51. Capital adequacy

One of the Bank's main tasks is to ensure an adequate level of capital. As part of the capital management policy of mBank Group, the Bank creates a framework and guidelines for the most effective planning and use of the capital base, which:

- are compliant with external and internal regulations in force,
- guarantee a continuity of financial targets achievement, which render an appropriate rate of return for shareholders,
- ensure the maintenance of a strong capital basis being a fundamental support for business development.

The capital management policy in mBank Group is based on two pillars:

- maintenance of an optimal level and structure of own funds with the application of available methods and means, like among others retention of net profit, subordinated loan or issue of shares,
- effective use of existing capital, among others through application of a set of measures of effective use of the capital, limitation of activities that do not provide an expected rate of return and development of products with lower capital absorption.

Effective use of capital is an integral part of the capital management policy oriented at reaching an optimal rate of return on capital and as a result forming a stable fundament of reinforcement of the capital basis in future periods. This enables to maintain the Common Equity Tier 1 capital ratio (calculated as a quotient of Common Equity Tier 1 capital to the total risk exposure amount) and the total capital ratio (calculated as a quotient of own funds and the total risk exposure amount) at the level higher than required by the supervision authority.

The strategic goals of mBank Group are aimed at maintaining the total capital ratio as well as the Common Equity Tier 1 capital ratio above the level required by the supervision authority. This allows to maintain business development while meeting the supervisory requirements in the long perspective.

Capital ratios

The adequacy assessment of the capital base, including among others: the calculation of capital ratios and the leverage ratio, the own funds, the total capital requirement in the mBank Group was made according to the following regulations:

- the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRR Regulation),
- the Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council with further amendments (ITS Regulation).
- the Banking Act of 29 August 1997 (Dz.U. from year 2002 No 72, item 665) with further amendments,
- the Act on Macro-prudential Supervision of the Financial System and Crisis Management of 5 August 2015 (Dz.U. 2015 item 1513),
- Regulation of the Minister of Development and Finance of May 25th, 2017 on the application of higher risk weights to credit exposures secured by mortgages on real estate property.

The entities included in the scope of prudential consolidation according to the rules of the CRR Regulation are taken into account in the process of calculating consolidated own funds and the own funds requirements.

As a result of the Act on Macro-prudential Supervision over the Financial System and Crisis Management in the Financial System ("the Act") that entered into force in 2015 and transposed the CRD IV provisions to the Polish prudential regulations, as of 31 December 2017 the mBank Group was obliged to ensure adequate own funds to meet conservation capital buffer designated under the provisions of the Act of 1.25% of total risk exposure amount.

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As of the end of 2017 the countercyclical capital buffer rate set for relevant exposures in Poland according to the article 83 of the Act amounted to 0%. mBank Group specific countercyclical capital buffer calculated in accordance with the provisions of the Act as the weighted average of the countercyclical buffer rates that apply in the countries where the relevant credit exposures of the Group are located, amounted to 2 bps as of 31 December 2017. Exposures of foreign branches in Czech Republic and in Slovakia, where countercyclical buffer rates as of 31 December 2017 amounted to 0.5%, had an impact on the mBank Group specific countercyclical capital buffer.

In 2016 the Bank received an administrative decision of the KNF that identified mBank as other systemically important institutions (O-SII). mBank was a subject to a capital buffer which on the basis of KNF administrative decision of December 19th, 2017 amounted to 0.75% of the total risk exposure amount, calculated in accordance with article 92(3) of the CRR Regulation, to be maintained on individual and consolidated levels. The Bank has applied the required capital buffer defined in the December 2017 decision to 2017 year end data.

The all-in-one combined buffer requirement set for the mBank Group as of the end of 2017 amounted to 2.02% of the total risk exposure amount.

Additionally, as a result of risk assessment carried out in 2017 by the KNF within the supervisory review and evaluation process (BION), in particular with regard to the evaluation of the risk related to the portfolio of foreign exchange retail mortgage loans, the mBank Group received on the consolidated level an individual recommendation to maintain own funds to cover additional capital requirement of 3.53 % for total capital ratio and 2.65 % for Tier 1 capital ratio (on individual basis: 4.10% and 3.07% respectively). Additional capital requirement in Pillar II set by the KNF in 2017 encompasses also additional risk factors related to the FX mortgage loan portfolio such as operational risk, market risk or risk of collective default of borrowers.

The high level of additional capital requirements resulted from the fact that the KNF applied one methodology to all banks in Poland. This did not take into account the results of the internal models applied by mBank to the calculation of capital requirements for credit risk. According to the KNF's methodology, the calculation of the additional capital requirement for each and every bank uses as a starting point the risk weight under the standardised approach used in Poland for calculation of capital requirements for credit risk relating to foreign exchange mortgage loans. Consequently, more than half of the additional capital requirements calculated by the KNF for mBank Group comes from "aligning" the capital requirement to the requirement calculated under the standardised approach. The second important component affecting an additional capital requirement within Pillar II related to the BION supervisory evaluation quantifying the risk of foreign exchange retail mortgage loans portfolio, where taking into account the specificity of the Bank portfolio, the following factors were taken into account:

- the share of loans with LTV >100% in the portfolio,
- the level of the Bank margin from the foreign exchange retail mortgage loans portfolio,
- sensitivity of the Bank's total capital ratio to exchange rates and interest rates changes,
- the Bank preparation for loan portfolio conversion.

The level of required capital ratios encompasses:

- the basic requirement of the KNF in terms of capital ratios addressed to the banks in Poland to maintain the total capital ratio of 12% and the Tier 1 ratio of 9%;
- the additional capital charge in Pillar II on consolidated basis associated with the portfolio of foreign currency housing loans: 3.53% at the level of total capital ratio and 2.65% at the level of Tier 1 capital;
- the combined buffer requirement of 2.02%.

In 2017 capital ratios on consolidated basis were above the required values.

mBank Group	31.12.2017		31.12.2016	
Capital ratio	**Required level**	**Reported level**	**Required level**	**Reported level**
Total capital ratio	17.55%	20.99%	17.00%	20.29%
Tier 1 ratio	13.67%	18.31%	13.19%	17.32%

The second component of adequacy assessment of the Group capital base, alongside the calculation of capital ratios and their comparison with the required levels (taking into account the combined buffer requirement and the additional capital charge within Pillar II), verifies whether the Group meets the requirements resulting from article 500 of the CRR Regulation. To this end, own funds are compared to the value of 80% of the comparable standardised-driven total capital requirement. This parallel calculation is meant to ensure that the Group own funds calculated under internal rating based approach are sufficient and they do not fall below 80% of the own funds that the Group would have to maintain under the standardised approach. mBank Group's own funds are well above the level determined by the reference value.

The consolidated leverage ratio calculated in accordance with the provisions of CRR Regulation and Commission Delegated Regulation (EU) 2015/62 of October 10th, 2014, amending Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to the leverage ratio, including provisions regarding transitional period, amounted to 9.00%.

Own Funds

In accordance with the CRR Regulation, the consolidated own funds consist of consolidated Common Equity Tier 1 capital, consolidated Additional Tier 1 capital and consolidated Tier 2 capital, however items that could be treated as Additional Tier 1 capital are not identified in the Group.

Common Equity Tier 1 capital of mBank Group contains:

- paid up capital instruments and the related share premium accounts,
- previous years retained earnings,
- independently reviewed interim profits,
- accumulated other comprehensive income,
- other reserves,
- funds for general banking risk,
- items deducted from a Common Equity Tier 1 capital (fair value gains and losses arising from the institution's own credit risk related to derivative liabilities, value adjustments due to the requirements for prudent valuation, intangible assets, AIRB shortfall of credit risk adjustments to expected losses, own CET1 instruments, regulatory adjustments relating to accumulated other comprehensive income and net impairment losses).

Tier 2 capital of mBank Group contains:

- capital instruments and the related share premium accounts (subordinated liabilities with specified maturity),
- amount of qualifying items referred to in Article 484 (5) of the CRR Regulation and the related share premium accounts subject to phase out from Tier 2 capital (subordinated liabilities resulting from securities of unspecified maturity).

The consolidated own funds of mBank Group as of 31 December 2017 amounted to PLN 14 280 242 thousand. Additionally the consolidated Common Equity Tier 1 capital of mBank Group amounted
to PLN 12 454 486 thousand.

Total risk exposure amount

The total risk exposure amount of mBank Group contains:

- risk weighted exposure amounts for credit risk, counterparty credit risk, dilution risk and free deliveries,
- risk exposure amount for market risk, including position risk, foreign exchange risk and commodities risk,
- risk exposure amount for operational risk,
- risk exposure amount for credit valuation adjustment,
- other risk exposure amounts including supervisory floor.

As at 31 December 2017 the AIRB approach was applied to the calculation of own funds requirements for credit and counterparty credit risk for the following portfolios:

- mBank corporate portfolio,
- mBank retail mortgage loan portfolio,
- mBank real estate-related specialised lending exposures (IRB slotting approach),
- mBank retail non-mortgage exposures,
- mBank retail microenterprises mortgage loan portfolio (conditional consent),
- bank exposures (conditional consent),
- mLeasing S.A. credit exposure (conditional consent),
- mBank Hipoteczny SA specialized lending exposures (IRB slotting approach).

In case of portfolios with conditional consent to the application of AIRB approach, mBank Group applies supervisory floor, which means that where the own funds requirement for credit risk calculated under AIRB approach is lower than the own funds requirement for credit risk calculated under standardised approach, it is necessary to supplement it up to the level of the own funds requirement for credit risk calculated under standardised approach.

In 2017 mBank Group received an official confirmation from the European Central Bank and the KNF regarding the Bank's fulfilment of the high significance conditions stipulated in the conditional consent to apply the internal rating based approach to the calculation of the capital charge for credit risk for mBank retail non-mortgage exposures. It allows to fully apply the advanced internal rating based approach to calculation of the own funds requirement for credit risk for the given portfolio.

With regard to conditional consent to the application of AIRB approach to the calculation of own funds requirement for credit risk for mBank retail microenterprises mortgage loan portfolio and portfolio of bank exposures high significance conditions specified by the bank supervision have been met, and the Group is waiting for formal confirmation by the bank supervision.

The total risk exposure amount of mBank Group as at 31 December 2017 amounted to PLN 68 031 807 thousand, including PLN 60 081 313 thousands of risk exposure amount for credit risk, counterparty credit risk and supervisory floor.

Internal capital

The ICAAP (Internal Capital Adequacy Assessment Process) implemented in mBank Group aims at adjusting own funds to the level and the profile of risk arising from mBank Group's operations.

Due to the fact that both, the total capital requirement of mBank Group calculated according to the CRR Regulation and the internal capital estimated for mBank Group according to the Regulation of the Minister of Development and Finance of March 6th, 2017 on the market management system and internal control system, remuneration policy and a detailed method for internal capital assessment at bank are lower than consolidated own funds, the consolidated own funds as at 31 December 2017 were maintained at the level consistent with the requirements of the CRR Regulation.

The internal capital of mBank Group as at 31 December 2017 amounted to PLN 4 282 200 thousand.

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Capital adequacy	31.12.2017	31.12.2016
Common Equity Tier 1 Capital	**12 454 486**	**11 303 332**
Total Own Funds	**14 280 242**	**13 244 239**
Risk weighted exposure amounts for credit, counterparty credit, dilution risk and free deliveries:	59 950 298	57 223 519
- including under standardised approach	14 283 317	12 466 389
- including under AIRB approach	45 665 766	44 755 625
- including risk exposure amount for contributions to the default fund of a CCP	1 215	1 505
Settlement / delivery risk exposure amount	-	-
Total risk exposure amount for position, foreign exchange and commodities risks	759 117	1 098 347
Total risk exposure amount for operational risks	6 938 734	6 586 472
Additional risk exposure amount due to fixed overheads	-	-
Total risk exposure amount for credit valuation adjustments	252 643	213 304
Total risk exposure amount for large exposures in the trading book	-	-
Other risk exposure amounts	131 015	138 335
Total risk exposure amount	**68 031 807**	**65 259 977**
Comon Equity Tier 1 capital ratio	**18.31%**	**17.32%**
Total capital ratio	**20.99%**	**20.29%**
Internal capital	**4 282 200**	**4 524 006**

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OWN FUNDS	31.12.2017	31.12.2016
Own funds	**14 280 242**	**13 244 239**
TIER 1 CAPITAL	**12 454 486**	**11 303 332**
Common Equity Tier 1 Capital	**12 454 486**	**11 303 332**
Capital instruments eligible as CET1 Capital	3 563 819	3 550 593
Paid up capital instruments	169 143	169 016
Share premium	3 394 928	3 381 975
(-) Own CET1 instruments	(252)	(398)
Retained earnings	1 015 536	2 674 588
Previous years retained earnings	625 597	2 211 205
Profit or loss eligible	389 939	463 383
Accumulated other comprehensive income	150 900	(14 319)
Other reserves	7 703 414	4 925 039
Funds for general banking risk	1 153 753	1 131 453
Adjustments to CET1 due to prudential filters	(32 136)	(43 746)
Fair value gains and losses arising from the institution's own credit risk related to derivative liabilities	(1 938)	(5 880)
(-) Value adjustments due to the requirements for prudent valuation	(30 198)	(37 866)
(-) Intangible assets	(674 689)	(547 658)
(-) Other intangible assets gross amount	(710 642)	(582 663)
Deferred tax liabilities associated to other intangible assets	35 953	35 005
(-) IRB shortfall of credit risk adjustments to expected losses	(256 144)	(310 101)
Other transitional adjustments to CET1 Capital	(29 988)	(22 838)
CET1 capital elements or deductions - other	(139 979)	(39 679)
Additional Tier 1 capital	**-**	**-**
TIER 2 CAPITAL	**1 825 756**	**1 940 907**
Capital instruments and subordinated loans eligible as T2 capital	1 250 000	1 250 000
Tier 2 capital elements or deductions - other	-	-
Transitional adjustments due to grandfathered T2 capital instruments and subordinated loans	575 756	690 907

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Credit risk	31.12.2017	31.12.2016
Risk weighted exposure amounts for credit risk, counterparty credit risk, dilution risk and free deliveries	**59 950 298**	**57 223 519**
Standardised approach	**14 283 317**	**12 466 389**
SA exposure classes excluding securitisation positions	14 283 317	12 466 389
Central governments or central banks	30 116	33 608
Regional governments or local authorities	195 085	262 711
Public sector entities	19 850	16 533
Multilateral Development Banks	-	-
International Organisations	-	-
Institutions	194 652	136 462
Corporates	7 416 649	5 182 543
Retail	2 175 102	1 286 578
Secured by mortgages on immovable property	3 543 293	4 935 420
Exposures in default	436 300	266 369
Items associated with particular high risk	50 084	29 401
Covered bonds	-	-
Claims on institutions and corporates with a short-term credit assessment	-	-
Collective investments undertakings (CIU)	160	155
Equity	191 566	293 801
Other items	30 460	22 808
AIRB approach	**45 665 766**	**44 755 625**
AIRB approaches when neither own estimates of LGD nor Conversion Factors are used	-	-
AIRB approaches when own estimates of LGD and/or Conversion Factors are used	42 274 686	41 773 094
Central governments and central banks	-	-
Institutions	1 234 473	1 601 493
Corporates - SME	5 629 507	5 131 499
Corporates - Specialised Lending	5 771 962	5 937 710
Corporates - Other	13 161 751	12 617 430
Retail - Secured by real estate SME	1 048 526	1 098 692
Retail - Secured by real estate non-SME	5 532 303	6 930 867
Retail - Qualifying revolving	-	-
Retail - Other SME	3 253 371	2 738 607
Retail - Other non-SME	6 642 793	5 716 796
Equity AIRB	-	-
Securitisation positions IRB	-	-
Other non credit-obligation assets	3 391 080	2 982 531
Risk exposure amount for contributions to the default fund of a CCP	**1 215**	**1 505**