

IV. MARKET CONDITIONS AND BUSINESS PROSPECTS

IV.1. Macroeconomic environment

Polish economy returned on the path of solid economic growth after the slowdown on the turn of 2012 and 2013. Gross domestic product was, in real terms, by 3.3% higher than in 2003 when it grew by 1.7%. The dynamics of domestic demand looks even better, in real terms it equalled 4.6% versus only 0.2% in 2013 and was the highest since 2008. Domestic demand was supported by both solid private consumption growth (by 3.0% vs 1.1% last year) and investment (9.4% vs 0.9% a year ago). The improvement of labour market conditions accompanied by low inflation or even falling prices supports real disposable income of households. It is however worth noting that there are no signs of the deflationary spiral, i.e. postponing of the consumption as a response to decreasing prices. Investment was growing in 2014 at the pace similar to 2011, however at that time booming public infrastructure investment financed by the EU funds was observed. Nowadays one can rather observe increasing private investment aimed to rebuilt capacity and modernize existing equipment. Negative contribution from net exports, equal to -1.3 pp, resulted from diminishing trade surplus, while growth of both exports and imports was sustained. The consequences of limited access to eastern markets for Polish exporters were smaller than feared at the beginning of the year thanks to high flexibility of the Polish companies that are actively seeking new markets. The Bank assesses that the economic growth in 2014 was balanced and the GDP data show no sign of macroeconomic imbalances.

Registered unemployment rate was equal to 11.5% in December 2014 and was by 1.9 pp lower than in the corresponding month of 2013. At the same time it was the lowest reading for December since 2008. The decline of unemployment observed since the second quarter was much stronger than seasonal pattern and represented improved standing of the companies. Mean employment in the enterprise sector in December 2014 was by 1.1% higher than in December 2013. During the year 2014 stable increase of nominal wages was observed. In December average wage in the enterprise sector increased by 3.7% in nominal terms which translates into real growth of 4.7%.

In the second half of the year Polish economy recorded deflation. In July Consumer Price Index fell below zero in year-on-year terms and the decrease has been deepening in the months that followed. to reach -1.0% in December. The persistence of negative inflation resulted from supply-side shocks on food and fuel markets. Demand pressure in the economy is very low as core inflation excluding food and energy was equal to just 0.5% yoy. Average annual inflation equalled to 0.0% in 2014 as compared with 0.9% in 2013. Cost and demand pressures in the economy remain extremely low and inflation is still much below the NBP target (2.50% +/-1%)

Leading indicators suggest further improvement of business sentiment. The Bank expects that in 2015 domestic demand will remain strong and the economic growth will be equal to 3.5%. The Bank expects that high dynamics of private consumption, supported by improved labour market conditions including unemployment falling to 10.7% in December, 2015 will be maintained. The Bank forecasts that the investment is likely to growth further but at a slightly slower pace than last year. Investment will still be supported by high capacity utilization and growing new orders in manufacturing as well as good financial standing and liquidity of the companies. Despite growth acceleration we do not expect fast return of the inflation.

In the environment of the lack of inflation pressures MPC kept loose monetary policy stance. In the first three quarters of the year reference rate was equal to 2.50%. In October the Council assessed that incoming information show slowing economic activity and increasing risk of inflation running below the target in medium term and decided to loose monetary policy. Reference rate was cut by 50 bps to record low of 2.00%, however lombard credit rate was cut by as much as 100 bps to 3.00%. It means that the maximum interest on consumption loans (stated by law as a quadruple of lombard rate) decreased from 16% to 12%. MPC does not rule out further policy adjustments if incoming information confirms significant risk of inflation running below the target in the medium term. The Bank does not currently see much space for rate cuts and expects one more cut by 25 bps. The rationale for that forecast is ongoing economic recovery and the fact, that negative inflation stems from supply-side shocks on fuel and food markets rather than from weak demand in the economy.

In coming quarters the activity of banking sector, including Bank Millennium, will be influenced by the following external factors:

- On 15th January 2015, the Swiss National Bank (SNB) announced that it was discontinuing maintaining the minimum exchange rate of CHF 1.20 per euro. At the same time, SNB announced that it was lowering the interest rate on sight deposit account balances to -0.75%. As a reaction, the EUR and the PLN depreciated versus the CHF.
The Bank does not expect significant worsening of the loans repayment as the influence of the Swiss franc appreciation against the Polish zloty will be partly offset by the decrease of CHF LIBOR3M rate. At the same time Polish banks have pledged to take measures against hypothetical problems with fx-

loans repayment including non-increase of obligations (collateral, new insurances) and decrease of servicing of the debt by a customer (prolongation of the loan maturity, “holidays” in instalment repayment, temporary reduction of fx spread).

However, taking into consideration the structure of the CHF denominated mortgage loan portfolio, temporary higher instalments may increase the level of impaired loans and cost of risk. Additionally, proposals put forward by different polish authorities may trigger, if enforced losses for the Bank.

- Introduction from 2015 significant increases of obligatory fees for Banking Guarantee Fund will cause increase of costs in 2015.
- The need of compliance to the new Supervision’s recommendation “U”, which will implement new rules and some restrictions to sale of insurances by banks (to be in force since 1 April 2015), may cause decrease of bancassurance commission revenue. Also change of this commission amount recognized up-front and accrued over time may cause decrease of current revenue (compensated by increases in the next years).
- Record low interest rates and expected further cuts limit the size of interest margin and may temporarily restrain interest result of the Bank.
- Growth acceleration resulting mainly from private consumption recovery and investment may support growth of households and corporate loans.
- The improvement of business sentiment, including good financial standing of the companies and further unemployment decrease will support the quality of loans portfolio.

IV.2. Banking sector in Poland and position of Bank Millennium Group

During most part of 2014, banks in Poland were operating in a moderately favourable macroeconomic environment, however towards the end of the year several events and negative regulatory developments were accumulated with an adverse impact on the Polish banking sector. These events include:

- Strong decrease of interchange fees, in force in Poland since 1 July 2014
- Reduction of interest rates in October 2014 - reference rate down by 50 bp. and unexpectedly sharper cut of lombard credit rate by 100 bp.
- Announcement of major increase of mandatory BFG changes (in force since 2015)
- Announcement by KNF of Recommendation U, which introduced new rules and some restrictions on sales of insurance products by banks (in force from 1 April 2015)

At the same time the process of growing concentration of the banking sector in Poland continues (merger of Nordea Bank with PKO BP, Santander Consumer Bank with BZ WBK, or takeover of Rabobank Polska by BGŻ and its subsequent acquisition by BNP Paribas). Despite that the degree of concentration of banks in Poland is not high, especially compared with many European countries: top 10 banks accounted for 66.8% of total assets at end of Q3 2014.

In the course of 2014 deposits of the banking sector grew 8.4% per annum (NBP data). It is worth noting that this high growth of deposits came despite the cutting of interest rates down to a record low level (2% reference rate). Total loans of banks operating in Poland grew 6.9%, with marked acceleration of corporate sector funding, the annual growth rate of which rose in the course of 2014 from 2.2% at the outset of the year to 9.2% at the year’s end.

Equity of Polish banks increased some 9% during the year, with average Solvency Ratio remaining at the very strong level of 14.9% in September 2014 (KNF data according to the new CRR/CRDIV standard). The strong capital position of Polish banks was confirmed by results of the Asset Quality Review (AQR) as well as Stress Tests carried out last year by KNF together with the European Central Bank and European Banking Authority and published on 26 October 2014. According to the Bank’s in-house calculations, the average weighted (with total exposure to risk) CET1 ratio for 15 Polish banks covered by the tests reached 12.3% in the adverse scenario and was much higher than the average in other European countries covered by the ECB/EBA test (it remained at approx. 9% in the largest economies).

Liquidity of Polish banks is also kept at a very safe level, with the Loans to Deposits ratio in the entire sector standing at 103% at the end of 2014.

According to own and other banks' data at end of September 2014 Bank Millennium was No. 7 among commercial banks in Poland by total loans and deposits, with an average market share of approx. 5%. Bank Millennium Group, comprising the Bank itself and a leasing company, mutual fund management company as well as a brokerage house, has a relatively strong foothold in retail loans and credit cards (approx. 6% market share). Other strong segments of the Bank include leasing (5th place on the market with 7% share in sales) as well as factoring (almost 10% share in total turnover of the sector). In deposits, Millennium keeps an average share of 5.1% of the market. Distribution of the Group's products and services is done through 423 branches as well as electronic channels, including cash machines, the internet, phone and mobile applications.

In 2014 Bank Millennium Group was consolidating its position in sales of cash loans and factoring, while the market share in mortgage loans and corporate deposits fell. The market position in retail deposits remained at a relatively stable level (5.2%).

In 2015 the Bank is expecting further growth of deposits in the banking sector, though probably at a slower pace than last year. A factor hindering growth of retail deposits may be growing consumption as well as the record-low interest rates in Poland. Also corporate deposits may demonstrate a slight slowdown because companies may be consuming part of their surplus liquidity by investing in fixed assets.

As regards banking sector loans, the Bank expects them to pick up pace. In the sector of households consumer finance should keep growing at a solid pace, supported by low interest rates and recovering consumption demand in the economy. Meanwhile residential loans should keep growing at a rate close to that of last year. The "Flat for the Young" programme, low interest rates as well as possible improvement of climate on the building construction sector may give this loan category a helping hand. The Bank expects corporate loans in the entire banking sector to at least keep last year's strong growth rate of more than 9% per year. The factor supporting corporate lending will be the recovery of capital expenditure, both private as well as public, also enjoying stronger EU funding support under the new perspective.

Moreover the Polish banking sector makes extensive use of new technologies in result of strong digitisation of the Polish public. This leads to already pronounced and still rapidly growing role of remote customer communication and service channels (online banking, mobile, e-payments).

IV.3. Strategy fulfilment and business development perspectives

In 2014 Bank Millennium continued to implement strategy for 2013-15, which was announced in October 2012. According to its guidelines, Bank focused in the past years on rebalancing business model towards productivity, while maintaining liquidity and capital discipline.

Bank's strategy for 2013-15 assumed:

- I. Sustained focus on valuable areas while redirecting product mix to higher margin products.
- II. Further enhancement of sales effectiveness of the network.
- III. Improved balance sheet structure and profitability of corporate franchise.
- IV. Sustaining efficiency advantage through strict platform management and cost savings discipline.
- V. Preparing the Bank for the future by investing in business analytics and multichannel platform.

Main strategy goals for end of 2015 assumed:

- ROE 14-15%
- Cost/income ratio at the level of 50%
- Loans to deposits ratio \leq 100%
- Capital ratio CT $1 >$ 10%
- Customer satisfaction level $>$ 90%
- Percentage share of corporate loans in portfolio at the level of 30-35%

In retail segment Bank established for 2014 priorities for acquisition of new clients, customer funds and consumer loans, achieving successes in all fields. In 2014 Bank opened 231 ths new current accounts, retail customer funds grew by 13%, with share of current and saving accounts at the level of near 50%. Cash loans sales reached record level of 2.1 bn PLN, increasing the portfolio by 24% YoY. Growth in retail segment was supported by business analytics development.

Taking into account changing customer trends in relation to banking service usage, Bank Millennium reviewed existing distribution model, in order to ensure optimum structure and format of branches. Bank promoted new website in “web responsive design” technology, further improved functionalities of electronic banking. The efforts were awarded by Newsweek ranking with Bank receiving “*Best electronic banking*” title. The magazine also recognized Bank’s superb quality of service, Millennium for the third time in a row on podium in category “*Newsweek - Friendly Bank - Individual Client*” - in 2014 placed second, fulfilling strategic objective in area of quality and customer satisfaction levels.

For the last few years mobile banking has been strategic area of development. Bank Millennium became one of the market leaders in Poland. It was the first bank in Poland to introduce mobile credit offer, first to introduce Personal Finance Manager, first to introduce express transfers first to introduce QR codes for payments, first to introduce tablet service for Windows 8 and Blackberry 10 and the first to introduce mobile banking for corporate clients.

In corporate segment, Bank Millennium continued to pursue corporate credit goals, increasing the portfolio by 1.5 bn PLN, growth of 13% YoY, faster than market average, which resulted in Bank reaching strategic goal of 30% share of corporate loans in total portfolio, a year before the plan.

In corporate segment many initiatives were undertaken in area of process improvement: outstanding onboarding process (new client activation), enhancement of quality of customer service and development of functionalities of remote channels thanks to innovative electronic banking solutions, in particular superb payments platform, continuously improved mobile banking.

The above actions, as well as strong cost discipline and efficient infrastructure management, led to Bank reaching an ambitious goal of decreasing cost to income ratio from 57% in 2012 to 50% in 2014, a year before the plan. At the same time ROE improved by 1.2% to 11.8%, even though it did not reach target due to higher than assumed capital levels.

Bank Millennium Group managed to keep strong capital position measured with CT1 ratio at 14.5%, which is significantly higher than level of 10% assumed in strategic plan. This results from increased regulatory requirements and conservative approach on Bank’s side to risk and capital. Total capital ratio (TCR) amounted to safe levels of 15.2%. In addition, liquidity norms of the Bank remained at safer levels than those assumed 2.5 years ago. Loans to deposits ratio amounted to 92%, lower than strategic limit of 100%, providing safety liquidity cushion, in case of e.g. unexpected exchange rate fluctuations, like those in January 2015. Solid capital base and assets quality of Bank Millennium were confirmed by good results of external assets quality review (AQR) and stress tests, which were conducted by KNF in 2014 and announced on the 26th of October (along with results of Pan-european asset quality review and stress tests conducted by ECB/EBA).

With majority of 2013-15 strategic goals achieved, and taking into consideration the changes in macroeconomic, regulatory and customer trends environment, Bank Millennium performed a strategy update review for the next 3 years (2015-17).

Macroeconomic scenario for Poland assumes GDP growth at 3,3% in 2015, mostly due to increased investment and private consumption. At the same time lower interest rates will challenge banks to maintain effectiveness and search for additional sources of revenue and cost reduction. Additional challenges are posed by regulatory environment: Recommendation U, increased contribution to Banking Guarantee Fund, consumer protection.

Changing customer trends, regarding preferred way of contact with the bank, pose further challenge. Poles are fast at adopting new technologies: sustained high pace of digitization with recent rapid acceleration in mobile can be observed. Online and mobile show growing importance in service and sales to existing customers, however are not yet driving significant customer acquisition. As digitization among Poles grows, so does the potential of electronic payments.

With rising client expectations towards quality of service and offer, as well as strong competition, banking sector will see growing importance of customer analytics in order to address those expectations.

As a consequence of these changes, Bank will focus in updated strategy for 2015-2017 on value creating organic growth. Strategy will be based on four pillars:

- I. Accelerating acquisition of retail customers through increased network effectiveness and optimized footprint, digital channels and acquisition of mass affluent, while maintaining segment profitability due to focus on high margin products.
- II. Keeping differentiating through customer experience, transforming digital channels to powerful engagement platforms: omnichannel, mobile payments and maximizing customer value through usage of advanced business analytics.
- III. Keeping the growth momentum in corporate segment while improving profitability, reducing cost of risk, further strengthening position in specialized finance.
- IV. Maintaining operational excellence and strict cost control, through maintaining leading lean and digital operating model, future proofing the IT platform to keep enhancing flexibility, scalability and security.

Main midterm goals to be achieved by Bank Millennium Group by 2017 year include:

- Increase number of retail clients to 1,6 million
- Grow market share of retail customer funds to above 6%
- Grow corporate lending market share to 4%
- Reach ROE level between 13-14%
- Decrease Cost to Income to a range between 45-47%
- Keep Loans to Deposits ratio below 100%

The Bank has approved a dividend policy of distributing between 35% to 50% of net profit what is also subject to regulatory recommendations. Up to the date of publications of financial statements, the Management Board of the Bank has not yet submitted its recommendation regarding 2014 net profit distribution.