corrective actions to be taken to remedy any irregularities identified by the internal control system, including specific corrective and disciplinary measures. The Bank's Management Board approves criteria for distinguishing the relevant processes taking into account the management strategy, the business model and the impact on the Bank's financial performance and capital adequacy, as well as risk appetite. The Bank's Management Board also approves the list of significant processes and their connection with the internal control system's objectives.

Supervision of the internal control system is exercised by the Supervisory Board with the support of the Audit and Finance Committee of the Bank's Supervisory Board. The Supervisory Board approves, in particular, the principles of operation of the internal control system and assesses the adequacy and effectiveness of the system. The Audit and Finance Committee supports the Supervisory Board by monitoring and reviewing the adequacy and effectiveness of the internal control system based on the reports obtained from compliance, internal audit and the control function matrix coordinator, as well as by reviewing draft resolutions of the Management Board in terms of the internal control system, the approval of which falls within the competence of the Supervisory Board.

In the first six months of 2018, the reporting within the internal control system and the remedial actions taken indicated that the internal control system in PKO Bank Hipoteczny SA was effective and commensurate with the scale of the Bank's operations.

5.4. RISK MANAGEMENT

The risk management process is a key process in PKO Bank Hipoteczny SA. Its purpose is to ensure, in a changing macroeconomic and legal environment, control of the risk level, and to ensure it is maintained within the risk tolerance established by the Bank and the system of limits that is in place. The assumed level of risk constitutes an important component of the planning and decision-making process.

Risk management in the Bank is based in particular on the following principles:

- the Bank manages identified types of risk associated with its operations;
- the process of risk management is adequate to the scale of the Bank's operations and to the materiality, scale and complexity of a given risk;
- the risk management process supports the execution of the Bank management strategy, while maintaining compliance with the risk management strategy, in particular in the area of the risk tolerance level;
- the process of risk management is continuously adjusted to new factors and sources of risk;
- methods of risk management and risk measurement systems are adjusted to the scale and complexity of the Bank's operations and to the nature and size of the risk to which the Bank is exposed;
- methods of risk management are periodically reviewed and validated;
- risk management is integrated with planning and controlling processes;
- the risk level is regularly monitored and compared against the system of limits that apply in the Bank, while the Bank's management receives regular information on the level of risk;
- the risk management process is cohesive with the risk management principles in the PKO Bank Polski SA Group.

PKO Bank Hipoteczny SA identifies and manages the following types of risk:

MATERIAL RISKS	• Credit risk • Liquidity risk • Interest rate risk • Business risk • Model risk • Operational risk
POTENTIALLY MATERIAL RISKS	• Concentration risk • Residual risk • Currency risk • Macroeconomic risk • Compliance risk • Reputation risk • Capital risk

The significance of individual types of risk is defined at the level of the Bank. While determining the criteria of considering a certain risk to be significant, the impact of such risk on the Bank's activities is taken into account, provided that there are three types of risk:

- material risks, which are subject to active management;
- potentially material risks, for which a monitoring of materiality is performed;
- other undefined risks or risks that do not exist in the Bank (immaterial and unmonitored).

For potentially material risks, PKO Bank Hipoteczny SA performs periodic monitoring of whether they should be designated as material. The Bank has defined significance criteria; when they are met, a risk will be recognised as significant.

In its Risk Management Strategy, the Bank defined a range of strategic limits defining the appetite for particular types of risk. The Bank monitors these limits on an ongoing basis. In the first half of 2018, as well as during the whole period of the Bank's activities, none of them was exceeded.

A detailed description of the Bank's risk management objectives and methods is provided in the condensed interim financial statements of PKO Bank Hipoteczny SA as at and for the six months ended 30 June 2018, in the chapter "Risk Management Objectives and Policies." It also includes important information on the level of financial risk in

the Bank's operations and a description of the adopted financial risk management objectives and methods, together with the methods of hedging significant types of planned transactions for which hedge accounting is applied.

5.5. MEASUREMENT OF MORTGAGE LOAN COLLATERALS

PKO Bank Hipoteczny SA's policy concerning loan collaterals and their measurement is based on the provisions of the following acts:

- the Polish Covered Bonds Act;
- the Act on Land and Mortgage Registers;
- the Banking Law.

Additionally, the question of loan collaterals is addressed by:

- the recommendations of the Polish Financial Supervision Authority, including Recommendations F, S and J;
- the Bank's internal regulations.

The Bank has in place and applies the Rules for Setting the Mortgage Lending Value of Real Estate, approved (as amended) by the Polish Financial Supervision Authority on 30 October 2017. The Rules take into account the provisions of Recommendation F concerning the basic criteria applied by the Polish Financial Supervision Authority in approving rules for setting the mortgage lending value of real estate issued by mortgage banks.

The mortgage lending value of real estate is the value determined by the mortgage bank which, in the Bank's opinion, reflects the level of risk associated with the real estate as the loan collateral. The mortgage lending value of real estate is used to determine the maximum amount of a loan that can be secured by a mortgage on a given property, and to make a decision on whether a receivable secured by a particular property can be acquired by the Bank. The mortgage lending value of real estate is set up with prudence taking into account long-term parameters.

PKO Bank Hipoteczny SA sets the mortgage lending value of real estate based on an expert mortgage lending value of real estate, which is prepared with due diligence and prudence. It takes into account only characteristics of the real estate and investments necessary for its construction that will have a permanent nature and which, assuming rational use, will be able to be realised by any keeper of the property. In the expert opinion, prepared as at a specific date, the assumptions and parameters of the analysis are documented, as is the process of setting the mortgage lending value of real estate and the proposed mortgage lending value of real estate that results. The expert opinion takes into account analyses and forecasts concerning specific parameters for a given property, which influence the evaluation of credit risk, as well as factors of a general nature, e.g. population growth, the unemployment rate and urban development planning.

The process of setting the MLV is carried out in the Bank by a dedicated team.

In the agency model, the process of setting the mortgage lending value of real estate comprises three stages:

PREPARATION OF THE MLV EXPERT OPINION	Appraiser with appropriate experience and the ability to estimate bank risk in the area of securing mortgage loans
CONFIRMATION OF THE MLV OPINION	PKO Bank Polski SA, under the outsourcing agreement
REVIEW OF AN EXPERT OPINION ON MORTGAGE LENDING VALUE OF REAL ESTATE AND DETERMINING THE MORTGAGE LENDING VALUE OF THE REAL ESTATE	A dedicated organisational unit of the Bank: the Collateral Valuation Team at the Loan Office

In the case of an acquisition of a receivable, the process of setting the mortgage lending value of real estate comprises four stages:

CONFIRMATION OF THE PROPERTY'S LEGAL STATUS	PKO Bank Polski SA, under the outsourcing agreement
PREPARATION OF AN INSPECTION PROTOCOL OF THE PROPERTY, TOGETHER WITH MARKET RESEARCH	Appraiser with appropriate experience and the ability to estimate bank risk in the area of securing mortgage loans
PREPARATION OF THE MLV EXPERT OPINION	A dedicated organisational unit of the Bank: the Collateral Valuation Team at the Loan Office
REVIEW OF AN EXPERT OPINION ON MORTGAGE LENDING VALUE OF REAL ESTATE AND DETERMINING THE MORTGAGE LENDING VALUE OF THE REAL ESTATE	A dedicated organisational unit of the Bank: the Collateral Valuation Team at the Loan Office

The processes of preparing an MLV expert opinion and setting the mortgage lending value of a property described above are executed by two independent individuals.

5.6. THE COVER POOL FOR COVERED BONDS

PKO Bank Hipoteczny SA maintains a cover pool for its mortgage covered bonds. The bank includes in the cover pool receivables on residential mortgage loans, and rights and funds that constitute the basis for the issuance of covered bonds, as well as additional funds that constitute the excess to cover interest on mortgage covered bonds in circulation which is due in the following six months. Only receivables secured by mortgages written into the first position in section IV of the Land and Mortgage Registry can serve as security for mortgage covered bonds. Certain bank funds can also constitute the basis for issuing mortgage covered bonds:

- funds invested in securities issued or guaranteed by the National Bank of Poland, the European Central Bank, governments and central banks of members of the European Union and/or the Organisation for Economic Cooperation and Development, excluding countries that are restructuring or have restructured their foreign debt in the past 5 years;
- funds deposited with the National Bank of Poland;
- funds held in cash.

The nominal value of loans included in the cover pool and constituting collateral for issues of mortgage covered bonds as at 30 June 2018 stood at PLN 14,208.4 million. The nominal value of the overcollateralisation in the form of securities issued by the State Treasury, denominated in PLN, stood at PLN 251 million. As at 31 December 2017, these figures were PLN 11,103.7 million and PLN 251 million respectively. The cover pool also takes into account CIRS transactions hedging currency risk and the interest rate on EUR-denominated covered bonds, FX-Forward transactions hedging the currency risk of issued EUR-denominated covered bond and an IRS transaction hedging the interest rate risk of Polish zloty-denominated covered bonds issued on a fixed-rate basis.

In the first half of 2018 and in previous years, the cover pool did not include asset-backed securities that do not meet the requirements described in paragraph 1 art. 80 of Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60) (recast).

The method of managing the cover pool is laid out by:

- the Polish Covered Bonds Act of 29 August 1997 (Journal of Laws of 2003, No 99, item 919, as amended);
- Resolution No 633/2015 of the Financial Supervision Authority of 1 December 2015 on establishing the form of a cover pool;
- Recommendation K of the Financial Supervision Authority of 9 February 2016 on the principles for maintenance by mortgage banks of cover pools.

The Cover Pool Monitor and the Deputy Cover Pool Monitor provide continuous supervision of the management of the cover pool.

The following table presents basic data on Cover pool as at 30 June 2018:

	30.06.2018	31.12.2017
Total cover pool, including:	**PLN 14,459.4 million**	**PLN 11,354.7 million**
loans secured by mortgages	*PLN 14,208.4 million*	*PLN 11,103.7 million*
other assets[8]	*PLN 251.0 million*	*PLN 251.0 million*
Liquidity buffer[9]	PLN 66.9 million	PLN 50.6 million
Nominal value of hedging transactions[10]	PLN 9,330.7 million	PLN 6,849.3 million
Number of loans	78,129	60,597
Average loan value	PLN 181.9 thousand	PLN 183.2 thousand
Average weighted time since loan issuance (seasoning)	41.6 months	39.7 months
Average weighted maturity	258.6 months	257.8 months
Average LtV (loan amount to market value)	56.9%	57.5%
Average weighted loan to mortgage lending value of real estate	71.1%	70.8%
Over-collateralisation[11]	20.5%	25.8%

5.7. THE COVER POOL MONITOR

The purpose of the cover pool monitor is to ensure protection of the material interests of the holders of covered bonds. The Law on covered bonds and mortgage banks guarantees protecting the independence of the monitor and their deputy. Monitors are appointed by the Polish Financial Supervision Authority, upon the request of the Bank's Supervisory Board, for a period of six years.

On 6 March 2015 the Financial Supervision Authority appointed the following cover pool monitor and deputy cover pool monitor for PKO Bank Hipoteczny SA:

	Position	Date of appointment	Date of dismissal/resignation
Tadeusz Swat	The Cover Pool Monitor	06.03.2015	-
Grzegorz Kędzia	Deputy Monitor	06.03.2015	-

5.8. STATUTORY LIMITS

Acting under the Act on covered bonds and mortgage banks, PKO Bank Hipoteczny SA is obliged to monitor and comply with designated limits related to the operations of a mortgage bank.

[8] Article 18(3) of the Polish Covered Bonds Act
[9] Article 18(3a) of the *Polish Covered Bonds Act*
[10] The nominal value of the hedging transaction corresponds to the issue price of the covered bond
[11] It includes the net value of hedging transactions but excludes NPL

The statutory limits and the level to which they have been met as of 30 June 2018 were as follows:

Limit	Legal basis	Limit level	Actual level	
			30.06.2018	31.12.2017
Total value of receivables on loans secured by mortgages, and receivables on such loans acquired from other banks, in which the value exceeds 60% of the mortgage lending value, in proportion to the total value of receivables secured by mortgages	Article 13(1)	≤30.0%	18.8%	18.7%
Value of funds received from the issuance of mortgage bonds designated for refinancing loans secured by mortgages or receivables on such loans acquired from other banks, in proportion to 80% of the mortgage lending value of particular residential properties that constitute the collateral	Article 14	≤100.0%	66.7%	58.0%
Total value of acquired shares in other entities, in proportion to the Bank's own funds	Article 15(1)(5)	≤10.0%	0.0%	0.0%
Total value of credits and loans taken out and bonds issued, in proportion to the Bank's own funds	Article 15(2)	≤1000.0%	529.7%	548.5%
Total value of credits and loans taken out and bonds issued, in proportion to the amount designated for refinancing of activities described in art. 12 of the Act, i.e. issuance of loans secured and unsecured by mortgages, receivables acquired from other banks on loans granted by them and secured or unsecured by mortgages	Article 15(3)	≤100.0%	34.7%	41.0%
Total nominal value of covered bonds outstanding, in proportion to the Bank's own funds and general risk provision	Article 17	≤4000.0%	974.3%	743.1%
Total nominal value of receivables secured by mortgages and value of rights and additional funds constituting the basis for issuance of mortgage covered bonds, in proportion to the total value of outstanding mortgage covered bonds (taking into account hedging instruments)	Article 18(1)	≥110.0%	120.5%	125.8%
Total nominal value of receivables secured by mortgages constituting the basis for the issuance of mortgage covered bonds, in proportion to the total nominal value of mortgage covered bonds outstanding	Article 18(1)	≥85.0%	116.8%	125.0%
Interest expense on mortgage covered bonds outstanding (cumulative from the beginning of the financial year and on any given day), in proportion to interest income on receivables secured by mortgages and rights and additional funds constituting the basis for the issuance of mortgage covered bonds (cumulative from the beginning of the financial year and on any given day), taking into account hedging instruments	Article 18(2)	≤100.0%	34.8%	61.6%
Bank funds constituting the excess described in Article 18(3a) over the nominal value of interest on mortgage bonds outstanding due in the following 6 months	Article 18(3a)	≥100.0%	120.6%	133.0%
Value of receivables secured by mortgages established during the course of construction investments, in proportion to the total value of receivables secured by mortgages that constitute the basis for the issuance of mortgage covered bonds	first sentence of Article 23(1)	≤10.0%	8.3%	8.3%

Value of receivables secured by mortgages established on land designated for construction in accordance with development plans, in proportion to the value of receivable secured by mortgages established during the course of construction investments that constitute the basis for the issuance of mortgage covered bonds	second sentence of Article 23(1)	≤10.0%	0.0%	0.0%

PKO Bank Hipoteczny SA did not breach any of these limits during the entire period covered by this Report.

The Bank achieved positive results on the coverage test and liquidity test performed at the end of June 2018.

6. STRUCTURE AND GOVERNING BODIES OF PKO BANK HIPOTECZNY SA

Organisational structure of PKO Bank Hipoteczny SA
Powers of the governing bodies and committees of PKO Bank Hipoteczny SA
The Management Board of PKO Bank Hipoteczny SA
The Supervisory Board of PKO Bank Hipoteczny SA
Human resource management

6.1. ORGANISATIONAL STRUCTURE OF PKO BANK HIPOTECZNY SA

The management of PKO Bank Hipoteczny SA is carried out on the basis of the organisational structure presented in the chart below and within the framework of the duties of the Bank's Governing Bodies, described in the following portion of this chapter.

6.2. POWERS OF THE GOVERNING BODIES AND COMMITTEES OF PKO BANK HIPOTECZNY SA

The competences of the **General Meeting of the Bank** include in particular:

- appointing and dismissing members of the Supervisory Board;
- adopting resolutions on settlement of claims for damages caused at the establishment of the Bank, or by the exercise of management or supervision;
- establishing the procedure for redemption of shares and the level of compensation for the redemption of shares and the expression of consent to the acquisition of the Bank's own shares for the purpose of redemption;
- creation and dissolution of special funds created from net profit;
- adopting resolutions on the issuance of bonds convertible into shares or other instruments entitling the holder to acquire or take up shares in the Bank;
- adopting resolutions on the liquidation, disposal or lease of enterprises of the Bank or an organised part of the Bank's enterprises, and establishing limited property rights over them.

The competencies of the **Bank's Supervisory Board** include in particular:

- approving the Bank's annual financial plan and long-term development plans (in particular the Bank's strategy);
- approving the foundations of the Bank's policy in the area of compliance risk;

- approving the principles for the prudent and stable management of the Bank and the risk management strategy, including the Bank's general level of risk, the information policy in the area of capital adequacy, management of operational risk, estimating internal capital, capital management and planning, the functioning of the management system, the rules for management of models, the risk measurement models, including the assessment of creditworthiness, the model for measurement of lost value, the internal capital adequacy assessment process (ICAAP) and acceptance of periodic reports in this area;
- approving the Bank's product, pricing and discount policy;
- approving the annual internal audit plans;
- approving and periodically reviewing the general principles of the policy on variable components of remuneration of persons holding managerial positions;
- approving the Management Board regulations;
- approving the Regulations for Setting the Mortgage Lending Value of Property, which take effect after the approval by the Financial Supervision Authority;
- affirming the Code of Ethics and the Rules for Management of Conflicts of Interest;
- approving the framework organisational structure of the Bank, adjusted to the scale and profile of the risk taken on by the Bank;
- approving and reviewing cooperation agreements with PKO Bank Polski SA;
- adopting the Supervisory Board By-laws;
- appointing and dismissing, by secret ballot, individual members of the Management Board;
- representing the Bank in agreements with members of the Management Board;
- assessing the Directors' report on the Bank's activities and the financial statements for the previous financial year in terms of their consistence with the books of accounts and documents and the proposals of the Management Board concerning the distribution of profit or the financing of losses and presenting, to the General Meeting, a written annual report on the results of these assessments;
- applying to the Polish Financial Supervision Authority for consent to the appointment of two members of the Management Board, including the President and for the appointment of a Bank cover pool monitor and deputy cover pool monitor;
- granting prior approval for actions that meet designated criteria, including acquiring or disposing of Bank assets, concluding agreements that exceed the normal scope of the Bank's operations, concluding transactions between the Bank and its shareholders or related parties or members of the Bank's governing bodies, changing the Bank's registered office or location (address);
- assessing the functioning of the remuneration policy in the Bank and presenting a report on this area to the General Meeting;
- assessing the application by the Bank of the Principles of Corporate Governance for Supervised Institutions.

In 2018, the following **Supervisory Board committees** operated:

Audit and Finance Committee	• monitoring and expressing periodic opinions on the adequacy and effectiveness of the internal control system, the adequacy and effectiveness of the risk management system, the effectiveness of the Bank's compliance risk management, the application of the Corporate Governance Principles for Supervised Institutions, the principles of operation of internal audit and compliance functions, the adequacy and effectiveness of the whistleblowing policy and the ethical procedures and standards in force at the Bank; • developing the policy of selecting an audit firm, submitting to the Supervisory Board a recommendation of an audit firm to conduct an audit of the Bank's financial statements; • monitoring the process of financial reporting, including reviewing the Bank's periodic and annual financial statements; • monitoring financial audit proceedings and the independence of the statutory

	auditor and the entity authorised to audit the financial statements; • consulting the rules of functioning of the internal control system, the approval of which is the responsibility of the Supervisory Board.
Risk Committee	• reviewing the Bank's overall current and future risk appetite, strategic risk directions and tasks in the context of the Bank's strategy and the conditions resulting from the macroeconomic situation and the regulatory environment, and, in particular, the risk management strategy developed by the Management Board and the Bank's acceptable overall risk level; • monitoring the compliance of the Bank's policy in the area of taking on risk with the strategy and financial plan; • analysing periodic risk-related reports, including the utilisation of strategic risk tolerance limits, and developing appropriate guidelines on the basis thereof, as well as reviewing periodically the implementation of the risk management strategy; • giving opinions on capital adequacy, creditworthiness evaluation principles, the risk measurement model, the impairment measurement model; • giving opinions on the principles of the information policy in the area of capital adequacy, managing capital adequacy, managing liquidity, operational and model risk and impairment measurement; • providing opinions on the draft Rules on setting the mortgage lending value of real estate.
the Remuneration and Nomination Committee	• evaluating and conducting periodic reviews of nominations for key managerial positions in the Bank; • submitting, to the Supervisory Board, proposals relating to appropriate forms of contracts with members of the Bank's Management Board; • preparing opinions on the Code of Ethics and the Principles for Management of Conflicts of Interest; • preparing opinions on requests concerning the consent for a member of the Management Board to engage in competitive activities or to participate in a competing company as a shareholder of a civil law company, a sole proprietorship or as a member of a governing body of a capital company, or to participate in another competing legal person as a member of a governing body; • evaluating and performing periodic reviews, subject to the approval of the Supervisory Board, of the general principles for the policy on variable remuneration components of individuals holding managerial positions; • evaluating and monitoring the variable remuneration components of individuals whose activities have a significant impact on the Bank's risk profile, second-level risk management, the compliance unit manager and the internal audit unit manager; • reviewing detailed rules and procedures for recruiting members of the Bank's Management Board and assessing the suitability of members of the Bank's Management Board; • preparing and carrying out, with potential support from external, independent entities, the programme for raising the qualifications of members of the Supervisory Board.
the Commercial Committee	• reviewing cooperation agreements concluded between PKO Bank Polski SA and PKO Bank Hipoteczny SA; • providing opinions and approving product regulations, including the criteria for selecting products for the mortgage bank; • providing opinions on the price and discount policy.

The competencies of the Bank's Management Board include, in particular:

- defining PKO Bank Hipoteczny SA's strategy, taking into account the risk of the operations it conducts and the principles of prudent and stable management of the Bank;
- setting the general level of risk acceptable for the Bank;
- setting the annual financial plan, including the conditions for its execution;
- adopting the Organisational Regulations of the Bank and the rules for division of competencies;
- establishing and closing down standing Committees of the Bank and defining their powers;
- adopting the Management Board by-laws;
- adopting the Regulations for setting the mortgage lending value of property;
- adopting the regulations for the usage of special funds created from net income;
- setting the dividend pay-out date within the period set by the General Meeting;
- adopting the rules for the functioning of the internal control system and the annual internal audit plan;
- establishing, restructuring and closing down branches and other organisational units of the Bank in Poland and abroad;
- taking decisions on issues of covered bonds.

The Bank's Management Board established the following standing committees:

The Asset and Liability Committee	• supporting the liquidity, interest rate, macroeconomic changes, currency, capital and related model risk management functions; • managing the Bank's capital adequacy; • examining materials on capital adequacy, equity, internal capital, stress tests, risks mentioned above, as well as tolerance limits for these risks; • making decisions regarding the Bank's operations, in particular as regards risk measures and limits as well as the initiation of capital and liquidity emergency actions; • issuing recommendations for the Bank's competent authorities, organisational units, members of the Bank's Management Board, project teams or task forces – within the scope of their competencies.
The Credit Committee	• supporting the credit, concentration, residual and related model risk management functions; • examining materials on the risks mentioned above, the profile and quality structure of the loan portfolio, impairment losses on assets, acquisition of loan portfolios, the real estate market; • making decisions on the Bank's operations, in particular as regards risk measures and limits, risk model validation results, the methodology and models of calculating impairment losses on loan assets, cut-offs used as part of credit risk assessment, credit receivables purchased by the Bank, single loan transactions; • issuing recommendations for the Bank's competent authorities, organizational units, members of the Bank's Management Board, project teams or task forces – within the scope of their competencies.
The Data Quality Committee	• determining the strategic directions of operations in the area of managing the quality of data and data architecture in the Bank, in the context of the Data Management System (DMS); • oversight over the functioning of the DMS, including evaluation of its efficiency and the operations of particular organisational units of the Head Office.
The Strategy and Business Initiatives Committee	• supporting the business, operational, reputation, compliance and related model risk management functions;

- examining materials on the risks mentioned above, directions of the Bank's development, the Bank's strategy and IT strategy, initiatives related to the implementation of the Bank's strategy and IT strategy together with the operational risk analysis, product offer, product profitability, credit process;
- making decisions regarding the Bank's operations, in particular as regards managing the risks mentioned above, the related risk measurement models and the related risk measures and limits;
- issuing recommendations for the Bank's competent authorities, organizational units, members of the Bank's Management Board, project teams or task forces – within the scope of their competencies.

6.3. THE MANAGEMENT BOARD OF PKO BANK HIPOTECZNY SA

In the period from 1 January to 30 June 2018, the composition of the Management Board of PKO Bank Hipoteczny SA was as follows:

	Position	Position holding period
Paulina Strugała	acting President, Vice-President President	16.04.2018 – 12.06.2018 12.06.2018 – until now
Agnieszka Krawczyk	Vice-President	01.01.2018 – until now
Jakub Niesłuchowski	acting President, Vice-President Vice-President	01.01.2018 – 16.04.2018 16.04.2015 – until now
Marek Szcześniak	Vice-President	01.06.2015 – until now

Due to the resignation of Mr Rafał Kozłowski as President of the Management Board, the Supervisory Board of PKO Bank Hipoteczny SA instructed as of 28 December 2017 Mr Jakub Niesłuchowski to act in the capacity of President of the Company's Management Board with regard to organizational and administrative matters until the appointment of the President of the Company's Management Board, and appointed Ms Agnieszka Krawczyk as Vice-President of the Company's Management Board as of 1 January 2018.

On 4 April 2018 the Supervisory Board of PKO Bank Hipoteczny SA appointed Ms Paulina Strugała President of the Bank's Management Board as of 16 April 2018, on condition and as of the date of the Polish Financial Supervision Authority (PFSA) granting consent to her appointment to the position of President of the Bank' Management Board. Until the PFSA granted its consent on 12 June 2018, Paulina Strugała performed the function of Vice President of the Bank's Management Board and acted as President of the Board. On 12 June 2018, the Polish Financial Supervision Authority issued its consent to the appointment of Ms Paulina Strugała as President of the Management Board of PKO Bank Hipoteczny SA.

The terms of office of members of the Management Board, who are appointed for a joint term of office, expire on the date when the General Meeting approves the financial statements for the year ended 31 December 2018, at the latest.

The Bank's Supervisory Board has established the following internal division of key competencies within the Bank's Management Board:

PAULINA STRUGAŁA	President
AGNIESZKA KRAWCZYK	Member of the Management Board in charge of the product offer
JAKUB NIESŁUCHOWSKI	Member of the Management Board in charge of financial matters
MAREK SZCZEŚNIAK	Member of the Management Board in charge of risk management matters

Other management functions of Members of the Management Board

	Position	Position holding period
Paulina Strugała	Member of the Supervisory Board of PKO BP Finat Sp. z o.o..	Since 30 June 2018
Agnieszka Krawczyk	Director of the Mortgage Banking Products Department at PKO Bank Polski SA, on a part-time (0.2) basis	During the reporting period
Jakub Niesłuchowski	did not hold any other positions as a member of the Management Board or the Supervisory Board, or directorial positions	
Marek Szcześniak	Deputy Chairperson of the Supervisory Board in Kredobank SA in Ukraine	During the reporting period

Recruitment policy concerning the selection of Management Board members and evaluation of Management Board members

The process of selecting and evaluating candidates for members of the Management Board in PKO Bank Hipoteczny SA is carried out by the Remuneration and Nomination Committee of the Bank's Supervisory Board. The Committee takes into consideration the guidelines of the European Banking Authority dated 22 November 2012 regarding evaluating the qualifications of members of a management body and persons performing key functions (the EBA guidelines) and the Regulation of the Minister of Development and Finance of 10 March 2017 on information and documents concerning the founders and the management board of the bank to be submitted to the Polish Financial Supervision Authority. During the candidate selection process, the Committee takes into account PKO Bank Hipoteczny SA's profile, area and scale of operations. During the evaluation of a candidate, the Committee also verifies that the candidate's experience and knowledge will strengthen the abilities possessed by the other members of the Bank's Management Board, and complement them, so as to ensure the coverage of all areas managed in the Bank. The examination of this criterion has as its purpose ensuring variety in the selection of members of the managing body, its purposes, tasks and area of operation.

Before their appointment, all members of the Management Board of PKO Bank Hipoteczny SA were subjected to an evaluation of their suitability, in accordance with the EBA guidelines.

Members of the Management Board are subject to continuous evaluation by the Supervisory Board's Remuneration and Nomination Committee, beginning from the moment of recruitment and continuing through their entire term of office. In addition, in accordance with Article 395 § 2(3) of the Code of Commercial Companies and Partnerships, each year the ordinary general meeting of shareholders grants each individual member of the Management Board a vote of approval. The granting of this vote of approval constitutes an evaluation of the Management Board members, independent of the approval by the general meeting of shareholders of the Management Board's report on the Bank's operations. On 29 March 2018, by resolutions of the ordinary general meeting, all members of the Bank's Management Board, who fulfilled their functions in 2017, were granted a vote of approval for the period ended 31 December 2017.

The process described above for appointments to perform functions on the Management Board and the positive evaluation of members of the Bank's Management Board constitutes a confirmation of their proper performance of their duties, based on adequate knowledge, abilities and experience, in accordance with the requirements of art. 22aa of the Banking Law.

Compensation of Management Board Members

On 14 February 2018, the Bank's Supervisory Board, in resolution no. 1/2018, set the rules for appointing and remunerating members of the Bank's Management Board, thus adjusting the form of employment and compensation of members of the Bank's Management Board to the provisions of the Act of 9 June 2016 on the rules for setting the remuneration of persons managing certain companies (Journal of Laws of 2016, item 1202, as

amended). As a result of introducing the Rules of appointing and remunerating members of the Management Board of PKO Bank Hipoteczny SA, each of the members of the Bank's Management Board, holding their positions on that day, concluded with the Bank the agreement on the provision of management services including, *inter alia*, remuneration and non-competition terms and conditions. As a result of the aforementioned changes, previous work contracts were settled.

6.4. THE SUPERVISORY BOARD OF BANK HIPOTECZNY SA

In the period from 1 January to 30 June 2018, the composition of the Supervisory Board of Bank Hipoteczny SA was as follows:

	Function on the Supervisory Board	Date of appointment	Date of dismissal / resignation	qualifications in finance	Independent member[12]	knowledge and skills in accounting or audit	Audit and Finance Committee	Risk Committee	Remuneration and Nomination Committee	Commercial Committee
Jakub Papierski	Chairperson	06.10.2014		✓					Ch	Ch
Piotr Mazur	Deputy Chairperson	06.10.2014		✓				Ch		D
Justyna Borkiewicz	Board Member	28.10.2016		✓				M		
Mieczysław Król	Board Member	28.10.2016		✓				D	D	
Bartosz Drabikowski	Board Member	18.10.2017	15.01.2018							
Artur Kluczny	Board Member	18.10.2017		✓	✓		Ch			
Piotr Kwiecień	Board Member	18.10.2017		✓	✓		M			
Jan Emeryk Rościszewski	Board Member	18.10.2017		✓						M
Rafał Kozłowski	Board Member	09.02.2018		✓		✓	D			M

Ch – Chairperson of the Committee; D – Deputy Chairperson of the Committee; M – Member of the Committee

The composition of the Committees is presented as at 30 June 2018.

In accordance with Article 395 § 2(3) of the Code of Commercial Companies, each year the ordinary General Shareholders' Meeting grants a vote of approval to each individual member of the Supervisory Board. The granting of this vote of approval constitutes an evaluation of the Supervisory Board members, independent of the approval by the General Shareholders' Meeting of the Supervisory Board's report on the Bank's operations. On 29 March 2018, by resolution of the ordinary General Shareholders' Meeting, all members of the Bank's Supervisory Board received a vote of approval for the period ended 31 December 2017.

[12]as defined in the Act of 11 May 2017 on registered auditors, audit firms and public oversight

This constitutes a confirmation that members of the Supervisory Board duly performed their duties, based on adequate knowledge, abilities and experience, in accordance with the requirements of art. 22aa of the Banking Law.

The Bank has a Policy on the Selection and Evaluation of Members of the Supervisory Board of PKO Bank Hipoteczny SA. The policy defines the criteria for suitability of the members of the Supervisory Board at the stage of their appointment and in the course of exercising their functions and governs the procedure for their evaluation. In accordance with this Policy, on 9 February 2018, the General Shareholders' Meeting evaluated the qualifications of a candidate for a member of the Supervisory Board.

7. CORPORATE GOVERNANCE AND INFORMATION FOR INVESTORS

Representation on compliance with the rules for corporate governance Entity authorised to audit financial statements Other information

7.1. REPRESENTATION ON COMPLIANCE WITH THE RULES FOR CORPORATE GOVERNANCE

The Bank has adopted the Principles of Corporate Governance for Supervised Institutions, as issued by the Polish Financial Supervision Authority, on the basis of the following decisions by the Bank's bodies:

- the Resolution of the Bank's Management Board of 15 December 2014 – in relation to the powers and duties of the Management Board, i.e. conducting the Bank's affairs and its representation, in accordance with the generally applicable laws and the Bank's Articles of Association;
- the Resolution of the Supervisory Board of 18 December 2014 – in relation to the powers and duties of the Supervisory Board, i.e. supervising the conduct of the Bank's affairs, in accordance with the generally applicable laws and the Bank's Articles of Association;
- the Resolution of the General Shareholders' Meeting of 22 December 2015 – in relation to the powers reserved for the General Meeting.

Pursuant to and to the extent arising from, the aforementioned decisions, the Bank opted out of the following provisions of the Principles of Corporate Governance for Supervised Institutions:

- the provisions referring to the principles of cooperation and rights of multiple shareholders (§ 8(4), § 9(1) and (6), § 10(3), § 11(3) and § 31(3)), which are not applied because the Bank only has a single shareholder;
- chapter 9, concerning the management of assets at the client's risk, because the Bank does not conduct operations in this area;
- the principle described in § 22(1), concerning the independence of Supervisory Board members, manifesting itself primarily in the lack of direct and indirect ties to the supervised institution, members of the management and supervisory bodies, significant shareholders and related parties; in addition, on 18 October 2017 two members meeting the independence requirements set out in the Act of 11 May 2017 on statutory auditors, audit firms and public supervision were appointed as members of the Bank's Supervisory Board. (Journal of Laws, item 1089 as amended).

In accordance with the requirement arising from § 27 of the Principles of Corporate Governance for Supervised Institutions, on 17 May 2018, the Supervisory Board evaluated the application of the said Principles in the Bank in 2017. In the Supervisory Board's opinion, the Bank ensured that the Principles, to the extent adopted by the Bank's bodies, were applied adequately to the scale, nature of operations and a specific character of a mortgage bank.

The text of the Principles is available on the website of the Polish Financial Supervision Authority:

https://www.knf.gov.pl/knf/pl/komponenty/img/knf_140904_Zasady_ladu_korporacyjnego_22072014_38575.pdf

MAIN CHARACTERISTICS OF THE INTERNAL CONTROL SYSTEM IN RELATION TO THE PROCESS OF PREPARING THE FINANCIAL STATEMENTS

The internal control system covers the process of preparing financial statements. In accordance with the rules adopted at the Bank, one of the purposes of the internal control system is to support decision-making processes contributing to ensuring the reliability and accuracy of the financial reporting, accounting procedures and reliable internal and external reporting.

The Director of the Finance and Accounting Office is responsible for ensuring compliance with controls in the area of financial reporting, while the internal audit function is reviewing and independently evaluating the adequacy and effectiveness of controls over the financial reporting processes and evaluating risk management in these processes, in accordance with the approved internal audit plans. No issues which would cast doubt on the reliability of the financial reporting have been observed so far as part of the internal audit operations.

LIST OF DIRECT OR INDIRECT HOLDERS OF SIGNIFICANT BLOCKS OF SHARES WITH AN INDICATION OF THE NUMBER OF SHARES HELD AND THE NUMBER OF VOTES ATTACHED TO THESE SHARES

No.	Shareholder's name	Date of registration in the National Court Register	Number of shares	Series	Share numbers	Nominal value per share	Number of votes at GSM	Amount paid in for shares	Number preference shares and type of preference
1	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	24 October 2014	300 000 000	A	from 1 to 300 000 000	PLN 1	300 000 000	PLN 300 000 000.00	All shares are ordinary shares
2	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	22 April 2016	200 000 000	B	from 1 to 200 000 000	PLN 1	200 000 000	PLN 200 000 000.00	All shares are ordinary shares
3	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	28 July 2016	200 000 000	C	from 1 to 200 000 000	PLN 1	200 000 000	PLN 200 000 000.00	All shares are ordinary shares
4	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	01 December 2016	100 000 000	D	from 1 to 100 000 000	PLN 1	100 000 000	PLN 100 000 000.00	All shares are ordinary shares
5	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	12 April 2017	150 000 000	E	from 1 to 150 000 000	PLN 1	150 000 000	PLN 150 000 000.00	All shares are ordinary shares
6	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	11 September 2017	150 000 000	F	from 1 to 150 000 000	PLN 1	150 000 000	PLN 150 000 000.00	All shares are ordinary shares
7	Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	16 November 2017	100 000 000	G	from 1 to 100 000 000	PLN 1	100 000 000	PLN 100 000 000.00	All shares are ordinary shares

DESCRIPTION OF THE RULES FOR APPOINTING AND DISMISSING MANAGERS

Members of the Management Board are appointed and dismissed by resolution of the Supervisory Board. When appointing Management Board members, the Supervisory Board determines the number of members. The appointment of two members of the Management Board, including the President and the member responsible for risk, requires the consent of the Polish Financial Supervision Authority. The terms of office of members of the Management Board expire on the date when the General Shareholders' Meeting approves the financial statements for the last full financial year during which a member served, at the latest. Additionally, the term of office of a Management Board member also expires as a result of his/her death, resignation or dismissal from the Management Board, as of the date of the event causing the expiration, unless the resolution on dismissal provides a different date of expiration. Management Board members may be dismissed before the end of their term of office at any time.

The Supervisory Board notifies the Polish Financial Supervision Authority of the composition of the Management Board and of any changes in the composition thereof immediately after its appointment or after any changes in the composition thereof. The Supervisory Board also notifies the Polish Financial Supervision Authority of the members of the Management Board who, as a result of the division of responsibilities, shall be in charge of the risk management and the internal audit unit. The Supervisory Board notifies the Polish Financial Supervision Authority of an intention to dismiss, and the reasons for dismissal of, a member of the Management Board who, as a result of

the division of responsibilities, is in charge of risk management and the internal audit unit, immediately after the relevant item has been placed on the agenda of the Supervisory Board meeting.

Additional information on the powers of management are provided in Chapter 6, Structure and Governing Bodies of PKO Bank Hipoteczny SA.

DESCRIPTION OF AUTHORISATIONS TO DECIDE ON SHARE ISSUES OR BUYBACKS

The powers of the General Shareholders' Meeting include adopting resolutions on establishing the share redemption method and the level of compensation for redeemed shares, approving the acquisition of the Bank's treasury shares for redemption, and approving the issue of bonds convertible into shares or other instruments giving the right to acquire or take up shares in the Bank.

INDICATION OF ANY LIMITATIONS ON THE TRANSFER OF OWNERSHIP RIGHTS TO THE ISSUER'S SECURITIES

There are no limitations on the transfer of ownership rights to the issuer's securities.

PRINCIPLES FOR AMENDING THE BANK'S ARTICLES OF ASSOCIATION

Amendments to the Bank's Articles of Association require a resolution of the General Shareholders' Meeting and must be entered in the Business Register of the National Court Register. To the extent defined by Article 34(2) of the Banking Law, an amendment to the Articles of Association requires the consent of the Polish Financial Supervision Authority.

COMPOSITION AND CHANGES DURING THE LAST FINANCIAL YEAR, AND A DESCRIPTION OF THE OPERATIONS OF THE MANAGEMENT, SUPERVISORY AND ADMINISTRATIVE BODIES OF THE ISSUER AND OF THEIR COMMITTEES

Information concerning the description of the management, supervisory and administrative bodies of the issuer, their committees and their composition and changes during the last financial year is presented in Section 6, Structure and Governing Bodies of PKO Bank Hipoteczny SA. Structure and Governing Bodies of PKO Bank Hipoteczny SA.

THE GENERAL SHAREHOLDERS' MEETING AND RELATIONS WITH SHAREHOLDERS

The method of operation of the General Shareholders' Meeting and its key powers as well as a description of the shareholder rights and the method of their execution follow directly from the applicable laws and the Bank's Articles of Association. In consideration of the fact that all shares in the Bank's share capital are held by a single shareholder, i.e. PKO Bank Polski SA, the resolutions of the General Shareholders' Meeting are adopted without formally convening a General Shareholders' Meeting, in accordance with the principles arising from Article 405 of the Polish Code of Commercial Companies.

7.2. ENTITY AUTHORISED TO AUDIT FINANCIAL STATEMENTS

On 3 March 2017 the Supervisory Board of PKO Bank Hipoteczny SA selected KPMG Audyt Spółka z ograniczoną odpowiedzialnością sp.k. as the entity authorised to audit and review the Bank's financial statements for the years 2017–2019.

KPMG Audyt Spółka z ograniczoną odpowiedzialnością sp. k. with its registered office in Warsaw at ul. Inflancka 4A ("KPMG") is entered on the list of entities authorised to audit financial statements is maintained by the National Board of Statutory Auditors, with the number 3546. The Bank's Supervisory Board appointed the auditor authorised to audit and review financial statements in accordance with applicable laws and occupational standards, on the basis of Section 18(1)(4) of the Bank's Articles of Association.

On 19 June 2017, an agreement was signed by and between PKO Bank Hipoteczny SA and KPMG on the performance of an audit of the financial statements for the years ended 31 December 2017, 2018 and 2019, respectively, and on a review of the financial statements for the periods ended 30 June 2017, 2018 and 2019, respectively.

7.3. OTHER INFORMATION

SHAREHOLDERS HOLDING DIRECTLY OR INDIRECTLY ,THROUGH THEIR SUBSIDIARIES, AT LEAST 5% OF THE TOTAL NUMBER OF VOTES AT THE GENERAL SHAREHOLDERS' MEETING

Powszechna Kasa Oszczędności Bank Polski SA holds 100 per cent of the shares in PKO Bank Hipoteczny SA.

The Bank's share capital amounts to PLN 1 200 000 000 (one billion two hundred million złoty) and is divided into 1 200 000 000 (one billion two hundred million) ordinary registered series A, B, C, D, E, F and G shares, with a nominal value of PLN 1 (one) each.

The shares issued by PKO Bank Hipoteczny are not preferred and have been fully paid up.

CHANGES IN THE HOLDING OF SHARES AND RIGHTS TO SHARES IN PKO BANK HIPOTECZNY SA BY INDIVIDUALS IN MANAGEMENT AND SUPERVISORY ROLES

In the first half of 2018, there were no changes in the holdings of shares and rights to shares in PKO Bank Hipoteczny SA by individuals in management and supervisory roles.

EVALUATION OF PKO BANK HIPOTECZNY SA'S FINANCIAL CREDIBILITY

On 27 March 2015, the Bank requested the rating agency Moody's Investors Service ("Moody's") to assign ratings to the Bank and to mortgage covered bonds issued by PKO Bank Hipoteczny SA.

On 7 September 2015, Moody's assigned Baa1/P-2 long- and short-term issuer ratings to PKO Bank Hipoteczny SA, with a stable outlook. On 19 December 2017, Moody's announced that the ratings had been maintained.

On 8 September 2015, Moody's assigned a long-term (P) rating (a provisional rating) of Aa3 to PKO Bank Hipoteczny SA's EUR-denominated covered bonds. This rating was confirmed by the agency on 12 December 2015, i.e. immediately after PKO Bank Hipoteczny SA conducted its first issue of covered bonds. The rating has been maintained for all issues of Polish zloty-denominated covered bonds of PKO Bank Hipoteczny SA.

On 29 September 2016, Moody's assigned a long-term (P) rating (a provisional rating) of Aa3 to PKO Bank Hipoteczny SA's EUR-denominated covered bonds. This rating was confirmed by the agency on 24 October 2016, i.e. immediately after PKO Bank Hipoteczny SA conducted its first issue of EUR- denominated covered bonds. The rating has been maintained for all issues of EUR-denominated covered bonds of PKO Bank Hipoteczny SA.

The rating assigned to the covered bonds of PKO Bank Hipoteczny SA is the highest rating achievable for Polish securities. The rating of Polish securities is limited by Poland's country ceiling for debt instruments, which is currently Aa3.

On 18 June 2018, Moody's Investors Service assigned new counterparty risk ratings (CRR) to the Bank. The long-term counterparty risk rating was set at A3, and the short-term counterparty risk rating – at P-2. The new ratings were assigned in connection with updating of the bank rating methodology by the agency in June 2018. At the same time, new ratings were assigned to 32 other banks in Central and Eastern Europe. Counterparty risk ratings reflect an entity's ability to settle an unsecured portion of the counterparty's financial liabilities not related with a debt (CRR liabilities) and the expected financial losses in the case of failing to settle such liabilities.

SIGNIFICANT AND MATERIAL AGREEMENTS WITH THE CENTRAL BANK OR SUPERVISORY BODIES

On 25 June 2018, an agreement was signed with the National Bank of Poland for a Lombard loan and a pledge securing the loan, and on technical loan and a transfer of rights from securities.

Financial liabilities and guarantees granted

In the first half of 2018, PKO Bank Hipoteczny SA did not issue any guarantees.

Financial liabilities under loans granted and not disbursed as at 30 June 2018 stood at PLN 784.7 million, up by PLN 101.8 million compared to 31 December 2017.

Off-balance-sheet liabilities to related parties

In the first half of 2018, PKO Bank Hipoteczny SA did not grant any off-balance sheet liabilities to related parties.

Loans taken out and loan and guarantee agreements unrelated to the Bank's operations

In the first half of 2018, Bank Hipoteczny SA did not take out any loans or enter into any loan or guarantee agreements unrelated to the Bank's operations.

Underwriting agreements and guarantees granted to subsidiaries

On 30 August 2017, PKO Bank Hipoteczny SA concluded with PKO Bank Polski SA, acting also through its branch, Dom Maklerski PKO Banku Polskiego in Warsaw, an agreement amending and consolidating the program agreement of 9 November 2015, by which it appointed Dom Maklerski PKO Banku Polskiego as the underwriter.

Identification of pending proceedings before courts, arbitration bodies or public-administration authorities

As at 30 June 2018, no proceedings were under way before courts, arbitration bodies or public administration bodies concerning liabilities or receivables whose value constituted at least 10% of PKO Bank Hipoteczny SA's equity.

Factors which will influence future financial performance over the horizon of at least one quarter

Among the significant factors and threats which may affect the Bank's results over the following quarter, the following should be mentioned:

- the development of the residential market in Poland;
- the development of the residential loans market in Poland;
- the possibility and timing of further transfers to the Bank of portions of the portfolio of mortgage loans granted by PKO Bank Polski SA;
- the development in the domestic and foreign mortgage bonds markets, and in particular, the investors' demand
- for mortgage bonds issued by the Bank.

Information on loan guarantees or other guarantees issued by the Bank or its subsidiary – in aggregate to a single entity or its subsidiary, if the total amount of the existing guarantees is equivalent to at least 10% of the issuer's equity

In the first half of 2018, PKO Bank Hipoteczny SA did not grant any loan or credit guarantees to a single entity or a subsidiary of such an entity with a total value equivalent to at least 10% of the Bank's equity.

Information on loan and credit agreements entered into and terminated during a financial year

On 17 May 2018, PKO Bank Hipoteczny SA concluded an annex to the medium-term working capital loan agreement of 5 June 2017 with an external financial institution, decreasing the limit from 150 PLN million to PLN 100 million and extending the financing period to 10 June 2019.

Moreover, as at 30 June 2018 the Bank, had a liability arising from acquired receivables of PLN 2 205.7 million resulting from the acquisition, from PKO Bank Polski SA, of residential mortgage loan receivable portfolios, as described in Note 25 to the financial statements. The payment date of the liability resulting from the acquisition of the receivables is agreed each time by the parties in a Receivables Sale Agreement. For receivables acquired in 2018, the parties agreed that payment would be made no later than within 12 months from the transfer date. In the case of failing to settle the liability within one month from the transfer date, interest shall be accrued.

INFORMATION ON A TRANSACTION OR A NUMBER OF TRANSACTIONS CONCLUDED BY THE ISSUER OR ITS SUBSIDIARY WITH RELATED PARTIES IF MATERIAL AND NOT CONCLUDED ON AN ARM'S LENGTH BASIS

Between 1 January and 30 June 2018, PKO Bank Hipoteczny SA did not conclude any significant transactions with related parties other than on an arm's length basis.

SUBSEQUENT EVENTS

On 5 July 2018, the Extraordinary Shareholders' Meeting changed the rules for remunerating members of the Supervisory Board by introducing monthly remuneration for independent Supervisory Board members. The remuneration shall be equal to the average monthly remuneration in the enterprise sector, excluding bonuses out of the profit in the fourth quarter of 2016, as announced by the President of the Central Statistical Office.

In the period from 1 January 2018 to the date of signing these statements, i.e. 16 August 2018 PKO Bank Hipoteczny SA issued bonds in the total nominal value of PLN 675.6 million while bonds with a total nominal value of PLN 566.7 million matured and were redeemed. The bonds were issued under the bond issue scheme up to the amount of PLN 3,500.0 million as determined by PKO Bank Hipoteczny SA on 30 September 2015. The bonds are to be redeemed between 14 September 2018 and 8 August 2019.

In the period from 1 July 2018 to the date of approval of these financial statements PKO Bank Hipoteczny SA purchased, based on the Framework Agreement for the Sale of Receivables signed with PKO Bank Polski SA on 17 November 2015, mortgage covered housing loan receivables portfolio in the amount of PLN 393.7 million.

On 13 August 2018 the Extraordinary General Meeting passed a resolution on increasing the share capital of PKO Bank Hipoteczny by PLN 95,000,000, i.e. to PLN 1,295,000,000 by issuing 95,000,000 new ordinary registered H-series shares with a nominal value of PLN 1 (one) each. Share issue price of each H-series share was PLN 1.05. The shares were taken up by PKO Bank Polski SA. Until the date of the Management Board's approval of the financial statements for publication, the shares were not paid up and the capital increase has not been registered in the Register of Businesses of the National Court Register.

On 13 July 2018 PKO Bank Hipoteczny SA concluded an annexe to the medium-term revolving credit facility dated 5 June 2017 with an external financial institution, increasing the limit by PLN 50 million, to PLN 150 million.

On 19 July 2018 PKO Bank Hipoteczny SA concluded an annex to the Renewable Current Account Credit Agreement with PKO Bank Polski SA, according to which the limit was increased from PLN 900 million to PLN 1,500 million and the financing period was extended by 3 years, i.e. to 29 October 2021. The additional limit will be provided in tranches.

On 27 July 2018 PKO Bank Hipoteczny SA issued mortgage covered bonds denominated in PLN, with a total nominal value of PLN 500 million and a 7 year period to redemption as of the issue date. Variable interest was determined at WIBOR 3 M + 0.62% margin. The mortgage covered bonds were purchased by investors at a price equal to the nominal value. The bonds are quoted on the Warsaw Stock Exchange.

INFORMATION ON CHANGES IN THE KEY PRINCIPLES OF MANAGING THE BANK'S ENTERPRISE AND ITS CAPITAL GROUP

In the first half of 2018, there were no changes in the key principles of managing the Bank's enterprise in PKO Bank Hipoteczny SA.

FINANCIAL SUPPORT AGREEMENTS

PKO Bank Hipoteczny SA did not conclude financial support agreements with other entities subject to consolidated supervision operating within the same holding, or with closely related parties.

DEPOSITS AND GUARANTEES AND SURETIES ISSUED

PKO Bank Hipoteczny SA does not accept any deposits or issue any guarantees or sureties.

8. STATEMENT OF THE MANAGEMENT BOARD OF PKO BANK HIPOTECZNY SA

The Management Board of PKO Bank Hipoteczny SA declares that, to the best of their knowledge:

- the condensed interim financial statements of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2018 have been prepared in accordance with the applicable accounting policies and give a true, fair and clear view of the financial position of PKO Bank Hipoteczny SA and of the result of its operations;
- the Directors' Report on the activities of PKO Bank Hipoteczny SA for six-month period ended 30 June 2018 gives a true view of the development and achievements as well as of the position of PKO Bank Hipoteczny SA, including a description of the key risks and threats.

The Management Board of PKO Bank Hipoteczny SA declares that the entity authorised to audit the financial statements which conducted a review of the condensed interim financial statements for the six-month period ended 30 June 2018 was selected in compliance with applicable law and that both the entity and the statutory auditor who conducted the audit fulfilled all the criteria for providing an unbiased and independent audit report on the condensed interim financial statements, in compliance with applicable law and professional standards.

This Directors' Report on the activities of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2018 comprises 44 sequentially numbered pages.

Signatures of all Management Board members

16 August 2018	Paulina Strugała	President of the Management Board	*Signed on the Polish original* ...../...../..... (signature)
16 August 2018	Jakub Niesłuchowski	Vice-President of the Management Board	*Signed on the Polish original* ...../...../..... (signature)
16 August 2018	Marek Szcześniak	Vice-President of the Management Board	*Signed on the Polish original* ...../...../..... (signature)
16 August 2018	Agnieszka Krawczyk	Vice-President of the Management Board	*Signed on the Polish original* ...../...../..... (signature)