

PKO Bank Hipoteczny SA

Directors' Report

for the six-month period ended 30 June 2019

This document is a translation of a document originally issued in Polish. The only binding version is the original Polish version.

PKO BANK HIPOTECZNY SA DIRECTORS' REPORT FOR THE SIX-MONTH PERIOD ENDED 30 JUNE 2019

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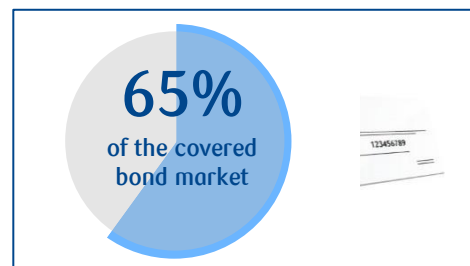
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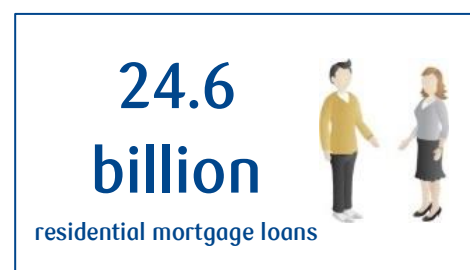
1. INTRODUCTION

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

PKO Bank Hipoteczny SA is leader of the Polish mortgage bank market in terms of total assets and the balance of residential mortgage 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 EUR-denominated covered bonds, five issues in total as at 30 June 2019. The outstanding covered bonds issued by the Bank account for more than two-thirds 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 SA. In the first half of 2019, the Bank's total assets were nearly PLN 26 billion, of which over PLN 24.6 billion were a high quality portfolio of housing loans. This means that there was a 17% increase in total assets compared with the end of 2018, 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 funding sources by obtaining long-term financing in the form of covered bonds intended for real-estate lending;



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.

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In the first half of 2019, PKO Bank Hipoteczny SA pursued its strategy by building a portfolio of residential mortgage loans under the agency and pooling models in cooperation with PKO Bank Polski SA. In subsequent periods, the Bank intends to similarly obtain housing loans, which, once included in the cover pool, will be the basis for issuing covered bonds.

In addition, during the first six months of 2019 the Bank conducted four issues of covered bonds, including the first issue of green covered bonds in Poland. In the first half of 2019, the Bank was the leader of the Polish mortgage bank market in terms of total assets and the balance of residential mortgage loans. The Bank intends to continue to be an active issuer of covered bonds in order to maintain its dominant market position.

At the same time, in the first half of 2019, the Bank worked on solutions facilitating the lending process – also for the needs of the PKO Bank Polski SA Group.

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2. EXTERNAL OPERATING CONDITIONS

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

2.1. MACROECONOMIC ENVIRONMENT

The Bank only operates in Poland.

Macroeconomic factors affecting the Polish economy in the first six months of 2019:

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 2019 show that Poland's GDP grew by 4.7% in Q1 2019 compared with Q1 2018. The European Commission's forecast published in July 2019 assumes that Poland's GDP will grow by 4.4% in 2019, and by another 3.6% in 2020. The high GDP growth rate may have a favourable impact on the employment level and consumers' wages. As a result, it may contribute to generating an increased demand for residential mortgage loans granted by banks to finance residential real estate purchases.

UNEMPLOYMENT AND WAGES AND SALARIES

Based on the data published by GUS, the number of unemployed registered with unemployment offices in Poland stood at 877.1 thousand at the end of June 2019, down 90.8 thousand, or 9.4%, compared with June 2018. The unemployment rate at the end of June 2019 was 5.3%, compared with 5.8% at the end of June 2018. The number of people employed at the end of Q1 2019 was 16,274 thousand, down 0.4% y/y, according to GUS's Labour Force Survey (BAEL). Whereas, the average monthly wage in the enterprise sector in Q2 2019 was PLN 5 116.13, up 6.7% y/y, based on GUS data. The increase in wage levels contributes to the development of the residential real estate market, and thus increases demand for residential mortgage loans.

INFLATION

Price changes affect consumers' purchasing power and the level of interest rates. The low inflation rate has a favourable effect on banking customers' creditworthiness, which in turn affects the value of residential mortgage loans granted. Based on GUS data, the Consumer Price Index (CPI) for June 2019 was 2.6% y/y.

INTEREST RATES

Low interest rates translate into reduced credit costs and increased consumer creditworthiness. As at 30 June 2019, 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.

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2.2. RESIDENTIAL REAL ESTATE MARKET

In Q1 2019, the transaction price growth remained at a high level of 10% per year. The ongoing upward trend in real estate prices which began in 2013 has continued uninterruptedly for six years now. Until 2016, the rate of price growth was moderate (below 5% per year). It began to accelerate in 2017, and in Q1 2019 approached 10% per year.

NEW HOUSING MARKET

According to RedNet data, the highest rate of growth in property prices of apartments sold by property developers at the stage of concluding pre-sale contracts and reservation agreements under the six most liquid markets were in Warsaw (15% per annum) and the Tricity (12% per annum).

The main causes of the growth in property prices on the new housing market are the rising prices of investment land and construction costs. Due to the continuing high demand on the markets, property developers are maintaining their margins by increasing the prices of apartments in their offers. The average price of investment land per square metre of usable floor area of an apartment in the six most liquid markets is fast increasing and the increase has been more than 20% per year for the past three quarters. On the other hand, according to SEKOCENBUD's costing rates for Q1 2019, the cost of construction (without the price of land) of selected single and multi-family residential buildings grew by 9% to 12.4% per annum.

The available data indicates that the increase in prices is not currently having an impact on inhibiting property sales on the new housing market on the six most liquid markets. Although there was a visible fall in sales in relation to the record result in 2017, last year ended with a very good result on sales and was rather better than in 2016.

The scale of demand on the residential real estate market is illustrated by the structure of the current offer of developers, which as at the end of Q1 2019 contained only 10% of unsold finished apartments. For the sake of comparison: in Q2 2013, there were 40% of such apartments and their proportion has been gradually decreasing since then. At the moment, the property developers' offer is predominantly real estate with a period of completion of one to two years. The majority of them are sold while the investment is still underway, and the down-payments of the purchasers constitute the main source of financing.

SECONDARY MARKET

NBP data for Q1 2019 show that, like the new housing market, the growth rate of residential real estate prices on the secondary market accelerated in all the market segments except Warsaw, where average transaction prices in Q1 2019 were only 4% higher than in the corresponding quarter of 2018. In the segment constituting six large cities, the rate of growth was 10% per annum, and in the segment constituting ten large cities, the rate of growth was 12% per annum. However, the slow price growth on the secondary market in Warsaw seems to be associated with varied quality of real estate in the comparative periods, since the hedonic index published by the National Bank of Poland (NBP) indicates a price growth of 12%-13% in the last two quarters. According to the PKO Bank Polski SA Group's internal real estate database, the same high growth rate was reported in the segment of other urban administrative districts (12% per annum) and in the segment of rural administrative districts (11% per annum).

SUPPLY AND DEMAND ON THE REAL ESTATE MARKET

GUS data for Q1 2019, compared to the corresponding period of 2018, point to a continuation of an upward trend in the number of apartments, the construction of which was commenced (+12%) and in the number of apartments commissioned for use (+6%), however the number of building permits granted fell significantly (-14%), which is related to the increasing problems with obtaining new investment land. This may indicate a limitation of supply in future periods, which would stimulate further growth of residential real estate prices given the continued strong demand.

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According to NBP data, in Q1 2019, the average affordability of apartments in large cities (a measure defining the number of square metres of housing available for an average one-month salary in the enterprise sector based on the average transaction price of an apartment on the given market) was 0.83 sq m. This is 0.32 sq m more than the minimum level reported in Q3 2007. Since the beginning of 2014, there has been a horizontal trend in the level of this indicator, fluctuating at around 0.85 sq m, which means that the rate of wage growth followed the rate of growth of residential real estate prices.

The good situation on the residential real estate market is supported by the favourable general economic situation in Poland, which has been maintained for the last five years, and strong internal demand. Low unemployment, wage growth, payment of benefits under the 500 Plus programme are the factors which improve consumer sentiment. In consequence, there has been a clear increase in consumer confidence indices (current – describing the assessment of the current situation, and anticipative – describing the situation expected by consumers in the coming months). Since 2017, these indices have been showing positive values, which means that there have been more consumers who optimistically assess their situation than those who have been pessimistic about it. In Q2 2019, the current confidence index was 8.4, and the anticipative index was 5.3 (both these values were the highest ever). Record-high values are also reported for the indicator of consumer willingness to make major purchases, which is important for the property market, and which is an element of the current consumer confidence index (16.4 in Q2 2019).

Residential property purchases are financed with household savings and mortgage loans. According to NBP data, the estimated share of cash purchases of apartments on the new housing market in the seven largest cities was 71% in Q1 2019. In the last 5 years, it ranged from 59% to 75%.

2.3. HOUSING LOAN MARKET

Based on NBP data, banks' receivables from housing loans in Poland were PLN 429.6 billion as at 30 June 2019, up 5.5% y/y. Loans denominated in Polish zloty were PLN 306.3 billion as at 30 June 2019 (71.3% of the Bank's total receivables from housing loans in Poland), up 11.6% y/y.

The total balance of housing loans in relation to gross domestic product expressed at market prices stood at 19.7% at the end of March 2019. That is significantly lower than the average for the European Union, which, according to 2018 data, was nearly 46.4%. This indicates a great potential for further growth of the housing loan market in Poland.

2.4. COVERED BOND MARKET

As at 30 June 2019 four mortgage banks were operating in Poland:

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

The Polish covered bond market is relatively small and moderately liquid. At the end of June 2019, the total value of outstanding covered bonds issued by Polish mortgage banks amounted to about PLN 24.3 billion, i.e. PLN 3.4 billion more than at 30 June 2018. As at 30 June 2019, covered bonds issued by Polish banks corresponded to 5.7% of the amount of housing loans granted by banks. For comparison, in 2017 this ratio was around 15.6% in Germany and around 34.4% in the Czech Republic.

PKO Bank Hipoteczny SA is the largest issuer of covered bonds in Poland. As at 30 June 2019, the value of outstanding covered bonds issued by PKO Bank Hipoteczny SA amounted to PLN 16 billion, which accounted for approx. 65% of the total value of outstanding covered bonds issued by Polish mortgage banks. The value of

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covered bonds issued by PKO Bank Hipoteczny SA in the first six months of 2019 accounted for 91% of the value of covered bonds issued by Polish mortgage banks in that period.

2.5. REGULATORY AND LEGAL ENVIRONMENT

In the first six months of 2019, legal and regulatory solutions affecting the operations of PKO Bank Hipoteczny SA came into force, including:

PERSONAL DATA	Act on amendments to certain acts with regard to ensuring that the regulation of the European Parliament and Council (EU) 2016/679 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, will be applied – the act has an impact on recruitment processes and employee relationships, as well as on the process of servicing loan applications.
BOND ISSUE	The Act of 9 November 2018 on amending certain laws in connection with strengthening supervision over the financial market and investor protection on that market - in a major part effective from 1 July 2019 – the act introduces significant changes in the bond issue process.
BANK GUARANTEE FUND	The Act of 17 January 2019 on amending the Bank Guarantee Fund Act, the deposit guarantee and resolution system and certain other acts – the Act excluded mortgage banks from the deposit guarantee system and adjusted the provisions of the Banking Law relating to mortgage transfers in connection with the disposal of the banks' receivables.
CREDIT EXPOSURES	Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures – the Regulation amends CRR with regard to minimum loss coverage for non-performing exposures. The amendment is applicable to credit exposures granted after 26 April 2019.
STATUTORY AUDITORS	Recommendation L of the PFSA (Polish Financial Supervision Authority) of 18 December 2018 concerning the role of statutory auditors in the process of supervising banks and cooperative credit unions – the regulation affects the process of cooperation between the audit process participants.

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3. FINANCIAL PERFORMANCE AND CAPITAL ADEQUACY

Key financial ratios of PKO Bank Hipoteczny SA
Statement of Financial Position of PKO Bank Hipoteczny SA
Income statement of PKO Bank Hipoteczny SA
Requirements regarding own funds (Pillar I)
Internal capital (Pillar II)
Disclosures (Pillar III)

3.1. KEY FINANCIAL RATIOS OF PKO BANK HIPOTECZNY

	30.06.2019	31.12.2018	30.06.2018
Total assets (in PLN millions)	25,955.0	22,103.1	20,267.7
ROA ¹	0.3%	0.4%	0.5%
ROE ²	3.8%	6.6%	7.0%
Total capital ratio	15.2%	15.2%	14.2%
Leverage ratio (LR)	6.5%	6.3%	6.1%
Cost to income ratio (C/I) ³	27.4%	21.5%	24.6%

3.2. STATEMENT OF FINANCIAL POSITION OF PKO BANK HIPOTECZNY SA

in PLN millions	30.06.2019	31.12.2018	30.06.2018
Cash and balances with the Central Bank	0.0	0.0	0.0
Amounts due from banks	0.0	0.0	122.2
Derivative hedging instruments	173.5	168.3	214.7
Securities	1,158.1	843.0	842.7
Loans and advances to customers	24,599.2	21,070.5	19,065.8
Other assets ⁴	24.2	21.3	22.3
TOTAL ASSETS	25 955.0	22 103.1	20 267.7

in PLN millions	30.06.2019	31.12.2018	30.06.2018
Amounts due to banks	4,137.6	4,292.3	3,858.3
Derivative hedging instruments	48.5	15.3	0.2
Mortgage covered bonds issued	15,965.6	12,841.5	12,168.0
Unsecured bonds issued	3,830.8	3,311.1	2,899.0
Other liabilities and provisions ⁵	116.6	155.0	49.3
Equity	1,855.9	1,487.9	1,292.9
TOTAL LIABILITIES AND EQUITY	25,955.0	22,103.1	20,267.7

¹ Annualized ratio expressed as the quotient of the net profit (loss) for the period and the average level of assets at the beginning and end of the reporting period and of the interim monthly periods

² Annualized ratio calculated by dividing the net profit (loss) for the period by the average level of equity at the beginning and end of the reporting period and of the interim monthly periods

³ Annualized ratio excluding tax on other certain financial institutions

⁴ Includes the following items of the statement of financial position: intangible assets, property, plant and equipment, and other assets

⁵ Includes the following items of the statement of financial position: amounts due to customers, other liabilities, current tax liabilities, deferred tax liabilities and provisions.

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As at 30 June 2019, the total assets of PKO Bank Hipoteczny SA were PLN 25,955.0 million, up 17% compared with the end of 2018. Residential mortgage loans were the key component of the Bank's assets. Their carrying amount, taking into account write-downs for expected credit losses recognized as at 30 June 2019, amounted to PLN 24,599.2 million, of which new loans amounted to PLN 10,395.4 million, whereas loans purchased from PKO Bank Polski SA amounted to PLN 14,203.8 million.

As far as liabilities and equity are concerned, the share of covered bonds rose to 62% thereof as at the end of June 2019. In the first six months of 2019, PKO Bank Hipoteczny SA carried out:

- one benchmark issue of euro-denominated covered bonds of EUR 500 million;
- two TAP issues of euro-denominated covered bonds with a total value of EUR 200 million,
- one issue of PLN-denominated green covered bonds of PLN 250 million.

Therefore as at the end of June 2019, the carrying amount of covered bonds was PLN 15,965.6 million and was up 24% compared with the end of 2018.

As at 30 June 2019, financial liabilities to PKO Bank Polski SA constituted a significant item of the Bank's equity and liabilities. These were liabilities in respect of lines of credit, overdraft facilities, liabilities in respect of the purchase of receivables, liabilities in respect of covered bonds and unsecured bonds acquired by PKO Bank Polski SA, liabilities in respect of hedging derivatives and other liabilities to PKO Bank Polski SA. Their total balance was PLN 4,353.7 million. Short-term bonds issued by the Bank were also a significant source of funding the Bank's operations. As at 30 June 2019, their total balance amounted to PLN 3,830.8 million, up 16% compared with the end of 2018.

3.3. INCOME STATEMENT OF PKO BANK HIPOTECZNY SA

in PLN millions	01.01.2019 – 30.06.2019	01.01.2018 – 30.06.2018	Change y/y (in PLN millions)
Net interest income	150.3	119.5	30.8
Net fee and commission income	(2.4)	(2.3)	(0.1)
Net gain/(loss) on financial instruments measured at fair value through profit or loss	0.0	0.0	0.0
Net foreign exchange gains/ (losses)	(1.9)	4.0	(5.9)
Net gain / loss on modification	0.4	(0.3)	0.7
Net credit losses	(5.7)	(4.4)	(1.3)
Net other operating income and expense	0.0	0.0	0.0
Administrative expenses	(25.0)	(21.9)	(3.1)
Regulatory charges	(24.5)	(6.4)	(18.1)
Tax on certain financial institutions	(39.0)	(27.4)	(11.6)
Operating profit	52.2	60.8	(8.6)
Profit before income tax	52.2	60.8	(8.6)
Income tax expense	(21.6)	(18.2)	(3.4)
Net profit	30.6	42.6	(12.0)

In the first six months of 2019, PKO Bank Hipoteczny SA generated a net profit of PLN 30.6 million, down PLN 12.0 million compared with the corresponding period of 2018. The most important reason for the drop was the increase in the annual contribution to the mandatory restructuring fund of the Bank Guarantee Fund.

In the same period, the Bank generated interest income of PLN 404.2 million, comprising primarily income from housing loans of PLN 394.0 million, and income from debt securities. In the same period, the Bank incurred interest expense of PLN 253.9 million. Interest expense resulted mainly from covered bonds issued (including costs of

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hedging transactions). The related interest expense was PLN 181.3 million. The Bank also incurred, among other things, interest expense of PLN 18.6 million on loans and overdrafts received, interest expense of PLN 14.9 million on the liability for the deferred payment for receivables purchased from PKO Bank Polski SA, and interest expense of PLN 39.0 million on bonds issued.

The Bank's turnover in the first half of 2019 (understood as the total value of interest income and fee and commission income) amounted to PLN 412.1 million. The realized turnover was generated entirely from the Bank's operations in Poland.

In the first half of 2019, the Bank incurred a net fee and commission loss of PLN 2.4 million. This item comprised, among other things, costs of expert valuations of the mortgage lending value of real estate (MLV), as prepared by real estate appraisers, in the amount of PLN 4.2 million, costs of the bond issue programme of PLN 2.0 million, costs of insuring loans of PLN 1.8 million, and costs of lines of credit of PLN 1.5 million. The Bank also recognized fee and commission income from customers for, among other things, real estate valuations performed by the Bank and for real estate inspections, as well as commission for early full or partial loan repayments. The total fee and commission income was PLN 7.8 million.

In first half of 2019 the Bank incurred administrative expenses of PLN 25.0 million. Non-personnel expenses of PLN 14.7 million, including costs related to services rendered by PKO Bank Polski SA of PLN 11.2 million under an outsourcing agreement, were a significant component of administrative expenses. Costs of employee benefits, whose amount during the reporting period was PLN 8.7 million, were also a significant component of administrative expenses. The increase in administrative expenses compared with the corresponding period of 2018 was mainly caused by an increase in costs of services provided by PKO Bank Polski SA under an outsourcing agreement (up PLN +2.2 million), which resulted from an increase in the number of loans in the Bank's balance sheet.

In the first half of 2019, the Bank also incurred regulatory expenses totalling PLN 24.5 million. The main item of such expenses was the contribution to the resolution fund of the Bank Guarantee Fund of PLN 22.1 million (PLN 17.5 million more than in 2018). The increase in the regulatory expenses adversely affected the Bank's profitability ratios.

Tax on certain financial institutions, which amounted to PLN 39.0 million in the reporting period, was a significant cost of the Bank's activities.

The Bank's net additions to credit losses amounted to PLN 5.7 million in the first half of 2019.

No unusual events significantly affecting the Bank's operations occurred in the first half of 2019.

THE BANK'S FINANCING STRUCTURE

The table below presents the structure of the Bank's funding sources:

	30.06.2019	31.12.2018
Equity	7.2%	6.7%
Funds from the parent	15.0%	18.7%
Covered bond issues	61.5%	58.1%
Bond issues	14.7%	15.0%
Other	1.6%	1.5%
Total	100.0%	100.0%

As at 30 June 2019 and 31 December 2018, the Bank had no overdue contractual liabilities.

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3.4. REQUIREMENTS REGARDING OWN FUNDS (PILLAR I)

GENERAL INFORMATION

In accordance with the CRR, the Bank calculates requirements in respect of own funds for the following risk types:

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

At 30 June 2019, 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 fund requirements	30.06.2019	31.12.2018
Credit risk (in PLN millions)	862.2	719.0
Operational risk (in PLN millions)	22.7	15.6
Total own funds requirement (in PLN millions)	884.9	734.6
Common Equity Tier 1 capital ratio (CET1)	15.2%	15.2%
Tier 1 capital ratio (T1)	15.2%	15.2%
Total capital ratio (TCR)	15.2%	15.2%

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

30.06.2019	Gross exposure	Exposure value ⁶	Risk-weighted assets (RWA)	Own funds requirement
Retail exposures ⁷	5,358.4	5,075.4	3,806.6	304.5
Exposures secured by mortgages on real estate	19,884.0	19,831.0	6,940.9	555.3
Exposures to central governments or central banks	1,158.2	1,158.2	0.0	0.0
Exposures to institutions	824.9	824.9	0.0	0.0
Exposures in default	12.3	9.3	9.9	0.8
Other exposures	20.5	20.5	20.5	1.6
Total	27,258.3	26,919.3	10,777.9	862.2

⁶The 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).

⁷These 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.

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31.12.2018	Gross exposure	Exposure value ⁸	Risk-weighted assets (RWA)	Own funds requirement
Retail exposures ⁹	3,985.8	3,658.9	2,744.2	219.5
Exposures secured by mortgages on real estate	17,824.0	17,768.4	6,218.9	497.5
Exposures to central governments or central banks	843.0	843.0	0.0	0.0
Exposures to institutions	729.1	729.1	0.0	0.0
Exposures in default	8.1	6.1	7.1	0.6
Other exposures	16.8	16.8	16.8	1.4
Total	23,406.8	23,022.3	8,987.0	719.0

CREDIT RISK ADJUSTMENTS

For the purpose of specific credit risk adjustments, the Bank uses impairment loss, which was recognized in the Bank's Tier 1 capital in accordance with the CRR 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 40.3 "Impairment loss on credit exposures" of the Condensed interim financial statements of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2019.

USE OF CREDIT RISK MITIGATION TECHNIQUES

The Bank uses mortgage collateral for the classification of exposures to classes of exposures secured by mortgages on real estate 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 42 "Residual risk management" of the Condensed interim financial statements of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2019.

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

⁸The 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).

⁹These 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.

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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 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	30.06.2019	31.12.2018
For credit risk	93.5%	93.5%
For operational risk	2.5%	2.0%
For liquidity risk	2.0%	2.2%
For interest rate risk	1.8%	2.1%
For model risk	0.2%	0.2%
Total	100.0%	100.0%

As at 30 June 2019, 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 regularly conducts stress tests.

3.6. DISCLOSURES (PILLAR III)

Considering the scale and specific nature of its operations, in the financial statements and in the Directors' Report the Bank discloses in particular 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 Law 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 for consolidation purposes.

Details of the scope of information disclosed, the method of its verification and publication are presented in PKO Bank Hipoteczny SA Capital Adequacy Information Policies and other information to be published, which is available on the Bank's website (www.pkobh.pl).

PKO BANK HIPOTECZNY SA DIRECTORS' REPORT FOR THE SIX-MONTH PERIOD ENDED 30 JUNE 2019

4. BUSINESS OF PKO BANK HIPOTECZNY SA

Sales of mortgage housing loans under the agency model
Acquisition of receivables under mortgage housing loans
Structure of the mortgage housing loan portfolio
Covered bonds
Financial market operations
Bonds – non-public programme
Bonds – public programme
Ratings of the Bank and its covered bonds

4.1. SALES OF MORTGAGE HOUSING LOANS UNDER THE AGENCY MODEL

PKO Bank Hipoteczny SA has been granting residential mortgage loans in Polish zloty since 1 April 2015. New residential mortgage 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.

In the first half of 2019, the Bank granted PLN 1,822.4 million worth of housing loans, a small drop of 3.9% compared with the first six months of 2018.

In accordance with Recommendation S of the PFSA, in the first half of 2019 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% ¹⁰
Loan amount/mortgage lending value of the property	Max 100%
Legal title to real estate	Ownership or perpetual lease
Loan collateral	Mortgage recorded in the first section Mortgage recorded as the first in Section IV of the Land and Mortgage Register
Currency	PLN
Purpose	Residential

In the first half of 2019, the Bank changed its offer by replacing the WIBOR 3M reference rate with WIBOR 6M for the purposes of determining interest rates on mortgage loans.

ENERGY EFFICIENT MORTGAGES INITIATIVE

PKO Bank Hipoteczny SA and PKO Bank Polski SA were the first banks in Poland to join the Energy Efficient Mortgages (EEM) Initiative pilot project on 11 April 2019. The aim of the project is to develop standardized, pan-European solutions for mortgage loans granted for the financing of energy-efficient apartments and houses. This

¹⁰Where a low down payment insurance policy was used, the Bank approved loans for which this ratio was not higher than 90%

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includes offering preference packages to encourage borrowers to buy energy efficient properties or to improve the energy efficiency of the existing buildings. In this way, banks would be encouraged to play a key role in stimulating climate change-related actions in the European construction sector.

4.2. ACQUISITION OF RECEIVABLES UNDER MORTGAGE HOUSING LOANS

Purchase of receivables in respect of mortgage housing loans, on the basis of a framework agreement signed in 2015 with PKO Bank Polski SA, is an important element of the business of PKO Bank Hipoteczny SA.

In the first half of 2019, PKO Bank Hipoteczny SA acquired from PKO Bank Polski SA a portfolio of receivables for housing loans secured by mortgages totalling PLN 2,519.3 million. The following table shows the main criteria applied by PKO Bank Hipoteczny SA in the process of acquiring mortgage loans.

CRITERIA	POOLING MODEL
Loan amount/mortgage lending value of the property	Max 100%
Legal title to real estate	Ownership or perpetual usufruct
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 HOUSING LOAN PORTFOLIO

PORTFOLIO STRUCTURE BY LTV

The structure of the gross portfolio of loans granted to customers in the statement of financial position of PKO Bank Hipoteczny SA according to the LTV ratio based on market valuation¹¹ and the LTV ratio based on the mortgage lending value is presented in the following tables.

Gross loans at LTV based on market valuation	30.06.2019	31.12.2018
below 50%	31%	29%
51% – 60%	18%	18%
61% – 70%	23%	23%
71% – 80%	20%	21%
81% – 90%	8%	9%
above 90%	0%	0%
Total, gross	100%	100%
Average LTV based on market valuation	58.0%	58.7%

¹¹ 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.

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Gross loans granted to customers at LtV based on MLV	30.06.2019	31.12.2018
below 50%	15%	14%
51% – 60%	9%	10%
61% – 70%	13%	13%
71% – 80%	18%	18%
5581% – 90%	24%	25%
above 90%	21%	20%
Total, gross	100%	100%
Average LtV based on MLV	72.8%	72.7%

In the first half of 2019, the average LtV ratio based on the market valuation of the loan portfolio declined by 0.7 p.p., which was the result of a rise in the market value of the real estate provided as loan collateral. For the LtV ratio based on MLV, this relationship is not observed because the mortgage lending value of the real estate did not need to be updated.

INTEREST ON LOANS

The base reference rate applied by the Bank for loans was WIBOR 3M, whose average value was 1.72% in the first six months of 2019. At the beginning of 2019 the Bank introduced loans based on the WIBOR 6M rate to its offer instead of WIBOR 3M. In the first half of 2019, the average value of WIBOR 6M was 1.79%.

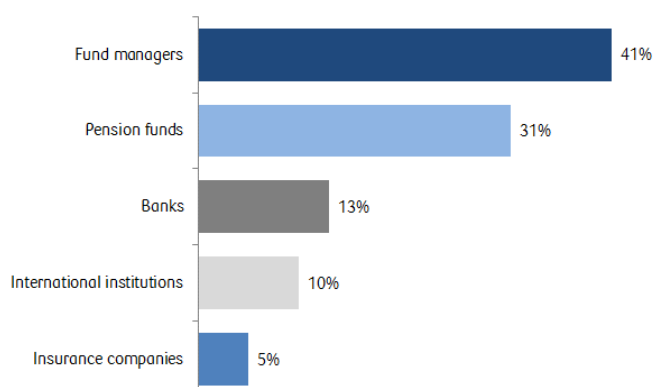
4.4. COVERED BONDS

The key objective of PKO Bank Hipoteczny SA concerning funding is issuing covered bonds which are the main source of long-term financing for loans secured with real estate.

POLISH ISSUES OF COVERED BONDS

On 10 June 2019, PKO Bank Hipoteczny SA carried out an issue of series 12 PLN-denominated covered bonds, which was yet another issue carried out under the firm commitment underwriting procedure.¹² It was the first issue of green covered bonds secured exclusively with PLN-denominated high-quality housing loans carried out in Poland. The Bank offered securities of PLN 250 million to institutional investors. During the book-building process, the spread of Series 12 covered bonds was set at 0.60% above WIBOR 3M. The period from the date of issue to redemption of the covered bonds was set at 5 years, 3 months and 20 days, and the maturity date was set at 30 September 2024.

Chart: Purchasers of domestic issues of PKO Banku Hipoteczny SA's covered bonds in the years 2015 - 2019

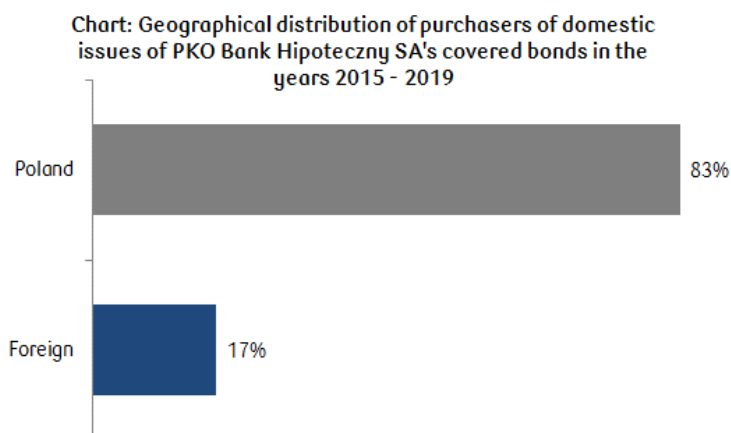


¹² Firm commitment underwriting is a contract whereby the underwriter undertakes to purchase on its own account all or a part of securities in a given issue from the issuer or from the arranger; the securities are only offered to that entity to further sell them in a public offering.

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The series 12 covered bonds of PKO Bank Hipoteczny SA were placed on the Warsaw Stock Exchange's parallel market and on the BondSpot OTC market on 24 June 2019; they have also been admitted to repo transactions by the National Bank of Poland.



PLN-denominated issues of covered bonds of PKO Bank Hipoteczny SA carried out to 30 June 2019:

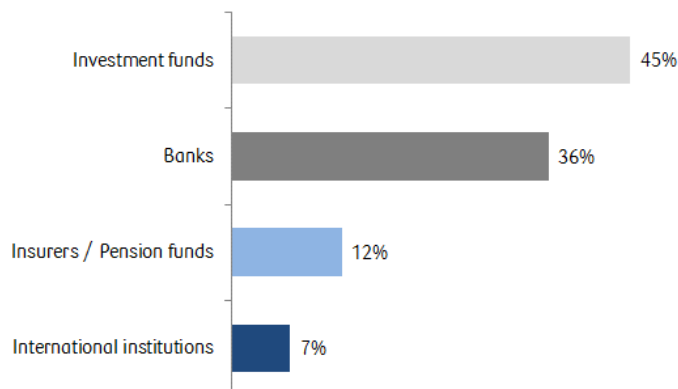
Series	Covered bond number (ISIN)	Issue date	Redemption date	Value in PLN million	Interest rate	Currency	Rating	Listing
1	PLPKOHP00017	11.12.2015	11.12.2020	30	WIBOR 3M + 0.75%	PLN	Aa3	BondSpot, WSE parallel market
2	PLPKOHP00025	27.04.2016	28.04.2021	500	WIBOR 3M + 0.65%	PLN	Aa3	BondSpot, WSE parallel market
3	PLPKOHP00033	17.06.2016	18.06.2021	500	WIBOR 3M + 0.59%	PLN	Aa3	BondSpot, WSE parallel market
4	PLPKOHP00041	28.04.2017	18.05.2022	500	WIBOR3M + 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	WIBOR3M + 0.60%	PLN	Aa3	BondSpot, WSE parallel market
7	PLPKOHP00074	27.04.2018	25.04.2024	700	WIBOR3M + 0.49%	PLN	Aa3	BondSpot, WSE parallel market
8	PLPKOHP00082	18.05.2018	29.04.2022	100	WIBOR3M + 0.32%	PLN	Aa3	BondSpot, WSE parallel market
9	PLPKOHP00090	27.07.2018	25.07.2025	500	WIBOR3M + 0.62%	PLN	Aa3	BondSpot, WSE parallel market
10	PLPKOHP00108	24.08.2018	24.08.2028	60	3.4875%	PLN	Aa3	BondSpot, WSE parallel market
11	PLPKOHP00116	26.10.2018	28.04.2025	230	WIBOR3M + 0.66%	PLN	Aa3	BondSpot, WSE parallel market
12	PLPKOHP00132	10.06.2019	30.09.2024	250	WIBOR 3M + 0.60%	PLN	Aa3	BondSpot, WSE parallel market

PKO BANK HIPOTECZNY SA DIRECTORS' REPORT FOR THE SIX-MONTH PERIOD ENDED 30 JUNE 2019

INTERNATIONAL ISSUES OF COVERED BONDS

On 28 January 2019, PKO Bank Hipoteczny SA carried out its fifth benchmark issue of Series 7 EUR-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 0.274% (and the coupon at 0.250%). In the process, investors expressed interest in purchasing securities for a total of about EUR 1 080 million. The period from the date of issue to redemption of the covered bonds was set at 2 years, 9 months and 26 days, and the maturity date was set at 23 November 2021.

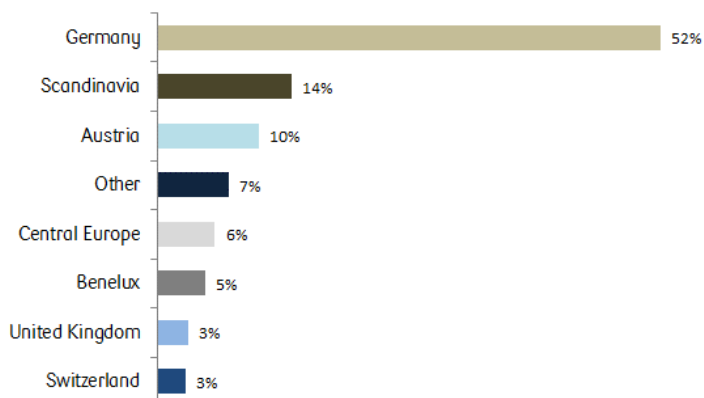
Chart: Purchasers of domestic issues of PKO Banku Hipoteczny SA's covered bonds in the years 2015 - 2019



Series 7 EUR-denominated covered bonds of PKO Bank Hipoteczny SA were listed on the Luxembourg Stock Exchange and the Warsaw Stock Exchange (parallel market) on 28 January 2019 and 25 February 2019 respectively. Since 28 January 2019, they have also been accepted in repo transactions by the European Central Bank.

On 1 March 2019, PKO Bank Hipoteczny SA placed the first TAP¹³ covered bonds issue for series 7 benchmark issue in the nominal amount of EUR 100 million. The yield on covered bonds of this issue was determined at 0.197%, and the coupon at 0.250%. The instruments were assimilated with series 7 covered bonds, as a result of which the nominal value of the securities quoted on the Luxembourg Stock Exchange and in the Warsaw Stock Exchange parallel market increased to a total of EUR 600 million.

Chart: Geographical distribution of purchasers of EUR-denominated covered bonds of PKO Bank Hipoteczny SA in years 2016 - 2019



On 8 March 2019, PKO Bank Hipoteczny SA placed the second TAP covered bonds issue for series 1 benchmark issue in the nominal amount of EUR 100 million. The yield on covered bonds of this issue was determined at 0.281%, and the coupon at 0.125%. The instruments were assimilated with series 1 covered bonds, as a result of which the nominal value of the securities quoted on the Luxembourg Stock Exchange and in the Warsaw Stock Exchange parallel market increased to a total of EUR 600 million.

EUR-denominated issues of covered bonds of PKO Bank Hipoteczny SA carried out to 30 June 2019:

Series	Covered bond number (ISIN)	Issue date	Redemption date	Value in PLN million	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

¹³ TAP a procedure allowing issuers to offer bonds or debt securities from previous issues by increasing their nominal value.

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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
7	XS1935261013	28.01.2019	23.11.2021	500	0.250%	99.933 %	EUR	Aa3	LuxSE, WSE parallel market
7 tranche 2	XS1935261013	01.03.2019	23.11.2021	100	0.250%	100.145 %	EUR	Aa3	LuxSE, WSE parallel market
1 tranche 2	XS1508351357	08.03.2019	24.06.2022	100	0.125%	99.489 %	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 mortgage loans and to purchase receivables for such loans from PKO Bank Polski SA.

THE COVERED BOND LABEL

On 6 February 2018, PKO Bank Hipoteczny SA, as the first Polish issuer of covered bonds, 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.

The Bank's details on the website of The Covered Bond Label are available at:

<https://coveredbondlabel.com/issuer/161/>

GREEN COVERED BONDS

In Q2 2019, PKO Bank Hipoteczny SA published the Green Covered Bond Framework (GCBF). In June 2019, PKO Bank Hipoteczny SA, as the first issuer in Poland, received a certificate granted by the international agency Climate Bonds Initiative for green covered bonds that satisfy the highest international standards with respect to the criteria for financing low emission projects. Through its participation in the financing of environmentally-friendly housing projects, the Bank will be able to obtain access to additional sources of financing from issues of Green covered bonds.

The proceeds from Green covered bonds are used exclusively to provide full or partial financing or refinancing of new and/or existing projects which have been classified as green. Such bonds should satisfy the criteria set by the International Capital Market Association (ICMA), which are known as Green Bond Principles (GBP). The GBP are a set of guidelines concerning transparency, disclosure and reporting, which promote the consistency of the green bond market. In June 2019, PKO Bank Hipoteczny SA obtained a second party opinion of a specialized, certified international institution Sustainalytics, which confirmed that the Bank's GCBF complies with the key GCB principles.

For more detailed information concerning green covered bonds issued by the Bank, please visit:

<https://www.pkobh.pl/en/investor-relations/green-covered-bonds/>

PKO BANK HIPOTECZNY SA DIRECTORS' REPORT FOR THE SIX-MONTH PERIOD ENDED 30 JUNE 2019

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 housing loans and purchase of receivables for housing loans granted by PKO Bank Polski SA, PKO Bank Hipoteczny SA issues covered bonds, 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 2019, there were no indicators of a risk of late payment of the liabilities incurred by the Bank. In the first six months of 2019, the Bank did not exceed any of the liquidity limits. Details of the levels of the Bank's liquidity limits are provided in Note 43 "Liquidity Risk Management" to the Condensed interim financial statements of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2019.

As far as the issue of EUR-denominated covered bonds is concerned, for the purpose of hedging interest-rate risk and foreign exchange risk, PKO Bank Hipoteczny SA entered into Cross-Currency Interest Rate Swap (CIRS) transactions, under which the Bank pays a coupon in PLN 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 covered bonds. Additionally, the Bank has executed a series of FX-Forward contracts, which constitute a hedge of currency exposure with maturities on the payment dates of the coupons for the EUR-denominated covered bonds.

As far as the issue of fixed-interest rate covered bonds in PLN is concerned, the Bank entered into IRS transactions to hedge interest rate risk in 2017 and 2018. 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 remain a regular issuer of covered bonds both on the Polish and international market.

4.6. BONDS – NON-PUBLIC PROGRAMME

On 30 September 2015, PKO Bank Hipoteczny SA established a non-public short-term bond issue programme. In 2019, the Bank issued a total of PLN 4,072.1 million worth of bonds under the programme. The balance of issued bonds was PLN 3,500.0 million as at 30 June 2019. The Bank intends to continue seeking financing in the form of short-term bond issues.

On 18 December 2018, PKO Bank Hipoteczny SA signed an agreement with a European financial institution for an issue of unsecured bonds based on a variable interest rate with a total nominal value of PLN 350.0 million and redemption date on 21 February 2020.

4.7. BONDS – PUBLIC PROGRAMME

On 11 April 2019, PKO Bank Hipoteczny SA established a public bond issue programme. On 31 May 2019 the PFSA approved the Base Bond Issue Prospectus of PKO Bank Hipoteczny SA.

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As part of this programme, bonds with a total nominal value of PLN 50 million were subscribed for by 30 June 2019. These bonds were admitted and introduced to trading on the WSE regulated market (the parallel market) in July 2019. The Bank intends to continue seeking financing under this programme.

4.8. 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	Data of initial rating/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 assessment	A3	n/a	18.06.2018
Short-term counterparty risk assessment	P-2	n/a	18.06.2018
Opinion on long-term counterparty risk (CR)	A3(cr)	n/a	19.12.2017
Opinion on short-term counterparty risk (CR)	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 limit for the ratings is the Polish country ceiling for debt instruments, which currently is at the level of Aa3.

PKO BANK HIPOTECZNY SA DIRECTORS' REPORT FOR THE SIX-MONTH PERIOD ENDED 30 JUNE 2019

5. INTERNAL OPERATING CONDITIONS

Qualified personnel Lending process and cooperation with PKO Bank Polski SA Internal control system Risk management Valuation of housing loan collaterals Cover pool for covered bonds Cover Pool Monitor Statutory limits

5.1. QUALIFIED PERSONNEL

The Bank implements tools and procedures to guarantee that personnel 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 of the personnel. 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 COOPERATION WITH PKO BANK POLSKI SA

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

- agency model;
- pooling model.

The cooperation with PKO Bank Polski SA is governed in detail by an outsourcing agreement concluded on 16 January 2015. The agreement governs the scope of the cooperation and describes in detail the method of performing the outsourced functions, first and foremost in the area of offering and administering residential mortgage 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 extensive reporting and control tasks on behalf of 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 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 PFSA, 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;

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- 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.

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 Head Office's business units which are responsible for carrying out the tasks assigned to this function;
- the compliance function, which, together with 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, the internal control system, and corporate governance, except for the aspects relating to the internal audit function itself.

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

- the first level consists of organizational structures that perform risk-generating operational tasks and operate under internal regulations;
- the second level is composed of specialized organizational structures operating under applicable policies, methodologies and procedures. The purpose of such structures is to ensure that actions at the first level are properly designed and ensure effective functioning with respect to risk mitigation, support risk management and measurement, and ensure the effectiveness of operations. 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 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 tolerance. 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 (AFC) 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 AFC supports the Supervisory Board by monitoring and giving opinions on the adequacy and effectiveness of the internal control system based on reports obtained from compliance, internal audit and the control function matrix coordinator, as well as by giving opinions on draft resolutions of the Bank's Management Board in terms of the internal control system, the approval of which falls within the competence of the Bank's Supervisory Board.

In the first six months of 2019, the reporting within the internal control system and the management actions taken indicated that the internal control system in PKO Bank Hipoteczny SA was effective and commensurate with the Bank's business model and scale of the operations.

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5.4. RISK MANAGEMENT

The risk management process is a key process in PKO Bank Hipoteczny SA. Its purpose is to ensure control of the risk level 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 all identified types of risk associated with its operations;
- the process of risk management is commensurate with 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	<ul style="list-style-type: none"> • Credit risk • Liquidity risk, including financing risk • Interest rate risk • Model risk • Operational risk, including legal risk and outsourcing risk
RISKS SUBJECT TO MONITORING	<ul style="list-style-type: none"> • Concentration risk • Residual risk • Currency risk • Business risk, including risk of macroeconomic changes; • Compliance risk • Reputation risk • Capital risk, including risk of excessive leverage.

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 material, 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;
- risks subject to monitoring – which are monitored for materiality;
- other risks which have not been defined or do not arise in the Bank (immaterial and unmonitored).

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

In its Risk Management Strategy, the Bank has defined a number of strategic limits which define the tolerance for different risks. The Bank monitors these limits on an ongoing basis. In the first half of 2019, 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 for the six-month period ended 30 June 2019, in the chapter "Objectives and principles of risk management." It also includes important information on the level of financial risk in the Bank's operations, 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 legal acts:

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

Additionally, the question of loan collaterals is addressed by:

- the recommendations of the PFSA, 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 PFSA on 30 October 2017. The rules take into account the provisions of Recommendation F concerning the basic criteria applied by the PFSA 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 determined in a prudent manner, taking into consideration long-term parameters.

PKO Bank Hipoteczny SA determines the MLV on the basis of expert valuations of the mortgage lending value of property. Such valuations are carried out with due diligence and prudence. They take 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, can be realized 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 MLV and the proposed MLV 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 banking risk in the area of securing mortgage loans

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CONFIRMATION OF THE OPINION	PKO Bank Polski SA, under the Outsourcing Agreement, or a dedicated organizational unit of the Bank: the Collateral Valuation Team at the Loan Office
REVIEW OF AN EXPERT OPINION ON MLV OF REAL ESTATE AND DETERMINING THE MLV OF REAL ESTATE	A dedicated organizational 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 banking risk in the area of securing mortgage loans
PREPARATION OF THE MLV EXPERT OPINION	A dedicated organizational unit of the Bank: the Collateral Valuation Team at the Loan Office
REVIEW OF AN EXPERT OPINION ON MLV OF REAL ESTATE AND DETERMINING THE MLV OF REAL ESTATE	A dedicated organizational 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 performed by two independent individuals.

5.6. THE COVER POOL FOR COVERED BONDS

PKO Bank Hipoteczny SA maintains a cover pool for its covered bonds. The bank includes in the cover pool receivables on housing mortgage loans, and rights and funds that constitute the basis for issuing covered bonds, as well as additional funds that constitute the excess to cover interest on covered bonds in circulation which is due in the following six months. The covered bonds are secured by loans secured by the highest priority mortgage. Certain bank funds can also constitute the basis for issuing 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 Organization 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;
- held in cash.

The nominal value of loans included in the cover pool and constituting collateral for issues of covered bonds as at 30 June 2019 stood at PLN 18,782.1 million. The nominal value of the over-collateralization in the form of securities issued by the State Treasury, denominated in PLN, stood at PLN 250 million. As at 31 December 2018, these figures were PLN 16,947.7 million and PLN 251 million respectively. The cover pool also takes into account CIRS transactions hedging foreign exchange risk and the interest rate risk on EUR-denominated covered bonds, FX-

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Forward transactions hedging the foreign exchange risk of issued EUR-denominated covered bonds and IRS transactions hedging the interest rate risk of PLN-denominated covered bonds issued on a fixed-rate basis.

In the first half of 2019 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 Act on Covered Bonds and Mortgage Banks of 29 August 1997 (Journal of Laws of 2003, No 99, item 919, as amended;
- Resolution No 633/2015 of the PFSA of 1 December 2015 on defining the form of a cover pool;
- Recommendation K of the PFSA of 9 February 2016 concerning the principles for maintaining the cover pool by mortgage banks;

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 the Cover Pool as at 30 June 2019 and as at 31 December 2018:

	30.06.2019	31.12.2018
Total cover pool, including :	19,032.1	17,198.7
Loans secured by mortgages (in PLN million)	18,782.1	16,947.7
other assets ¹⁴ (in PLN million)	250.0	251.0
Liquidity buffer ¹⁵ (in PLN million)	114.2	100.4
Nominal value of hedging transactions ¹⁶ (in PLN million)	12,138.2	9,262.7
Number of loans	101,273	92,561
Average loan value (PLN thousands)	185.5	183.1
Average time since granting of loan (seasoning) (month)	46.9	44.9
Average maturity (month)	258.2	258.1
Average LTV (loan amount to market value)	54.8%	55.8%
Average loan to mortgage lending value of real estate	71.0%	71.2%
Over-collateralization ¹⁷	18.9%	34.6%

¹⁴Article 18(3) of the Polish Covered Bonds and Mortgage Banks Act

¹⁵Article 18(3a) of the Polish Covered Bonds and Mortgage Banks Act

¹⁶ The nominal value of the hedging transaction corresponds to the issue price of the covered bond

¹⁷ Includes the net value of hedging transactions but excludes NPL

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5.7. COVER POOL MONITOR

The purpose of the cover pool monitor is to ensure protection of the interests of the holders of covered bonds. The Act on Covered Bonds and Mortgage Banks guarantees protecting the independence of the monitor and his deputy. Monitors are appointed by the PFSA, upon the request of the Bank's Supervisory Board, for a period of six years.

On 6 March 2015 the PFSA 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	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.

The statutory limits and the level to which they have been met as of 30 June 2019 and 31 December 2018 were as follows:

Limit	Legal basis	Limit level	Actual level	
			30.06.2019	31.12.2018
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%	18.9%	18.7%
Value of funds received from the issue 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 housing properties that constitute the collateral	art.14	≤100.0%	67.8%	63.5%
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 loans and advances taken out and bonds issued, in proportion to the Bank's own funds	Article 15(2)	≤1000.0%	473.1%	551.3%
Total value of loans and advances taken out and bonds issued, in proportion to the amount designated for refinancing of activities described in art. 12 of the Act, i.e. granting 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%	32.4%	36.5%
Total nominal value of covered bonds outstanding, in proportion to the Bank's own funds and general risk provision	art.17	≤4000.0%	946.8%	920.7%

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Total nominal value of receivables secured by mortgages and value of rights and additional funds constituting the basis for issuing covered bonds, in proportion to the total nominal value of outstanding covered bonds (taking into account hedging instruments)	Article 18(1)	$\geq 110.0\%$	118.9%	134.6%
Total nominal value of receivables secured by mortgages constituting the basis for issuing covered bonds, in proportion to the total nominal value of covered bonds outstanding	Article 18(1)	$\geq 85.0\%$	117.7%	132.1%
Interest expense on 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 issuing covered bonds (cumulative from the beginning of the financial year and on any given day), taking into account hedging instruments	Article 18(2)	$\leq 100.0\%$	35.7%	35.1%
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)	$\geq 100.0\%$	153.0%	139.9%
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 issuing covered bonds	first sentence of Article 23(1)	$\leq 10.0\%$	8.4%	8.6%
Value of receivables secured by mortgages established on land designated for construction in accordance with development plans, in proportion to the value of receivables secured by mortgages established during the course of construction investments that constitute the basis for issuing covered bonds	second sentence of Article 23(1)	$\leq 10.0\%$	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 2019.

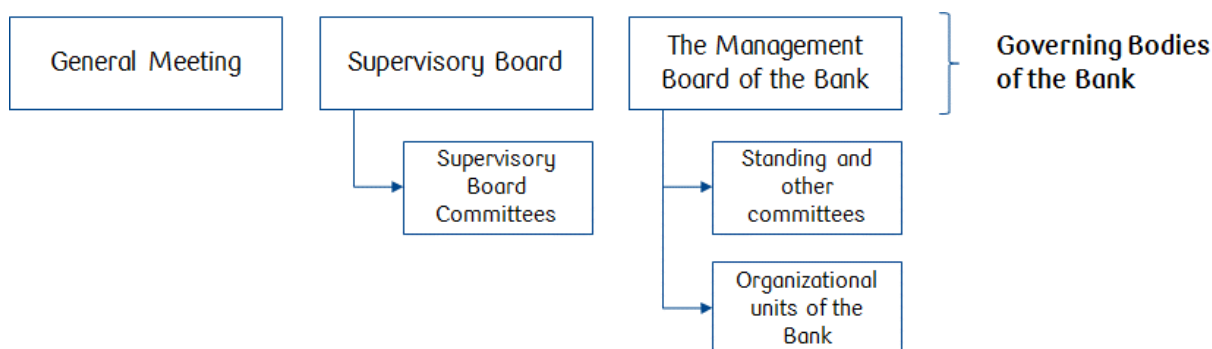
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6. STRUCTURE AND GOVERNING BODIES OF PKO BANK HIPOTECZNY SA.

Organizational 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 Bank Hipoteczny SA

6.1. ORGANIZATIONAL STRUCTURE OF PKO BANK HIPOTECZNY SA

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



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

The powers of the **General Shareholders' Meeting of the Bank** include in particular:

- appointing and dismissing members of the Supervisory Board;
- adopting resolutions on the 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 redeemed shares and granting consent to the purchase of the Bank's own shares for the purpose of redemption;
- creating and dissolving special funds created from net profit;
- adopting resolutions on issuing bonds convertible into shares or other instruments entitling the holder to purchase or take up shares in the Bank;
- adopting resolutions on the liquidation, disposal or lease of enterprises of the Bank or an organized part of the Bank's enterprises, and establishing limited property rights over them.

The powers 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 Bank's management strategy, the risk management strategy, including the general level of risk at the Bank, the policy for estimating internal capital and capital management and reviewing the internal capital assessment strategies and procedures and capital management procedures;
- approving the Bank's product, pricing and discount policy;

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- approving the audit charter, the internal audit function's strategy, the annual and long-term internal audit plans and the principles for cooperation with the internal audit function at PKO Bank Polski SA and the statutory auditor;
- approving and periodically reviewing the general principles of the remuneration policy concerning persons whose professional activities significantly affect the Bank's risk profile;
- approving the Management Board regulations;
- approving the Regulations for Setting the Mortgage Lending Value of Property, which take effect after the approval by the PFSA;
- affirming the Code of Ethics and the Rules for Management of Conflicts of Interest;
- approving the framework organizational 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 Rules;
- appointing and dismissing, by secret ballot, individual members of the Management Board;
- representing the Bank in agreements with members of the Management Board;
- approving the policy and procedure for selecting an audit firm responsible for auditing the Bank's financial statements and the policy for providing permitted non-audit services by the audit firm performing the audit, its related entities and members of its network;
- selecting an audit firm to conduct an audit or review of the Bank's financial statements;
- 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 off-setting of losses and presenting, to the General Shareholders' Meeting, a written annual report on the results of these assessments;
- applying to the PFSA 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 their 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 Shareholders' Meeting;
- assessing the application by the Bank of the Principles of Corporate Governance for Supervised Institutions.

In the first half of 2019, the following **Supervisory Board committees** operated:

AUDIT AND FINANCE COMMITTEE

- monitoring and periodically expressing its opinions on: the adequacy and effectiveness of internal controls; the adequacy and effectiveness of the risk management system; the degree of effectiveness of compliance risk management in the Bank; the application of corporate governance principles to supervised institutions, the internal audit and compliance principles; the adequacy and effectiveness of whistleblowing procedures (i.e. anonymous reporting of violations of the law and the ethical procedures and standards in force at the Bank);
- developing a policy for selecting an audit firm, recommending an audit firm to audit the Bank's financial statements to the Supervisory Board;
- monitoring the process of financial reporting, including reviewing the period and annual financial statements of the Bank;
- monitoring the audit performance and independence of the registered auditor and the audit firm;

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	<ul style="list-style-type: none"> consulting the rules of functioning of the internal control system, the approval of which is the responsibility of the Supervisory Board.
RISK COMMITTEE	<ul style="list-style-type: none"> giving opinions on 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 reports, including the utilization of strategic risk tolerance limits and developing relevant guidelines on their basis, as well as periodic reviews of pursuance of the risk management strategy; issuing opinions about capital adequacy, the rules of evaluation of creditworthiness, the risk measurement models, the impairment model; reviewing the principles of the disclosure policy regarding capital adequacy, capital adequacy management, liquidity risk, operational risk, model risk, and impairment measurement risk. providing opinions on the Rules on setting the mortgage lending value of real estate.
REMUNERATION AND NOMINATIONS COMMITTEE	<ul style="list-style-type: none"> 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 Managing 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 partnership, a sole proprietorship or as a member of a governing body of a 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; giving opinions on 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; giving opinions on 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.
COMMERCIAL COMMITTEE	<ul style="list-style-type: none"> 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.

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

- defining PKO Bank Hipoteczny SA's strategy, taking into account the risk of the operational risk and the strategy for managing 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 Organizational Regulations of the Bank and the rules for segregation of duties;
- establishing and closing down standing Committees of the Bank and defining their powers;
- adopting the Management Board rules;
- adopting the Regulations for setting the mortgage lending value of real estate;
- adopting the regulations for the use of special funds created from net profit;
- setting the dividend pay-out date within the period set by the General Shareholders' 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 organizational units of the Bank in Poland and abroad;
- making 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, foreign exchange, capital and related model risk management functions;
- managing the Bank's capital adequacy;
- examining materials on capital adequacy, equity, internal capital, stress tests, the 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, organizational units, members of the Bank's Management Board, project teams or task forces – within the scope of their powers.

CREDIT COMMITTEE

- supporting the functions that manage credit, concentration and residual risks, as well as the risk of the models measuring such risks;
- examining materials on the risks mentioned above, the profile and quality structure of the loan portfolio, impairment losses on assets, acquisition of loan portfolios and 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 powers.

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);

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	<ul style="list-style-type: none"> oversight over the functioning of the DMS, including evaluation of its effectiveness and the operations of particular organizational units of the Head Office.
STRATEGY AND BUSINESS INITIATIVES COMMITTEE	<ul style="list-style-type: none"> 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, lending process; making decisions regarding the Bank's operations, in particular as regards managing the risks mentioned above and their 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 powers.
THE GREEN COVERED BONDS COMMITTEE	<ul style="list-style-type: none"> supporting the supervisory functions in the process of Green covered bonds issue; defining the directions of changes in the principles of Green covered bonds issues; assessing and selecting assets that qualify for co-financing with Green covered bonds; making decisions concerning the Bank's actions relating to the assessment and selection of qualified loans, adopting the principles for Green Covered Bond issues at the Bank; 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 powers.

6.3. THE MANAGEMENT BOARD OF PKO BANK HIPOTECZNY SA

In the period from 1 January to 30 June 2019, the composition of the Management Board of PKO Bank Hipoteczny SA was as follows:

	Position	Period of holding the position
Paulina Strugała	President of the Management Board	12.06.2018 – to date
Piotr Kochanek	Vice-President of the Management Board	01.01.2019 – to date
Agnieszka Krawczyk	Vice-President of the Management Board	01.01.2018 – to date
Jakub Niesłuchowski	Vice-President of the Management Board	01.04.2015 – 28.02.2019

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Due to the resignation of Mr. Marek Szcześniak as Vice-President of the Management Board as of 26 November 2018, on 12 December 2018 the Supervisory Board of PKO Bank Hipoteczny SA appointed Mr. Piotr Kochanek Vice-President of the Management Board as of 1 January 2019. Moreover, the Supervisory Board appointed Mr. Piotr Kochanek for the position of Vice-President of the Bank's Management Board responsible for management of material risk, on the condition that the PFSA grants a consent mentioned in Article 22b of the Banking Law and effective from the date of such consent. The PFSA unanimously granted such consent on 26 February 2019.

Mr. Jakub Niesłuchowski resigned from the position of Vice-President of the Management Board and stepped down from this function on 28 February 2019.

The Bank's Supervisory Board has established the following internal division of key powers within the Bank's Management Board, which was in force as of 30.06.2019:

PAULINA STRUGAŁA	President of the Management Board responsible for supervising compliance and reputation risk, the internal audit functions, human resources management, communication and legal services
Other functions performed:	Chairperson of the Strategy and Business Initiatives Committee Chairperson of the Asset and Liability Committee
PIOTR KOCHANEK	Vice-President of the Management Board responsible for supervising the management of all types of banking risk (excluding the compliance risk and reputation risk), supervising restructuring and debt collection, supervising the process of making lending decisions taking into account credit risk, and supervising the process of verification and assessment of real estate constituting collateral for loans granted or acquired
Other functions performed:	Chairperson of the Credit Committee Chairperson of the Data Quality Committee Deputy Chairperson of the Asset and Liability Committee Deputy Chairperson of the Green Covered Bonds Committee Member of the Strategy and Business Initiatives Committee
AGNIESZKA KRAWCZYK	Vice-President of the Management Board responsible for supervising development, preparation and functioning of the product offer for individuals and business entities, coordinating activities relating to the sales of mortgage-secured products in all distribution channels, supervising the process of acquisition of loan receivables, setting principles and the process of servicing loans granted and acquired, the functioning and efficiency of IT resources, developing principles for and outsourcing services to third parties, as well as supervising the areas of financial planning and financial control, accounting and financial reporting, issuing securities and obtaining financing
Other functions performed:	Deputy Chairperson of the Green Covered Bonds Committee Deputy Chairperson of the Strategy and Business Initiatives Committee Member of the Credit Committee Member of the Asset and Liability Committee

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OTHER MANAGEMENT FUNCTIONS OF THE MANAGEMENT BOARD MEMBERS

	Position	Period of holding the position
Paulina Strugała	Member of the Supervisory Board of PKO BP Finat Sp. z o.o.	Throughout the reporting period
Agnieszka Krawczyk	Director of the Mortgage Banking Products Department at PKO Bank Polski SA on a part-time (0.2 FTE) basis	Throughout the reporting period
Jakub Niesłuchowski	did not hold any Management Board or Supervisory Board positions, nor any other managerial positions	Up to 28.02.2019
Piotr Kochanek	did not hold any Management Board or Supervisory Board positions, nor any other managerial positions	Throughout 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 Nominations Committee of the Bank's Supervisory Board. The Committee takes into consideration the guidelines of the European Banking Authority dated 21 March 2018 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 PFSA. During the candidate selection process, the Committee takes into account PKO Bank Hipoteczny SA's profile, scope 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 is to ensure diversification 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 Nominations Committee and the Supervisory Board, 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, each year the Ordinary General Shareholders' Meeting 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, which is independent of the approval of the Bank's Directors' Report by the General Shareholders' Meeting.

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 confirms the proper performance of their duties, based on adequate knowledge, abilities and experience, in accordance with the requirements of art. 22aa of the Banking Law.

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6.4. THE SUPERVISORY BOARD OF BANK HIPOTECZNY SA

In the first half of 2019, 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 ¹⁸	Audit and Finance Committee	Risk Committee	Remuneration and Nominations Committee	Commercial Committee
Jakub Papierski	Chairperson	06.10.2014		✓				Ch	Ch
Piotr Mazur	Deputy Chairperson	06.10.2014	29.03.2019	✓			Ch		D
Justyna Borkiewicz	Board Member	28.10.2016		✓			M		
Mieczysław Król	Board Member	28.10.2016	29.03.2019	✓			D	D	
Artur Kluczny	Board Member	18.10.2017		✓	✓	Ch			M
Piotr Kwiecień	Board Member	18.10.2017		✓	✓	M			
Jan Emeryk Rościszewski	Board Member	18.10.2017		✓					M
Rafał Kozłowski	Board Member Deputy Chairperson	09.02.2018 30.03.2019	29.03.2019	✓		D		D	D
Paweł Metrycki	Board Member	30.03.2019		✓			Ch		M
Ilona Wołyniec	Board Member	30.03.2019		✓			D		

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 2019.

In accordance with Article 395 § 2(3) of the Commercial Companies Code, each year the Ordinary General Shareholders' Meeting grants a vote of approval to each individual member of the Supervisory Board. Granting 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 2019, 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 2018.

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.

¹⁸As defined in the Act of 11 May 2017 on statutory auditors, audit firms and public oversight

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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 29 March 2019, the General Shareholders' Meeting evaluated the qualifications of a candidate for a member of the Supervisory Board.

INFORMATION ON THE AUDIT AND FINANCE COMMITTEE

In the first half of 2019, the composition of the Audit and Finance Committee of Bank Hipoteczny SA was as follows:

	Function in the Audit and Finance Committee	Independent member ¹⁹	knowledge and skills in accounting or auditing financial statements	knowledge and skills in mortgage banking
Artur Kluczny	Chairperson of the Committee	✓		
Rafał Kozłowski	Deputy Chairperson of the Committee		✓	✓
Piotr Kwiecień	Member of the Committee	✓		

During his professional career, Mr Rafał Kozłowski acquired knowledge and skills in accounting, financial reporting and mortgage banking.

In the first half of 2019 there were two meetings of the Audit and Finance Committee.

¹⁹As defined in the Act of 11 May 2017 on statutory auditors, audit firms and public oversight

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7. CORPORATE GOVERNANCE AND INFORMATION FOR INVESTORS

Representation on compliance with the rules for corporate governance Entity authorized to audit financial statements Other information
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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 PFSA, on the basis of the following decisions by the Bank's bodies:

- the Resolutions 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 Resolutions 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 Resolutions of the General Shareholders' Meeting of 22 December 2015 – in relation to the powers reserved for the General Shareholders' 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 links 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 oversight were appointed 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 24 June 2019, the Supervisory Board evaluated the application of the said Principles in the Bank in 2018. The Supervisory Board positively evaluated the application of the Principles in the Bank confirming that the Principles adopted by the Bank and its authorities were applied adequately to the scale, nature of operations and the specific character of the Bank.

The text of the Principles is available on the website of the PFSA:

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

To ensure the reliability and accuracy of the financial reporting process, the Bank introduced a number of control mechanisms included in the reporting system and the internal regulation of this process. Such mechanisms involve, among other things, continued verification and reconciliation of reporting data with the books of account, subsidiary ledgers and other documents which provide the basis for the preparation of the financial statements.

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The process of preparing the financial statements is verified regularly, in particular with regard to arithmetical correctness, technical analysis and reliability of information. In accordance with the internal regulations, the financial statements are approved by the Management Board of PKO Bank Hipoteczny SA and the Audit and Finance Committee appointed by the Supervisory Board of PKO Bank Hipoteczny SA.

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 reviews and independently evaluates the adequacy and effectiveness of controls over the financial reporting processes and evaluates 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 CARRIED BY THESE SHARES

As at 30 June 2019 the share capital of PKO Bank Hipoteczny SA amounted to PLN 1,526,500,000 and comprised 1,526,500,000 shares with PLN 1 nominal value. The shares are paid up in full. The share capital increased by PLN 231,500,000 in relation to the end of 2018. The PKO Bank Hipoteczny SA shares are non-preference shares. The holders of PKO Bank Hipoteczny SA shares do not have any control rights due to holding such shares. 100% of the shares of PKO Bank Hipoteczny SA are held by Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna.

Structure of the share capital of PKO Bank Hipoteczny SA

Series	Type of shares	Number of shares	Nominal value per share	Number of votes at the GSM	Amount paid in for shares
A	Ordinary registered shares	300,000,000	PLN 1	300,000,000	PLN 300,000,000.00
B	Ordinary registered shares	200,000,000	PLN 1	200,000,000	PLN 200,000,000.00
C	Ordinary registered shares	200,000,000	PLN 1	200,000,000	PLN 200,000,000.00
D	Ordinary registered shares	100,000,000	PLN 1	100,000,000	PLN 100,000,000.00
E	Ordinary registered shares	150,000,000	PLN 1	150,000,000	PLN 150,000,000.00
F	Ordinary registered shares	150,000,000	PLN 1	150,000,000	PLN 150,000,000.00
G	Ordinary registered shares	100,000,000	PLN 1	100,000,000	PLN 100,000,000.00
H	Ordinary registered shares	95,000,000	PLN 1	95,000,000	PLN 95,000,000.00
I	Ordinary registered shares	100,000,000	PLN 1	100,000,000	PLN 100,000,000.00
J	Ordinary registered shares	131,500,000	PLN 1	131,500,000	PLN 131,500,000.00

Shareholder	30.06.2019		31.12.2018	
	Number of shares	Percentage of votes at the GSM	Number of shares	Percentage of votes at the GSM
Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna	1,526,500,000	100%	1,295,000,000	100%

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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 PFSA. 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 PFSA 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 PFSA of the members of the Management Board who, as a result of the segregation of duties, shall be in charge of the risk management and the internal audit unit. The Supervisory Board notifies the PFSA of the intention to dismiss, and the reasons for dismissal of a member of the Management Board who, as a result of the segregation of duties, 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 AUTHORIZATIONS TO DECIDE ON SHARE ISSUES OR REDEMPTIONS

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 purchase 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 PFSA.

COMPOSITION AND CHANGES DURING THE LAST FINANCIAL PERIOD, 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 period is presented in chapter 6 "Organization 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

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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 Commercial Companies Code.

7.2. ENTITY AUTHORIZED TO AUDIT FINANCIAL STATEMENTS

On 3 March 2017 the Supervisory Board of PKO Bank Hipoteczny SA, based on the recommendation of the Audit and Finance Committee of the Supervisory Board that complied with all the binding conditions, selected KPMG Audyt Spółka z ograniczoną odpowiedzialnością sp.k. as the entity authorized 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 authorized to audit financial statements maintained by the Polish Chamber of Statutory Auditors, with the number 3546. The Bank's Supervisory Board appointed the auditor authorized 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 for 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.

In the first half of 2019, the audit firm KPMG provided the Bank with services other than audit, which related to the issue of attestation letters. The Audit and Finance Committee of the Bank's Supervisory Board assessed the audit firm's independence and approved the provision of such services.

On 27 February 2019 the Supervisory Board of PKO Bank Hipoteczny SA, based on the recommendation of the Audit and Finance Committee of the Supervisory Board that complied with all the binding conditions of 21 February 2019, selected PricewaterhouseCoopers Polska spółka z ograniczoną odpowiedzialnością Audyt sp. k. as the entity authorized to audit and review the Bank's financial statements for the years 2020-2021.

PricewaterhouseCoopers Polska spółka z ograniczoną odpowiedzialnością Audyt sp. k. with its registered office in Warsaw, ul. Polna 11 (PwC) is entered on the list of entities authorized to audit financial statements maintained by the Polish Chamber of Statutory Auditors, with the number 144. The Bank's Supervisory Board appointed the auditor authorized 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 26 April 2019, an agreement was signed by and between PKO Bank Hipoteczny SA and PwC to carry out an audit and review of the financial statements and the consolidation package of the Bank in the years 2020-2021.

In accordance with the policy for selecting an audit firm to perform an audit of the Bank's financial statements, the Supervisory Board conducts an open tender procedure to commission an audit of the financial statements. The Audit and Finance Committee of the Bank's Supervisory Board makes a recommendation concerning the audit firm selection to the Supervisory Board. Unless it concerns renewing an existing audit contract, the recommendation contains at least two suggestions with justifications and indicates the preferred firm. The Bank's Supervisory Board selects an audit firm based on the recommendation of the Audit and Finance Committee of the Bank's Supervisory Board. The offers made by audit firms are assessed based on transparent and non-discriminatory selection criteria.

In accordance with the policy for providing permitted non-audit services by the audit firm conducting the audit, its related entities and members of its network to the Bank, providing such services by the above requires the approval of the Audit and Finance Committee of the Bank's Supervisory Board and the approval of the Audit Committee of the Supervisory Board of PKO Bank Polski SA.

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7.3. OTHER INFORMATION

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 2019, 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. 100% of the shares are held by PKO Bank Polski S.A.

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 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 PLN-denominated covered bonds. This rating was confirmed by the agency on 11 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 PLN-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 limit for the ratings is the Polish country ceiling for debt instruments, which currently is at the level of 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.

FINANCIAL LIABILITIES AND GUARANTEES GRANTED

In the first half of 2019, as in 2018, PKO Bank Hipoteczny SA did not grant any guarantees.

Financial liabilities under loans granted and not disbursed as at 30 June 2019 stood at PLN 621.8 million, up by PLN 97.4 million compared to 31 December 2018.

OFF-BALANCE-SHEET LIABILITIES TO RELATED PARTIES

In the first half of 2019, as in 2018, PKO Bank Hipoteczny SA did not grant any guarantees to its subsidiaries.

LOANS TAKEN OUT AND LOAN AND GUARANTEE AGREEMENTS UNRELATED TO THE BANK'S OPERATIONS

In the first half of 2019 and in 2018, PKO Bank Hipoteczny SA did not take out any loans or enter into any loan or guarantee agreements unrelated to the Bank's operations.

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UNDERWRITING AGREEMENTS AND GUARANTEES GRANTED TO SUBSIDIARIES

On 31 May 2019, PKO Bank Hipoteczny SA signed with PKO Bank Polski SA (also acting through its Branch - the Brokerage House of PKO Bank Polski in Warsaw) a programme agreement in which it engaged the Brokerage House of the PKO Bank Polski SA to act as its underwriter.

In the first half of 2019, PKO Bank Hipoteczny SA did not grant any guarantees to its subsidiaries.

IDENTIFICATION OF PENDING PROCEEDINGS BEFORE COURTS, ARBITRATION BODIES OR PUBLIC ADMINISTRATION AUTHORITIES

As at 30 June 2019, 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

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

- expected moderate slow-down of the global economy;
- the development of the housing market in Poland;
- the development of the housing loans market in Poland;
- planned amendments to BRRD and Recommendation S;
- 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 situation of the domestic and foreign mortgage bonds markets;
- investor 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 2019 and in 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 AGREEMENTS FOR LOANS AND ADVANCES CONCLUDED AND TERMINATED DURING A FINANCIAL YEAR

On 28 May 2019, PKO Bank Hipoteczny SA concluded a revolving working capital loan agreement with an external financial institution of up to PLN 150 million until 12 June 2020. The loan was granted for the financing of the Bank's current activities. In accordance with the agreement, it was used on 10 June 2019 to repay a loan granted by the same external financial institution on 5 June 2017.

On 18 June 2019, PKO Bank Hipoteczny SA and PKO Bank Polski SA concluded annex no. 9 to the agreement on the revolving current account overdraft increasing the limit from PLN 1 500 million to PLN 2 000 million and extending the financing period by three years, i.e. until 29 October 2022.

Moreover, as at 30 June 2019 the Bank had a liability arising from acquired receivables of PLN 2 278.5 million resulting from the receivables portfolios acquired from PKO Bank Polski SA in the first half of 2019 pertaining to mortgage housing loans, described in Note 21 to the Condensed interim financial statements of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2019. The maturity date of the liability resulting from the purchase of receivables is agreed by the parties in the Receivables Sale Agreement for each transaction. For receivables acquired in 2019, the parties agreed that payment would be made no later than within 18 months of

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the transfer date. If the liability is not settled within 1 month from the date of transfer, the principal amount is subject to interest. As at 31 December 2018 the liability amounted to PLN 2 300.3 million.

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

PKO Bank Polski SA and PKO Bank Polski SA Group entities are related to the Bank in terms of equity.

In the first half of 2019 and in 2018, PKO Bank Hipoteczny SA did not conclude any material transactions with related parties other than on an arm's length basis.

INFORMATION ON CHANGES IN THE KEY PRINCIPLES OF MANAGING THE BANK'S ENTERPRISE

In the first half of 2019 and in 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 Group, or with closely related parties.

DEPOSITS AND GUARANTEES AND SURETIES ISSUED

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

INFORMATION ON THE VALUE OF SECURITY ESTABLISHED ON THE ACCOUNTS OR ASSETS OF BORROWERS

In the first half of 2019, as in 2018, PKO Bank Hipoteczny SA did not set up any security on the borrowers' accounts.

The value of collateral for mortgage loans as at 30 June 2019 was PLN 50.4 billion.

SUBSEQUENT EVENTS

In the period from 1 July 2019 to the date of signing these statements, PKO Bank Hipoteczny SA acquired another portfolio of receivables of residential mortgage housing loans amounting to PLN 225.9 million under the Framework Receivables Sale Agreement concluded on 17 November 2015 with PKO Bank Polski SA.

On 10 July 2019, PKO Bank Hipoteczny SA concluded with PKO Bank Polski SA a current account revolving credit agreement with a limit of PLN 1 billion for a period of 3 years. The loan is earmarked for servicing the redemption of bonds issued under the Non-Public Programme. The Bank acquired the funding due to the duty to register and settle all non-public issues of securities through the National Depository of Securities binding as of 1 July 2019. In effect it is impossible to redeem and receive funds from a new issue (roll-over) on the same day.

On 10 July 2019 PKO Bank Hipoteczny SA issued bonds of PLN 161,5 million to be redeemed after six months under the Public Bond Issue Programme as part of the underwriting services provided by Dom Maklerski PKO Banku Polskiego SA. Furthermore, on 11 July 2019 bonds primarily addressed to retail investors with a value of PLN 50 million and two-year period to redemption were issued under the programme.

This document is a translation of a document originally issued in Polish. The only binding version is the original Polish version.

**PKO BANK HIPOTECZNY SA DIRECTORS' REPORT
FOR THE SIX-MONTH PERIOD ENDED 30 JUNE 2019**

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 2019 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 the six months ended 30 June 2019 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 authorized to audit the financial statements which conducted a review of the Condensed interim financial statements of PKO Bank Hipoteczny SA for the six-month period ended 30 June 2019 was appointed in compliance with the applicable regulations and that both the entity and the statutory auditor who conducted the review fulfilled all the criteria for providing an unbiased and independent review report on the condensed interim financial statements, in compliance with the applicable regulations and professional standards.

This Directors' Report on the activities of PKO Bank Hipoteczny SA for the six months ended 30 June 2019 comprises 47 sequentially numbered pages.

Signatures of all Members of the Bank's Management Board

8 August 2019	Paulina Strugała	President of the Management Board	<i>Signed on the Polish original</i> (signature)
8 August 2019	Piotr Kochanek	Vice President of the Management Board	<i>Signed on the Polish original</i> (signature)
8 August 2019	Agnieszka Krawczyk	Vice President of the Management Board	<i>Signed on the Polish original</i> (signature)