Supervisory Board's Assessment of ING Bank Śląski S.A. Group Operations in 2019

In 2019, Polish economy started to slow down in response to the global downturn which had started a year earlier as a result of trade wars, among other things. The GDP growth rate went down from 5.1% in 2018 to 4.0% in 2019. Internal demand remained invariably the driving force of the GDP growth. Throughout 2019, household spending rose by 3.9% y/y. However, over the final quarter of the year, it slowed down to 3.4 y/y despite the stimulus in the form of growing social transfers. In the second half of the year, the government extended the Family 500+ child benefit programme to first-born children and then lowered the effective income tax rate. Households increased, however, their savings rate (by purchasing the retail T-bonds, among other things). Capital expenditure on non-current assets throughout 2019 grew by 7.8% y/y and was also moving downward. It was reflected in a declining demand for loans among companies (their growth rate was down by more than a half compared to 2018).

2019 saw significant acceleration of inflation, from an average 1.2% y/y in the first quarter to 3.4% y/y in the final month of the year. The increase resulted from a combination of supply-related factors (higher labour costs and energy prices) and demand-related factors (growing consumer spending). Even so, the Monetary Policy Council resolved not to increase the interest rates, arguing that it might amplify the slowdown of the economic situation. The judgement of the Court of Justice of the European Union (CJEU) on FX mortgage loans proved to be the main driving force behind PLN volatility. However, the EUR/PLN exchange rate as at the end of the year was only slightly lower (4.26) than it was at the year beginning (4.30).

In addition to the macroeconomic environment, the performance of the banking sector was also significantly influenced by the judgements of the Court of Justice of the European Union (CJEU) on two matters – the first one concerned foreign exchange mortgage loans and the other the consumer's ability to repay a consumer loan before its contractual maturity date. As far as the foreign exchange mortgage loans are concerned, banks estimated their provisions for the portfolio-wide risk of foreign mortgages, as expected by the regulators and auditors. There are several ramifications of the other CJEU judgement for the banking sector. Firstly, clients who prepaid such a loan in the past are now able to file a complaint and request reimbursement of a portion of the commission charged by the bank; secondly, there are ongoing settlements with clients who pay off their loans before the maturity date; and thirdly, the product offer needs to be adapted. In 2019, the profitability of the banking sector was also adversely affected by significant increase in regulatory costs, including BGF (+26.9% y/y) and PFSA (around +64% y/y). The entry into force of PSD2-related regulations was a landmark event for the banking sector (not only in Poland). In addition to duties imposed on regulated entities (such as strong authentication), PSD2 has also offered new opportunities relating to open banking.

In 2019, the ING Bank Śląski S.A. Group generated net profit of PLN 1,658.7 million versus PLN 1,523.8 million as at the end of 2018 (up by 9%). As in the previous years, the improvement in the net profit was achieved thanks to growing income. In 2019, the result on banking operations rose by PLN 557.1 million (or, 11%) to PLN 5,789.8 million compared to PLN 5,232.7 million in the previous year. It was primarily triggered by a higher net interest income which was up by 14% y/y, following higher commission volumes and flat interest margin. Net commission income rose by 5%, mainly owing to fees and commissions on payment cards.

Higher result on banking operations was partially consumed by higher costs of the Group. The costs of the Bank Group rose by 7% to PLN 2,497.4 million due to higher personnel expenses (+9% y/y) and higher regulatory costs (the BGF and PFSA-related costs increased by 24% y/y); increase in the risk costs by PLN 104.6 million (or, 21% y/y) to PLN 605.5 million was caused by relatively higher write-downs in the corporate segment and the growth of the entire corporate portfolio. As a year ago, the provisioning balance was also affected by the receivables sale transactions, whereby the balance was reduced by PLN 32.3 million compared to PLN 26.7 million in 2018. The balance of provisions versus the gross credit receivables portfolio settled at 0.54% in 2019 (0.52% in 2018). As at the end of December 2019, loans and other receivables in Stage 3 (the most at risk ones) accounted for 3.0% of the gross receivables portfolio measured at amortised cost. The provision coverage ratio for loans and other receivables in Stage 3 was 54.1%. With an increase in total assets and liabilities (+12% y/y), the costs related to the bank levy also rose (+17% y/y). In 2019, the Group paid the tax on certain financial institutions (the so-called bank levy) which was PLN 61.9 million higher than the tax paid in 2018.

The Supervisory Board exercises oversight over the Company's operations by keeping watch over the Company's adherence to the relevant regulations in the area of accounting, finance and reporting of public companies. The powers of the Supervisory Board also include supervision of the individual risk management processes at ING Bank Śląski S.A. with the support of the Risk Committee and Audit Committee. Based on the recommendations of those Committees, the Supervisory Board accepts and approves the business risk management strategy of the Bank, the key principles of the policy and the related risk appetite. Further, the Supervisory Board monitors the utilisation of internal limits vis-à-vis the current strategy of the Bank.

The Risk Committee supports the Supervisory Board in monitoring the risk management process, including operational risk, liquidity risk, credit risk and market risk. The Committee also supervises the risk management process as well as the assessment of internal capital, capital adequacy, and of the risk of capital-related models and other models. The Committee voices its opinion about the overall readiness of the Bank to assume risk on ongoing and long-term bases.

Monitoring of the financial reporting process is among the tasks of the Audit Committee. In this context, the Audit Committee periodically analyses the Bank financial statements and the results of their audit. Further, the Chairman of the Audit Committee – who is the Chairman of the Supervisory Board and an independent member of the Board at the same time – holds periodic meetings with the Vice-President of the Management Board in charge of the CFO Division in which the Chairman is updated on the interim financial results of the Bank prior to their publication. The Audit Committee also analyses the performance of works by the entity authorised to audit financial statements, safeguarding its independence and effectiveness. Furthermore, the Audit Committee monitors the effectiveness of internal control and internal audit systems, and also assesses the effectiveness of measures used to mitigate the compliance risk and the said risk management quality.

There was also established the Remuneration and Nomination Committee within the Supervisory Board, which monitors i.a. the situation of the labour market in the context of salaries, the employee turnover process, and also staff satisfaction survey results. The Committee regularly monitors the remuneration system of the Bank, the payroll and bonus policy included. In 2019, the Committee also assessed the suitability (including collective suitability) of Supervisory Board members appointed for a new term of office and of the new Management Board members, based on the suitability assessment made by a third party. In consequence, the Committee resolved to recommend that the Supervisory Board appoint a new Management Board member – the Vice-President of the Bank Management Board in charge of the CIO Division and a new Management Board member – the Vice-President of the Bank Management Board in charge of the CRO Division. Bearing in mind that the permission of the Polish Financial Supervision Authority is required to appoint a Management Board member in charge of the CRO Division, the relevant resolution of the Supervisory Board will come into force on the condition of receiving the PFSA's consent, and it will be effective as of the date of such permission; however, not earlier than as of 1 April 2020. The Committee also assessed the collective suitability of the Management Board in the composition including the newly appointed Management Board members.

In the opinion of the Supervisory Board, the risk management system at the ING Bank Śląski S.A. Group covers all material risks. Moreover, the instruments and techniques used to identify, measure, manage and report risks are adequate for a given risk type. In 2019, ING Bank Śląski S.A. satisfied all the requirements of sound business operations and capital adequacy, and in particular the Bank:

- pursued prudent lending policy. The lending processes and procedures were compliant with the regulatory requirements and best practices on the market. In 2019, the Bank took account of the economic situation in its lending policy and applied more restrictive procedures towards sectors characterised by increased risk. The Bank's lending portfolio was diversified with a significant share of high-quality loans granted to business entities. Within the Bank Group, credit receivables in Stage 3 represented 3.0% of the total gross exposure (measured at amortised cost), which is significantly less than the average for the entire banking sector (5.9%).
- had systems and procedures in the market risk management area (for interest rate or currency risk, among others) that meet the top market standards. Throughout 2019, individual market risk categories were managed actively so that their levels were within the limits effective at the Bank. The balance sheet structure of the Bank is balanced from the currency perspective; its distinctive feature is the low share of FX receivables in the total mortgage receivables, among other things.
- maintained good liquidity. As at 2019 yearend, the LtD ratio settled at 90.7%. The sound liquidity position of the Group is attributable to one of the largest among Polish banks (and still growing) stable household deposits base.

- had an adequate level of equity meeting supervisory requirements. In December 2019, the total capital ratio of the ING Bank Śląski S.A. Group was 16.87%, while the Tier 1 ratio stood at 14.41%.

Furthermore, the internal control system used by the Bank is effective enough to secure the Bank against unexpected developments in terms of the financing granted, non-financial risk, market risk, liquidity or capital adequacy.

The slowdown in economic growth expected in 2020 (as a consequence of further deceleration of investments, particularly the public ones, due to further slowdown in absorption of EU funds) may contribute to slower lending and pressure on the risk cost, especially in the corporate segment. As a result, capital ratios can be pressurised. This is why, the Supervisory Board is of the opinion that the Bank should continue to focus on the actions enhancing its security as well as competitiveness of products and customer experience, such as:

- adequate capital management in order to ensure safe lending growth as well as fulfilment of all present and future regulatory requirements.
- further development of the product offer and electronic distribution channels. In stiff competition, it is possible to increase revenues by expanding the customer base through acquiring new customers and increasing loyalty of the existing ones. Such an approach boosts customer balances and transactions' volumes.
- increase of lending capabilities, while being prudent when assessing clients' risk. That will foster keeping high quality of the portfolio and boost net interest income.
- maintenance of adequate stable deposits. It will ensure liquidity indispensable to develop lending.
- further improvement of cost effectiveness while maintaining high quality of processes through optimal use of existing resources and benefits resulting from the increased scale of operations.

According to the Supervisory Board, the strategy pursued by the Bank over the last few years to increase the scale of its operations proved to be successful which is reflected in the achieved financial and commercial results. The hitherto success of the strategy justifies the intention of its continuation by the Bank in 2020 while maintaining the appropriate level of capital.