

Supervisory Board of Bank Zachodni WBK

- I. REPORT OF THE SUPERVISORY BOARD ON THE EXAMINATION OF :**
- **FINANCIAL STATEMENTS OF BANK ZACHODNI WBK S.A. FOR 2012**
 - **MANAGEMENT BOARD REPORT ON BANK ZACHODNI WBK PERFORMANCE IN 2012**
 - **CONSOLIDATED FINANCIAL STATEMENTS OF BANK ZACHODNI WBK GROUP FOR 2012**
 - **MANAGEMENT BOARD REPORT ON BANK ZACHODNI WBK GROUP PERFORMANCE IN 2012**
- II. ASSESSMENT OF BANK ZACHODNI WBK STANDING INCLUDING AN EVALUATION OF THE INTERNAL CONTROL SYSTEM AND THE SIGNIFICANT RISK MANAGEMENT SYSTEM**

Warsaw, March 2013



Bank Zachodni WBK



Bank Zachodni WBK jest członkiem Santander Group.

I. REPORT OF THE SUPERVISORY BOARD

This report was produced based on the conducted examination and includes the opinion of the Supervisory Board on the following documents presented by the Bank's Management Board to the Annual General Meeting of Shareholders of Bank Zachodni WBK, convened for 17th April 2013:

- Financial Statements of Bank Zachodni WBK S.A. for 2012,
- Management Board Report on Bank Zachodni WBK S.A. Performance in 2012,
- Consolidated Financial Statements of Bank Zachodni WBK Group for 2012,
- Management Board Report on Bank Zachodni WBK Group Performance in 2012,
- Management Board motion on the 2012 profit distribution.

The obligation to review the above documents is imposed on the Supervisory Board by § 32 clause 1 and clause 6 of the Bank's Statutes.

1. Examination of Financial Statements and Reports on operations for 2012

By force of resolution no. 19/2012, adopted on 10th May 2012, the Supervisory Board, based on the recommendation of the Audit & Compliance Committee, selected Deloitte Polska Spółka z ograniczoną odpowiedzialnością Sp. k. (formerly: Deloitte Audyt Sp. z o.o.) as the Bank's auditor and vested it with a task of auditing the Financial Statements for 2012. The above audit covered the following documents produced by the Bank's Management Board:

1. Financial Statements of Bank Zachodni WBK S.A. for 2012:

- Statement of Financial Position as at 31 December 2012,
- Income Statement for the accounting year ended 31 December 2012,
- Statement of Comprehensive Income for the accounting year ended 31 December 2012,
- Movements in Equity for the accounting year ended 31 December 2012,
- Cash Flow Statement for the accounting year ended 31 December 2012,
- Additional Notes.

2. Management Board Report on Bank Zachodni WBK S.A. Performance in 2012.

3. Consolidated Financial Statements of Bank Zachodni WBK Group for 2012:

- Consolidated Statement of Financial Position as at 31 December 2012,
- Consolidated Income Statement for the accounting year ended 31 December 2012,
- Consolidated Statement of Comprehensive Income for the accounting year ended 31 December 2012,
- Movements in consolidated equity for the accounting year ended 31 December 2012,

- Consolidated Cash Flow Statement for the accounting year ended 31 December 2012,
- Additional Notes.

4. Management Board Report on Bank Zachodni WBK Group in 2012.

Based on the findings of the audit conducted by Deloitte Polska Spółka z ograniczoną odpowiedzialnością Sp. k. (formerly: Deloitte Audyt Sp. z o.o.), presented in the following documents:

- Opinion of the Independent Auditor and Report supplementing the Auditor's opinion on the separate Financial Statements of Bank Zachodni WBK S.A. for the financial year ended 31 of December 2012,
- Opinion of the Independent Auditor and Report supplementing the Auditor's opinion on the consolidated Financial Statements of Bank Zachodni WBK Group for the financial year ended 31 of December 2012,

the Supervisory Board stated that the 2012 Financial Statements presented by the Management Board, have been prepared, in all material respects, and give a true and fair view of the financial position of the Bank and the Group as at 31 December 2012 and of their financial performance and their cash flows for the year then ended, in accordance with International Financial Reporting Standards as adopted by the European Union, and are in compliance with the respective regulations that apply to the Bank's unconsolidated financial statements and the consolidated financial statements applicable.

The Supervisory Board decided with resolution no. 14/2013, dated 7th March 2013, to submit to the AGM for approval:

- Financial Statements of Bank Zachodni WBK S.A. for 2012,
- Management Board Report on Bank Zachodni WBK S.A. Performance in 2012,
- Consolidated Financial Statements of Bank Zachodni WBK Group for 2012,
- Management Board Report on Bank Zachodni WBK Group Performance in 2012.

2. Review of the Bank's Management Board motion related to the 2012 profit distribution

The Supervisory Board examined the Bank's Management Board motion related to the 2012 profit distribution, and with resolution no. 18/2013, dated 7th March 2013 decided to recommend approval of the above motion to the General Annual Meeting of Shareholders.

3. Wrap-up

The Supervisory Board stated that it acted with due diligence with regard to comprehensive examination of the documents presented by the Bank's Management Board and in line with its

resolution no. 20/2013, dated 19th March 2013, the Supervisory Board presents this report to the General Annual Meeting of Shareholders of Bank Zachodni WBK.

II. ASSESSMENT OF THE BZWBK GROUP'S STANDING INCLUDING AN EVALUATION OF THE INTERNAL CONTROL SYSTEM AND THE SIGNIFICANT RISK MANAGEMENT SYSTEM

1. Assessment of the BZ WBK Group's operations in 2012

- *Macroeconomic Environment in 2012*

Economic Growth

In 2012, GDP growth slowed down – from 3.6% y-o-y in Q1 to ca. 1% y-o-y in Q4. Overall GDP growth in 2012 reached 2%. 2012 was the period of deceleration of economic growth in Poland. Global markets saw a significant economic slowdown, which was most pronounced in the euro zone, which entered a recession. A marked slump in export orders was recorded, which in turn had a negative effect on domestic exports and manufacturing sector. There was a strong deterioration in domestic demand, whose growth dropped below zero already in the second quarter. It was driven, among others, by stagnation in private consumption, sharp slowdown in fixed investment growth and reduction of inventories. Fixed investment growth decelerated in Q2. Indicators of consumer optimism decreased sharply, approaching 2009 lows.

Labour Market

From January to December the number of the employed fell by ca. 73k. At the same time, wage growth decelerated significantly, falling well below the inflation rate. After a seasonal drop, the registered unemployment rate was increasing from August to 13.4% at the end of the year.

Inflation

In the first half of the year the inflation rate persisted at an elevated level, exceeding 4%. H2 saw a drop in the core inflation and in the headline CPI growth. In December, the CPI inflation rate fell to 2.4%, decreasing below the NBP's official target for the first time since August 2010. Excluding prices of food and energy, CPI declined at the end of the year to 1.4%.

Monetary Policy

In response to the inflation staying above the official NBP target, the Monetary Policy Council decided to increase main interest rates by 25bps in May 2012. Deepening economic slowdown and stagnation in the labour market implied lack of inflationary pressure and no risk of second-round effects. In November and December, the Council made two cautious interest rate reductions by 25bps each. MPC may consider further monetary policy easing.

Credit Market

The pace of total loan growth in the banking sector decelerated from 14% y-o-y at the start of the year to nearly 1% y-o-y in December 2012. As regards business loans, the annual momentum declined from ca. 18% y-o-y at the end of 2011 to ca 1.5% y-o-y in December. Adjusted for FX movements, the growth rate declined from 15.4% to 3.3% y-o-y.

The biggest slowdown was observed with investment loans – from ca. 25% y-o-y to almost zero after FX adjustment. The pace of growth of household loans also plunged nearly to zero. Growth in mortgage loans abated to all-time-low of ca. 5% y-o-y (after FX adjustment).

Financial Markets

The start of 2012 was marked by a significant improvement of moods in international financial markets. This was, among other things, due to the ECB's LTRO in December 2011 and February 2012, successful restructuring of the Greek debt, and hopes for additional monetary stimulus from the Fed. The rise in global risk appetite triggered the strengthening of the Polish zloty and domestic bonds, and gains in the stock markets. In Q2, moods on the global markets started to deteriorate because of the weakening outlook for the world economic growth and returning fears about the debt crisis in the southern Europe. In H2, the situation in the world financial markets was still characterised by some volatility due to unresolved problems of the euro zone, deteriorating global economic outlook and investors' uncertainty about the crisis. Still, a tendency of declining risk aversion was prevailing.

An increase in the global risk aversion in mid-year led to high volatility of the zloty – after a decrease to ca. 4.11 in mid-March, the EUR/PLN rate increased above 4.40 in early June, and then fell again, stabilising in the 4.05-4.20 range in the final months of the year. The scale of zloty appreciation was curbed by growing market expectations of prospective interest rate cuts by the MPC. Domestic bonds proved relatively immune to increased global risk aversion. In the second half of the year the money market started pricing-in aggressively chances for monetary policy easing. Rising hopes for interest rate cuts, improvement of sentiment in global markets, and uninterrupted inflow of foreign portfolio capital to the Polish treasury securities market triggered a fall in yields of Polish bonds to the lowest levels in history. Towards the year-end, the yield of 2Y bonds was just below 3.1%, 5Y bonds paid below 3.2%, while the yield of 10Y bonds fell to nearly 3.7%. In effect, the yield of Polish treasury bonds decreased by 1.75 p.p. during the year in the 2Y segment, and by more than 2 p.p. in the case of long-term instruments.

Stock Market

2012 saw a clear rise in key indices at the Warsaw Stock Exchange. WIG and WIG 20 grew by over 26% and 20%, respectively. After an early-year optimism, the indices reversed and reached an all-year low in mid-year amid global concerns about the euro zone breakup and debt crisis. H2 brought about a visible improvement of sentiments on WSE, which staged a spectacular rally at the year end.

- ***Merger of Bank Zachodni WBK S.A. and Kredyt Bank S.A.***

On 27 February 2012, Banco Santander S.A. and KBC Bank NV signed an investment agreement, in which the parties expressed their intention to merge Bank Zachodni WBK S.A. and Kredyt Bank S.A. On 4 January 2013, the merger between Bank Zachodni WBK S.A. and Kredyt Bank S.A. was entered to the National Court Register. Bank Zachodni WBK S.A. assumed all rights and obligations of Kredyt Bank S.A. which was wound up without a liquidation.

The merger was effected pursuant to Article 492 §1 (1) of Commercial Companies Code by way of a transfer of all of the assets of Kredyt Bank S.A. to Bank Zachodni WBK S.A. in exchange for newly issued series J shares allotted to all of the existing shareholders of Kredyt Bank S.A. at the exchange ratio of 6.96 merger shares for 100 shares in Kredyt Bank S.A. 18,907,458 series J merger shares were admitted to trading on 25 January 2013.

As a result of the issue of series J shares, the share capital of Bank Zachodni WBK S.A. was increased to PLN 935,450,890, while the share of Banco Santander S.A. in the total voting power at the GM of Bank Zachodni WBK S.A. dropped to 75.19%. KBC Bank NV took up merger shares representing 16.17% of total voting power at the GM of the merged Bank. Following the merger on 4 January 2013, BZ WBK Group is currently ranked 3rd in Poland in terms of total assets.

- ***BZ WBK Group's Financial Standing in 2012***

Profit and Loss Account

In 2012, Bank Zachodni WBK Group generated a profit-before-tax of PLN 1,837.0m, an increase of 19.1% y-o-y. The net profit attributable to Bank Zachodni WBK shareholders was PLN 1,433.8m and 21.1% higher y-o-y.

Income

The total income earned by Bank Zachodni WBK Group in 2012 was PLN 4,136.3m and up 8.2% y-o-y. In 2012, interest income came in at PLN 2,301.1m, i.e. up 11.2%, while the commission and fee income amounted to PLN 1,385.0m, which represented a y-o-y increase of 2.0%.

Costs

In 2012, total costs of Bank Zachodni WBK were reduced by 5.3% y-o-y to PLN 1,817.2m. In 2012, the Group's cost-to-income ratio stood at 43.9% (vs. 50.2% in 2011).

Assets and Liabilities

As at 31 December 2012, total assets of Bank Zachodni WBK Group amounted to PLN 60,019.2m.

Following the registration of share capital increase through the issue of 1,561,618 series I ordinary shares placed in total with EBRD, the most pronounced y-o-y growth of 20% was observed in the equity line .

Deposits

In 2012, deposits from customers went up by 0.5%. Personal deposits added up to PLN 28,636.3m and were higher by 5.6% y-o-y. Balances in business and public sector went down by 6.5% y-o-y to PLN 18,440.8m due to maturity of a few short-term high-value deposits placed by corporate customers at the end of 2011.

Loans

Gross loans climbed up by 5% y-o-y reaching PLN 41,411.8m as at 31 December 2012. Adjusted for FX movements, gross loans increased by 7.5% y-o-y. Total value of the business and public sector loan portfolio grew by 3.5% y-o-y, reaching PLN 25,386m, while the personal loan portfolio increased by 9.0% y-o-y, totalling PLN 13,708.6m.

As at 31 December 2012, the non-performing loans accounted for 5.4% of gross portfolio vs. 5.5% recorded as at the end of December 2011. The provision coverage ratio for impaired loans was 53.5% (49.1% in December 2011).

Loans to deposits ratio was 84.7% as at 31 December 2012 compared with 81.2% as at 31 December 2011.

Share Price of Bank Zachodni WBK S.A.

During the year, the share price of Bank Zachodni WBK S.A. increased by 7%, i.e. from PLN 226.0 as at 31 December 2011 to PLN 241.90 as at 31 December 2012. The maximum share price was PLN 242.90 (21 and 27 December 2012) versus the minimum of PLN 221 (17 January 2012). In 2012, the share price of Bank Zachodni WBK continued on an upward trend amid reports on the planned merger with Kredyt Bank S.A. As at the end of December 2012, the share price hit a record high in the last five years, reaching PLN 242.90. In June, the Bank paid out a dividend at PLN 8 per share out of the profit earned in 2011. As a result the Bank's shares yielded 10.6% per annum.

Rating

In 2012, Fitch Ratings took four rating actions on Bank Zachodni WBK S.A.:

1. On 25 January 2012, Fitch Ratings withdrew – globally - individual ratings for banks, and replaced them with Viability Ratings introduced in 2011. As a result, Individual Rating at “C” was removed from the Bank's ratings.
2. On 13 February 2012, Fitch Ratings downgraded Long-term Issuer Default Rating from “A+” to “A-”, removed it from Rating Watch Negative and assigned a negative outlook. The agency also downgraded Short-term Issuer Default Rating of the Bank from “F1” to “F2” and removed it from Rating Watch Negative. The rating action followed the downgrade of Long-term Issuer Default Rating of Banco Santander from “AA-” to “A” and Viability Rating from “aa-” to “a”, which largely reflected the deterioration in the Spain's risk profile.
3. On 1 March 2012, Fitch Ratings affirmed the support driven ratings of Bank Zachodni WBK S.A. and placed its "bbb" Viability Rating (VR) on Rating Watch Negative (RWN). The rating actions followed the statement made on 28 February 2012 by Banco Santander and KBC announcing the agreement to merge Bank Zachodni WBK S.A. and Kredyt Bank S.A.
4. On 14 June 2012, Fitch Ratings downgraded the Long-term IDR of Bank Zachodni WBK S.A. from “A-” to “BBB” with stable outlook, Short-term foreign currency IDR from “F2” to “F3” and the Support Rating from “1” to “2”. The agency also affirmed the Viability Rating (VR) at ‘bbb’ and removed it from Rating Watch Negative (RWN). The rating actions followed the downgrade of Banco Santander S.A. on 11 June 2012 (to “BBB+”).

Bank Zachodni WBK Rating in 2013

In response to the legal merger of BZ WBK S.A. and KB S.A., on 10 January 2013, Fitch Ratings affirmed all Bank Zachodni WBK S.A. ratings and withdrew all ratings of Kredyt Bank S.A. Rating actions for Bank Zachodni WBK S.A: Long-term foreign currency IDR: affirmed at “BBB”, Outlook Stable; Short-term foreign currency IDR: affirmed at “F3”; Viability Rating: affirmed at “bbb”; Support Rating: affirmed at “2”.

The affirmation of IDRs and VR reflects Fitch's view that the merged entity's stand-alone credit profile is broadly in line with that of the pre-merger BZ WBK S.A., albeit marginally weaker as a result of the incorporation of KB. The ratings are based on BZ WBK intrinsic strength. The affirmation of the Support Rating reflects Fitch's view that the Bank's majority shareholder, Banco Santander, will have a high propensity to provide support to the merged entity in case of need, given the strategic importance of Polish banking operations to Santander Group. Within Fitch's base case scenario, BZ WBK's ratings will not be impacted by any further possible downgrade of Long-term IDR of Banco Santander.

2. Assessment of the Internal Control System and the Risk Management system

- *Assessment of Internal Control System*

As required by the Statutes, the bank operates an internal control system which supports the decision-making processes and contributes to the bank's efficient operation, reliability of financial reporting as well as compliance with the law and internal regulations.

The bank's internal control system is adjusted to the bank's organisational structure and risk management system as well as to the size and complexity of the bank's business. It covers all units across the bank as well as its subsidiaries.

Internal control and risk management systems are structured into three lines of defence. Control measures under the first line check compliance with procedures and ad hoc/on-going response to any identified deficiencies or shortcomings. It underlies reviews of procedures and effectiveness of controls across the organization.

The second line of defence is formed by specialist units performing control functions which support the bank's management in risk identification and management and serve assessment of the first line controls.

The third line of defence is the Internal Audit Area which provides independent and objective examination as well as assurance on the first and second tier controls as well as on the bank's management system, including the effectiveness of managing the risk related to the bank's business. For that matter, Internal Audit verifies the adequate coverage of the Group's risks, in compliance with top management policies, applicable procedures and internal and external regulations. Using its own risk matrix and knowledge, IAA performs a regular assessment of the present and future risk across the bank and BZ WBK Group, developing audit annual plans to cover them. Also, priorities highlighted by the bank's management, the Audit and Compliance Committee, the external auditor, and banking supervision institutions are taken into account.

The Audit and Compliance Committee of the Supervisory Board exercises oversight over the Internal Audit Area. The Audit and Compliance Committee approves an annual audit plan and is regularly updated on audit results and progress in management actions.

As a result of the third line activity, the Management Board and the Supervisory Board receive current and accurate information on compliance with the law and internal regulations applicable in the Bank, effectiveness of identifying errors and irregularities as part of the internal control system, efficient management actions, completeness and correctness of accounting procedures as well as adequacy, functionality and security of the IT system. The Risk Management Committee and the Audit and Compliance Committee are updated on a regular basis on the operation of the internal control system from the units of the second and third lines of defence which facilitates the on-going monitoring of the system's effectiveness.

Findings of control are taken account of and used to improve the existing processes and safety by making relevant changes to internal processes and regulations. The implementation of a necessary new process is regularly verified by Internal Audit Area.

- ***Assessment of risk management system***

Bank Zachodni WBK has an integrated risk management framework ensuring that all risks having material impact on the bank's operations are identified, measured, monitored and controlled. In the Supervisory Board's opinion, this framework is appropriately matched to the bank's size and risk profile. The bank optimizes the risk management framework on a regular basis, adapting it to the changing environment and risk profile associated with the planned strategy.

The responsibility for the management of individual risks was split between the bank's organizational units that are supported by relevant Committees. The risk management strategy is set by the Risk Management Committee (RMC) overseeing the activity of other Committees having risk management authority. The fact that Members of Management Board and senior management sit on key Committees ensures high quality of management and consistent risk strategy.

One of the basic elements of the risk management framework of Bank Zachodni WBK is setting the levels of risk that the bank is ready to accept in its day-to-day business. The acceptable risk level is expressed in the form of quantifiable limits set out in the "BZWBK Group Risk Appetite Statement" approved by the Management Board and Supervisory Board. The bank conducts a detailed review of the limits with regard to the existing and potential risks, market conditions as well as the financial and capital plan at least once a year. Stress-testing and scenario analyses represent the key tool used to analyse the limits and ensure that the bank retains an adequate capital position even in extreme and severe circumstances.

The bank has methodologies and processes in place to identify and assess risks to determine their potential impact on the bank's operations now and in the foreseeable future. With a view to identifying and assessing risks for the entire organisation, the review of material risks is carried out as part of the ICAAP process. Identified risks are managed using policies and best

practices to keep them at an acceptable level. The bank uses various risk assessment and measurement techniques depending on risk type and materiality, including the following key ones:

- customer and/or transaction grading models - for credit risk assessment purposes;
- VAR methodology - market risk;
- operational risk self-assessment methodology.

The comprehensive risk management framework is supported by a consistent and transparent system aimed at monitoring and reporting risk levels and excesses against defined limits. The reporting system covers key management levels. The Supervisory Board receives regular reports assessing the level of identified risks and reports assessing the effectiveness of actions taken by the bank's Management Board.

The bank aims to keep the right risk/reward balance. Support for the bank's development strategy, while keeping top risk management standards, is amongst the key assumptions underlying the risk management process.

In 2012, the bank reviewed its risk management system, revising the structure of the risk management committees. By merging the Risk Management Division with the Credit Division, the responsibility for credit risk management has been consolidated. New rules were implemented for management of market risk on the banking book and the trading book, taking account of the division of roles between the units participating in the process. In response to the prevailing macroeconomic conditions the bank was carefully analysing the situation in financial markets and tracking the risk levels to make appropriate adjustments to its risk management policy parameters.