

- I. REPORT OF THE SUPERVISORY BOARD ON THE EXAMINATION OF :**
- **FINANCIAL STATEMENTS OF BANK ZACHODNI WBK S.A. FOR 2010**
  - **MANAGEMENT BOARD REPORT ON BANK ZACHODNI WBK PERFORMANCE IN 2010**
  - **CONSOLIDATED FINANCIAL STATEMENTS OF BANK ZACHODNI WBK GROUP FOR 2010**
  - **MANAGEMENT BOARD REPORT ON BANK ZACHODNI WBK GROUP PERFORMANCE IN 2010**
  - **MOTION OF THE MANAGEMENT BOARD ON THE 2010 PROFIT DISTRIBUTION**
- II. ASSESSMENT OF BANK ZACHODNI WBK STANDING INCLUDING AN EVALUATION OF THE INTERNAL CONTROL SYSTEM AND THE SIGNIFICANT RISK MANAGEMENT SYSTEM**

**Warsaw, March 2011**

## **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 20<sup>th</sup> April 2011:

- Financial Statements of Bank Zachodni WBK S.A. for 2010,
- Management Board Report on Bank Zachodni WBK Performance in 2010,
- Consolidated Financial Statements of Bank Zachodni WBK Group for 2010,
- Management Board Report on Bank Zachodni WBK Group Performance in 2010,
- Management Board motion on the 2010 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 2010**

By force of resolution no. 17/2010, adopted on 9<sup>th</sup> June 2010, the Supervisory Board selected KPMG Audyt Spółka z ograniczoną odpowiedzialnością sp. k. (KPMG Audyt Polish Limited Liability Partnership/KPMG Audyt) as the Bank's auditor and vested it with a task of auditing the Interim Financial Statements for H1 2010. Next, by force of resolution no. 30/2010, adopted on 22<sup>nd</sup> September 2010, the Supervisory Board vested KPMG Audyt with a task of auditing the Financial Statements for 2010. The above audit covered the following documents produced by the Bank's Management Board:

#### **1. Financial Statements of Bank Zachodni WBK S.A. for 2010:**

- Statement of Financial Position as at 31 December 2010,
- Income Statement for the accounting year ended 31 December 2010,
- Statement of Comprehensive Income for the accounting year ended 31 December 2010,
- Movements in Equity for the accounting year ended 31 December 2010,
- Cash Flow Statement for the accounting year ended 31 December 2010,
- Additional Notes.

#### **2. Management Board Report on Bank Zachodni WBK S.A. Performance in 2010.**

#### **3. Consolidated Financial Statements of Bank Zachodni WBK Group for 2010:**

- Consolidated Statement of Financial Position as at 31 December 2010,
- Consolidated Income Statement for the accounting year ended 31 December 2010,
- Consolidated Statement of Comprehensive Income for the accounting year ended 31 December 2010,

- Movements in consolidated equity for the accounting year ended 31 December 2010,
- Consolidated Cash Flow Statement for the accounting year ended 31 December 2010,
- Additional Notes.

#### 4. Management Board Report on Bank Zachodni WBK Group in 2010.

Based on the findings of the audit conducted by KPMG Audyt, 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 for the financial year ended 31 of December 2010,
- 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 2010,

the Supervisory Board stated that the 2010 Financial Statements of Bank Zachodni WBK S.A. and the 2010 Consolidated Financial Statements of Bank Zachodni WBK Capital Group 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 2010 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. 9/2011, dated 1<sup>st</sup> March 2011, to submit to the AGM for approval:

- Financial Statements of Bank Zachodni WBK S.A. for 2010,
- Management Board Report on Bank Zachodni WBK Performance in 2010,
- Consolidated Financial Statements of Bank Zachodni WBK Group for 2010,
- Management Board Report on Bank Zachodni WBK Group Performance in 2010.

## **2. Review of the Bank's Management Board motion related to the 2010 profit distribution**

The Supervisory Board examined the Bank's Management Board motion related to the 2010 profit distribution, and with resolution no. 10/2011, dated 1<sup>st</sup> March 2011 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. 15/2011, dated 22<sup>nd</sup> March 2011, 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 2010**

- *2010 macroeconomic environment*

#### **Global situation**

2010 saw the revival of global economy, which was driven in most countries by rebuilding activity in manufacturing and foreign trade. Asian economies (e.g. China, India) recorded the quickest growth rate. The high economic growth noted by Germany was very positive from the Polish economy's perspective. The financial markets focused on the debt problems of some eurozone countries and the risk of spreading the debt crisis over Europe.

#### **Domestic economy**

The Polish economy continued economic revival, based largely on the growth in manufacturing and exports, supported by growing foreign demand and still competitive level of the zloty.

GDP growth accelerated steadily from 3.0% in Q1 2010 to more than 4.5% in the last quarter of the year. Throughout 2010, the GDP growth reached 3.8% and was more than twice that of the previous year.

Over the year domestic demand grew by 3.9% against a fall of 1% recorded in 2009. It was largely fuelled by acceleration in private consumption growth – from 2.2% in Q1 to around 4% in Q4 2010 (3.2% on average in the entire year).

At the turn of the first and the second quarter of 2010, employment in the enterprise sector and in the entire economy started growing. Growth in the labour demand did not cause a strong pressure on salaries, due to increased labour activity of Poles. This is also why despite an increase in employment, there was a rise in unemployment rate (according to the Labour Force Survey, from 6.6% in Q3 2008 to 9.1% in Q3 2010).

Improving economic situation in 2010 was not accompanied by the revival in fixed investments. Despite growth in capacity utilization, quite a substantial increase in demand and good financial results, the private sector businesses delayed investments. Public investment continued to be supported by the EU funding. Overall, gross fixed capital formation decreased during the year by 2%, after declining by 1.1% in 2009.

#### **Inflation**

In H1 2010, inflation was in a downward trend, which brought the annual CPI growth rate to 2% y-o-y in the summer months. In the subsequent months, however, there was a clear rebound of inflation, driven primarily by strong growth in food, fuel, clothing and footwear prices. As a result, in the last quarter of the year the CPI growth rate returned above the NBP inflation target (2.5%), and in December it was at 3.1% y-o-y.

#### **Interest rates**

At the beginning of 2010 the Monetary Policy Council's term of office finished. In addition, Sławomir Skrzypek was replaced by Marek Belka as the Governor of the National Bank of Poland in Q2 2010. The main interest rates of the Central Bank remained unchanged

throughout the year (main reference rate at 3.5%). In October 2010, the Monetary Policy Council decided to raise reserve requirement rate from 3.0% to 3.5% with effect from January 2011.

### **Exchange rate**

Despite the gradual increase in economic activity, 2010 saw considerable turbulences in financial markets, which were primarily caused by fiscal problems in some countries of the euro zone and concerns about the risk of spreading fiscal crisis. As a result, during the year there were significant fluctuations in exchange rates. The zloty remained in the medium-term appreciation trend, which however was interrupted by periods of clear corrections caused by growing concerns about debt problems in the euro zone.

### **Situation in the banking market**

In 2010, banks were gradually relaxing their lending policies, among others, due to improved macroeconomic situation, the labour market recovery and the expected improvement in the economic outlook.

Household loans recorded a moderately high growth, mainly in home mortgage loans segment which increased by ca. 13% y-o-y on the constant currency basis, similar to 2009. A slowdown occurred in consumer loans (growth below 2% in 2010 compared with 13% rise in 2009).

The business lending market remained in stagnation – the total loan-book declined by about 2.5% y-o-y (on the constant currency basis). The increase in deposits from business customers stabilised at 10% y-o-y. The increase in household deposits slowed slightly compared with 2009 and amounted to ca. 10% y-o-y.

#### **• *BZWBK Group's financial standing in 2010***

In 2010, Bank Zachodni WBK Group continued its strategy for 2009-2011, trying to be distinctive in the market by its customer proposition and customer service quality.

The Group flexibly responded to the changing business environment with a focus on maintaining its deposit base, developing its loan-book and controlling risk in all aspects of its activity.

On September 10, 2010, it was announced that Allied Irish Banks p.l.c. agreed to sell the entire stake in Bank Zachodni WBK (70.4% of share capital) to Banco Santander.

### **Profit & Loss Account**

In 2010, Bank Zachodni WBK Group achieved a profit-before-tax of PLN 1,357.2 m, i.e. 16.8% more than in 2009. The profit-after-tax attributable to shareholders of Bank Zachodni WBK was PLN 974.2 m, and higher by 10% y-o-y. This performance reflects the Group's consistent efforts to diversify its income streams, align the product structure to the customer needs and market conditions, execute well-crafted marketing campaigns and deliver effective risk management.

### **Income**

The total income earned by Bank Zachodni WBK Group in 2010 was PLN 3,539.8 m and up 7.7% y-o-y

Net interest income amounted to PLN 1,822.2 m and increased by 16.6% y-o-y as the situation in the Polish deposits market continued to improve. Under the impact of declining money market prices, improved liquidity position of Polish banks and slower credit delivery,

the competition for customer deposits changed in nature and intensity, which is also reflected in the increase of annualized net interest margin of Bank Zachodni WBK Group from 3.40% for 2009 to 3.98% for 2010.

Over the last three quarters of 2010, the market interest rates remained in a relatively narrow volatility band, and the recovering deposit margins compensated for falling lending margins. Net interest income was also favourably impacted by changes in the Group's balance sheet structure, particularly an increase in current balances in the customer accounts (+6.2% y-o-y).

In 2010, net commission income amounted to PLN 1,344.7 m and increased by 2.3% y-o-y. The income earned by the Group from its activities in the mutual funds and asset management market amounted to PLN 289.7 m, up 22.5% y-o-y. This is primarily due to the upward trend observed on Warsaw Stock Exchange since February 2009.

Direct Banking services of BZ WBK Group generated net commission income of PLN 280.3 m, which was 2.6% higher year-on-year.

The 5% decline in the net income from credit fees to PLN 145.8 m can be attributed, among other things, to the prudential policy continued by the Group with regard to sanctioning credit cards limits, which constrained the portfolio of newly issued cards.

Net commission income of Dom Maklerski BZ WBK increased by 3.1% y-o-y to PLN 101.6 m on account of higher income from servicing mutual funds and primary market offerings. In 2010, the company arranged 8 IPOs and was acclaimed a market leader of the stock exchange debuts.

Dividend income decreased by 43.6% y-o-y to PLN 54.5 m due to lower dividend received from Aviva Towarzystwo Ubezpieczeń na Życie in 2010 compared with a year before.

In 2010, the loan impairment charge to the profit and loss account was PLN 420.8 m compared with PLN 481 m in 2009.

The impairment level is an effect of improved macroeconomic conditions in Poland compared with 2009. In 2010, the financial and market position of Polish companies was gradually improving, and so was their debt repayment capacity. Also, the property market was showing clear signals of recovery, favourably affecting investors, real estate developers, their business partners and contractors. The revised outlook for this and other sectors influenced the decision to write back the provisions of PLN 60 m in total for incurred but not reported losses (IBNR) in the Business and Corporate Banking portfolio.

The economic slowdown of 2009 and its after-effects most strongly impacted the SME sector and weakened the solvency of such representatives. Higher impairment was also recognized in BZ WBK Group's leasing portfolio as a result of lower prices of leased assets that collateralize receivables from customers.

### **Costs**

Total costs of Bank Zachodni WBK Group amounted to PLN 1,766.3 m and were 7.4% higher y-o-y due to development of the Group's business. The C/I ratio remained at 50%.

In 2010, staff expenses increased by 7.8% y-o-y to PLN 959 m, mainly as a result of accruals for staff bonuses linked to the Group performance in 2010. Base salaries reflect the average 3.5% pay increase while the average employment was similar to the previous year's level.

The Group's other administrative expenses increased by 5.4% y-o-y to PLN 641.6 m driven by the cost of consultancy, maintenance and lease of buildings, advertising and marketing, and other third party services.

## **Assets & liabilities**

As at 31 December 2010, total assets of Bank Zachodni WBK Group amounted to PLN 53,153.9 m, down 1.7% on 31 December 2009.

## **Loans**

As at 31 December 2010, gross loans and advances to customers amounted to PLN 34,205.1 m, down 4.2% on the end of December 2009.

In 2010, loans and advances to business and public sector customers decreased by 9.1% y-o-y to PLN 20,311.7 m. As at the end of December, property loans, which make up a large portion of this portfolio, decreased by 16.9% y-o-y to PLN 9,545.8 m in line with declining credit exposures to commercial property sector.

Loans to personal customers amounted to PLN 11,437.5 m, an increase of 7.6% compared with 2009. The main growth driver were mortgage loans, which went up by 14.3% y-o-y to PLN 6,926.6 m at the end of December 2010 due to the quality of the bank's mortgage proposition.

## **Deposits**

Deposits from customers, which represent 79% of the Group's total equity and liabilities are the primary source of funding the Group's lending business. At the end of December 2010 they amounted to PLN 41,970.5 m, up 1.8% on 31 December 2009.

As at 31 December 2010, the Group's deposits from retail customers amounted to PLN 25,230.8 m, down 1.5% y-o-y. The structure of these deposits changed as customers were shifting funds from term deposits to current accounts, which is attributable to the increase in the number of personal and savings accounts and lower attractiveness of term deposits in the low interest rates environment. Deposits from business customers amounted to PLN 16,739.7 m and were by 7.2% higher y-o-y.

## **Bank Zachodni WBK share price**

An upward trend in the Warsaw stock indices observed from February 2009 levelled off in the second quarter of 2010 as a consequence of the adjustments related to the profits generated by investors. The beginning of summer saw another dynamic upward shift which lost its momentum as late as early December.

The price of Bank Zachodni WBK shares increased from PLN 190 on 31 December 2009 to PLN 214.9 on 31 December 2010. The minimum share price during the year was PLN 168.10 (5, 8 and 25 February 2010). The maximum share price was PLN 220.90 (14 April 2010).

From 10 September 2010 when AIB announced its intention to sell its Polish assets to Banco Santander till the end of the year, the share price of Bank Zachodni WBK traded in the region of PLN 210-214.

During the year, WIG grew by 18.8%, WIG20 by 14.9% and WIG-Banks by 17.9%.

As at 31 December 2010, capitalisation of the BZ WBK Group amounted to PLN 15,704 m compared to PLN 13,884.4 m a year before. P/E ratio totalled 17.13 times vs. 14.09 times as at the end of 2009 whereas P/BV amounted to 2.6 times vs. 2.5 times at the end of 2009.

## **Rating**

Bank Zachodni WBK has a bilateral credit rating agreement with Fitch Ratings Ltd.

On 31 March 2010, the agency announced that AIB's plan to sell its stake in Bank Zachodni WBK would have no immediate impact on Bank Zachodni WBK's ratings.

In the announcement dated 12 May 2010, Fitch revised the bank's outlook (Long-term IDR) to stable from negative while the other ratings were affirmed. The revision reflected the resilience of BZ WBK's profitability in a deteriorating operating environment.

The recent change in rating reflected Allied Irish Banks p.l.c. decision to sell the BZWBK stake (70.4%) to Banco Santander (AA/Stable/'F1+') that was announced on 10 September 2010.

After the transaction is completed Fitch will resolve the RWP on BZ WBK's ratings. BZ WBK's support rating as well as short-term and long-term IDRs will be based on support from the bank's new parent - 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. The IAA performs a regular assessment of the present and future risk across the bank and BZWBK Group in order to identify the demand for audits. When developing annual audit plans, priorities highlighted by the bank's management, the Audit Committee, the external auditor and banking supervision institutions are taken into account.

The Audit Committee of the Supervisory Board exercises oversight over the Internal Audit Area. The Audit 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 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.

- ***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 executed 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 Management Board Members and senior management sit on key Committees ensures high quality of management and consistent risk strategy.

To strengthen the credit risk management framework and ensure an adequate level of independence, in 2010 the Bank set up the Credit Risk Measurement Committee responsible for the approval of credit risk measurement methods and tools. Moreover, in line with the idea to build value by setting common targets for the Bank's business units (Risk&Reward), the committee responsible for the lending policy was restructured to meet the needs of business segments.

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 limits set out in the "BZWBK Group Risk Appetite Statement" approved by the Management Board and Supervisory Board. The Bank conducted a detailed review of the limits for actual and potential risks, market conditions as well as the financial and capital plan. The analysis covered stress testing and scenario analyses whose purpose was to ensure that the Bank has an adequate level of capital even in a stressed situation.

The Bank has methodologies and processes that identify and assess risks to set their potential impact on the Bank's operations now and in the foreseeable future. Identified risks are managed using available policies and best practices to keep them at an acceptable level. The Bank uses various risk assessment techniques depending on risk type and materiality. The most important ones include:

- customer and/or transaction grading – for credit risk assessment purposes,
- VAR methodology - market risk,
- operational risk self-assessments.

In 2010, the Bank took actions to further develop and adapt credit risk assessment tools to ensure appropriate portfolio quality.

It is worth noting that actions were taken to develop market risk measurement tools covering a number of VAR model validations.

The Bank strives to keep the right risk/reward balance. That is why it is worth emphasizing the Bank's actions taken to ensure appropriate risk rating and reflect risk elements in profitability measurement process and bonus schemes.

To assess risks at the group-wide level, they are comprehensively reviewed as part of regular ICAAP material risk reviews and the reviews of key risks that identify major threats to the Bank's business. In 2010, risk identification and assessment was performed in accordance with the policies implemented by the Bank. The identified risks are closely managed in line with the risk mitigating action plans.

The comprehensive risk management framework is supported by a consistent and transparent system of reporting risk levels and types as well as risk limit excesses. The reporting process covers key management levels. The Supervisory Board gets regular reports presenting identified risks and actions taken by the Management Board to mitigate them.