

REPORT OF THE BOARD OF DIRECTORS ON THE COMPANY'S BUSINESS ACTIVITY AND ASSETS

Macroeconomic development in the Czech Republic

In 2016 the Czech economy slowed down significantly compared with the previous year. Even so, with a year-on-year growth rate of 2.3%, it ranks among the fastest growing economies in the European Union and, according to various indicators, remains in very good condition. The slowdown was caused by the absence of one-off factors that contributed to record-high economic growth in 2015, namely investment. In 2015, investment was artificially increased by the final drawdown of European funds from the 2007-2013 programming period, all of which had to be paid out by the end 2015. In 2016 the high basis of comparison and a slow emergence of new projects led to investment contributing negatively to economic growth. Personal consumption, on the other hand, remains strong, growing at a stable pace of 2.5% since 2015, thus contributing 1.3% to growth. International trade also showed good results. The balance of trade (goods and services) exhibited a record surplus of CZK 350 billion, contributing 1% to growth.

The supply side of the economy has not changed significantly. Industry continued to be the main driver of growth in 2016, although it grew at a slower rate in 2016, with the manufacturing industry contributing 1.2% to growth (i.e. 0.8 percentage points less than in the previous year). The biggest contributor is the automotive industry, which continued to prosper in 2016, mainly thanks to high demand for new cars in Europe, the destination of the bulk of Czech exports. The growth rate decreased for services as well, and construction production dropped by 5.8%, reducing economic growth by 0.4%. The construction sector was thus hit hardest by the lack of public investment.

The situation in the labour market, too, continues to be positive, with the lowest unemployment in the whole of the European Union. According to the Czech Statistical Office, in the fourth quarter of 2016 the general unemployment rate in the Czech Republic fell to 3.6%, the lowest level in the history of the Czech Republic as an independent country. Conversely, the proportion of employed people is record high, at 72.9%. The number of vacant jobs developed positively as well and keeps growing despite record employment (in 2016 the number of vacancies increased by 25,000 to more than 130,000). The labour market may thus find itself under the natural rate of unemployment, and the lack of workers is driving wage growth. The average wage grew 4.2% year-on-year in 2016. Wages increased primarily for low-income workers, which was largely caused by a hike in the minimum wage.

For the first time in four years, inflation finally reached the Czech National Bank's target level at the end of 2016. This was helped by several factors, in particular by the rising prices of commodities and foods. Core inflation, reflecting not only rising prices at restaurants due to the electronic reporting of sales but, to a certain extent, also wage pressures, started increasing, too. Last but not least, inflation growth is also being fuelled by global prices, which are starting to slowly increase as well.

As inflation growth was very slow during 2016, the Czech National Bank (CNB) had no reason to change its loose monetary policy. The main rate remained at "technical zero" (0.05%) throughout the year, and the CNB did not change its approach to the Czech crown, which it has been keeping from appreciating to above 27 EUR/CZK since November 2013. Growing inflation during the year led to speculation that the intervention regime would end soon and that the Czech crown might subsequently appreciate, which resulted in larger interventions and an increase in foreign exchange reserves. At the end of 2016, the CNB held reserves of EUR 81 billion (47% of GDP).

The fiscal situation continues to be favourable. Government debt as a percentage of the GDP decreased to 37.2% and the Czech Republic remains one of the least indebted countries of the European Union. In 2016, for the first time in 21 years, the Czech Republic posted a budget

surplus (CZK 61.8 billion). The surplus was caused by both higher revenue (better tax collection, incoming EU funds) and lower expenditure (low investment).

2016's favourable economic situation also had an effect on the banking sector. The total volume of loans provided by banks at the end of 2016 rose by 6% year-on-year, to CZK 2,950 billion. Loans to households increased by 7.7% year-on-year, exhibiting a slight slowdown toward the end of the year, when households' demand was affected by the new act on consumer loans and by the CNB's macro-prudential measures restricting the provision of mortgages.

Loans to non-financial businesses, totalling CZK 976 billion at the end of 2016 (up 6% from the previous year), increased as well. 2016 saw a gradual change in the structure of corporate loans in terms of currency. While the volume of crown-denominated loans to non-financial businesses decreased by almost 1% year-on-year, foreign-currency loans grew by 29% in 2016. At the end of 2016, a third of loans to non-financial businesses was denominated in foreign currency. As the end of the CNB's foreign exchange interventions draws near, demand for euro-denominated loans is increasing since they can be used as a form of foreign exchange hedge.

The overall quality of the loan portfolio continued to improve. In 2016 the proportion of non-performing loans decreased by 1 percentage point to 4.8%.

Stress tests performed by the CNB showed that the resilience of the Czech Republic's financial sector to potential adverse shocks is even higher than in 2015.

PPF banka's financial performance in 2016

2016 was another year of excellent performance for PPF banka. Profit after tax in 2016 was CZK 1,204 million. Equity increased by almost 19%, to CZK 8,750 million. Compared with the end of 2015, total assets and receivables from customers grew by 32% and 15%, respectively.

Net interest income remained virtually unchanged year-on-year (2016: CZK 1,808 million; 2015: CZK 1,810 million). The effect of decreasing interest rates is noticeable when comparing the volume of both interest income (-4%) and interest expense (-17%). Net fee and commission income decreased slightly in 2016, to CZK 164 million. In 2016 PPF banka reported a gain from financial operations of CZK 476 million, as compared to CZK 482 million in 2015. The essentially same result in both periods was helped by successful trading in securities.

As in the previous year, total operating income exceeded CZK 2.4 billion.

Losses arising from the impairment of receivables and guarantees decreased to CZK 38 million for 2016. In 2015 these losses amounted to CZK 73 million.

The 6% increase in general administrative expenses for 2016 compared with 2015 is due to a rise in personnel expenses. The massive year-on-year increase of CZK 72 million in other operating expense is caused by a newly introduced resolution fund contribution. The remaining portion relates to the depreciation of assets. The ratio of administrative expenses to total operating income (excluding expenses relating to adjustments) slightly increased, to 31%, as compared with 29% in 2015.

The gross amount of non-performing loans was CZK 4.3 billion, down CZK 384 million from 2015. The non-performing loan ratio currently amounts to 14%, down 3% from the end of 2015. However, this percentage does not accurately reflect the risk borne by PPF banka, as the category of non-performing loans contains loans covered by EGAP insurance. The non-performing loan ratio is calculated based on gross exposure per clients, and EGAP insurance is not considered. After adjusting the volume of non-performing loans for EGAP insurance (for non-performing loans insured by EGAP, the insurance value is deducted from gross exposure), the ratio of non-performing loans to total loans provided equals 4.38%, down 1% from the end of 2015. The actual credit portfolio exposure is thus significantly lower and well below the upper limit defined by the risk appetite.

In 2016 PPF banka generated profit before tax of CZK 1,473 million, down CZK 110 million from 2015. The decrease can be primarily attributed to a rise in operating expenses. Last year PPF banka paid income tax of CZK 269 million.

Receivables from customers increased 15% year-on-year to CZK 29.6 billion, mainly in the non-financial organisation sector.

Cash and balances with central banks totalled CZK 60.0 billion in 2016, as compared with CZK 31.9 billion in 2015. The increase is due to higher deposits from customers.

Deposits from customers are the primary source of financing. The volume of funds in client accounts totalled CZK 103 billion. The massive increase in deposits repayable on demand is attributable to non-resident businesses and the public sector. The year-on-year increase in term deposits is primarily attributable to the public sector segment, as is the decrease in liabilities arising from debt securities. Financial liabilities held for trading increased by CZK 2.5 billion, to CZK 10.5 billion, from the end of 2015.

Return on equity was 14.75% in 2016, and total capital ratio at 31 December 2016 was 15.86%.

PPF banka carried on with its charity projects in 2016 and continues to regard corporate social responsibility as one of its fundamental values.

PPF BANKA'S BUSINESS ACTIVITY IN 2016

PPF banka's activity in the financial markets

In 2016, PPF banka traded in the financial, capital, derivative and foreign exchange markets with the aim of expanding its product portfolio and increasing the volumes of instruments.

With respect to securities, in 2016 PPF banka became the most active dealer in the primary Czech government bond market and came first in the Czech Ministry of Finance's ranking. Of all the primary dealers, PPF banka thus helped the Czech Republic market the highest volume of government bonds (duration weighted), which the Czech Ministry of Finance uses to finance government debt. In the overall ranking (including both the primary and secondary markets), PPF banka came second, an excellent result.

Overview of PPF banka's securities trading volumes:

In CZK billion	2016	2015	2014
Domestic bonds	228.6	161.5	153.2
Foreign bonds	37.4	19.4	77.5
Total bonds	266.0	180.9	230.8
Domestic shares	2.1	0.9	0.7
Foreign shares	6.8	4.0	21.7
Total shares	8.9	4.9	22.4
Total	274.9	185.8	253.2

PPF banka played a key role in the issue of CZK and EUR bonds of Česká telekomunikační infrastruktura (CETIN), acting as the arranger of the entire scheme and the manager of the CZK issue. In terms of volume issued, the CETIN bonds represented the largest euro- and crown-denominated issue effected by a Czech firm as part of corporate financing in 2016. In addition, PPF banka successfully managed the engagement to repurchase the bonds of Home Credit & Finance Bank and PPF Real Estate.

In the foreign exchange market, the traded volume decreased slightly in both the spot and derivatives markets. This was largely caused by the minimal volatility and overall reduced liquidity of the EUR/CZK currency pair. The distribution and timing of the volume of PPF banka's transactions in the foreign exchange market is shown in the table below.

In CZK billion	2016	2015	2014
FX spot	166.7	178.5	173.0
FX derivatives	373.1	425.3	469.3
Total	539.8	603.8	642.3

With respect to interest rate derivatives, PPF banka has expanded primarily in terms of hedging debt instruments for clients, and successfully increased the total volume of interest rate swaps and other instruments.

In CZK billion	2016	2015	2014
IR derivatives	45.0	26.0	14.6

In addition to its trading activity, PPF banka started distributing analytical materials that assess the trends in the financial markets both periodically and on an ad hoc basis.

Public sector

In recent years, PPF banka a.s. has become a major partner of the largest public sector clients. As a result of such partnerships, last year was characterised by new products and services. We successfully implemented payment card acceptance services and started preparing smart city services.

2016 was a record year in terms of performance in this sector; we reported increases in the number of major clients, the volume of liabilities and other key indicators.

We also became proud partners of several major professional conferences and provided financial support to certain non-profit clients.

Our core principles include a tailored approach, expert knowledge, and the ability to listen and seek customised solutions. We will continue to focus on building these values in the coming years, offering our clients a completely different view of banking services.

Corporate banking

In 2016, our corporate banking efforts continued to focus on developing relationships with our key clients in segments in which we have long specialised. These primarily include production/industrial sectors such as engineering, logging, wood processing and energy projects both in the Czech Republic and abroad, as well as domestic wholesale and retail, including e-shopping, and foreign trade activities. We also continued to seek new attractive real estate deals, the share of which has significantly supported our portfolio's growth and stability. In 2016, PPF banka's export and structured finance activities continued to focus on providing services to clients in the Czech Republic, the Commonwealth of Independent States ("CIS") and Central and Eastern Europe. The Bank also provides services to Czech exporters expanding abroad, and helps Czech and foreign investors finance projects and acquisitions. In 2016 the Bank led and entered into a range of major structured finance transactions designed to support its clients' development and acquisition activities.

In 2016, our corporate banking division, which focuses primarily on small and medium-sized enterprises, managed to maintain the prior year's financial performance, thanks to the exceptional effort of all employees of the division, while expanding cooperation with existing clients and selectively acquiring new clients. Our financing continued to help clients grow and achieve excellent results.

All our corporate banking activities were conducted based on a high level of cooperation with our clients, the professionalism of our team and a high-quality product offer, while aiming to maintain the high quality of our loan portfolio.

Private banking for individuals

PPF banka's private banking division specialises in the most demanding private clients. In 2016 we continued to increase the number of satisfied clients and other key parameters. During 2016 our team of experienced private bankers issued various unique products that succeeded in the highly competitive market, thus strengthening the position of both PPF banka and the entire group. Our long-term strategy continues to be based on providing a tailored approach, building mutual trust and focusing on client satisfaction. Our clients' continued interest motivates us to look for additional ways to maximise the quality and range of our services.

Information technology and security

For the IT function, 2016 was a year of advances in processes, infrastructure and key projects. Additional human resources were assigned to IT infrastructure, information security and project management teams.

The autumn of 2016 saw the successful completion of the SEPA project, which aligned the Bank with the standard processing of payments within the single European area. During the year, the project involving the replacement of the client information recording system moved toward the acceptance phase. In accordance with the Bank's overall strategy and its five-year outlook, we focused on defining the key requirements for developing digital interaction with clients, both in terms of functionalities as well as impacts on the Bank's overall IT architecture. At the end of the year, the upgrade of the main banking system was started. Our DWH and BI efforts included, in particular, the development of reconciliation mechanisms and the strengthening of BI governance. Activities related to MIFID 2, EMIR 2, PSD 2 and GDPR passed the initiation phase, with the detailed definition of impacts expected in 2017, followed by the implementation phase (depending on the results).

The Bank's IT infrastructure underwent several significant changes last year, including the planning and subsequent successful relocation of the backup data centre into new premises, which was carried out at the start of 2017. This was accompanied by upgrades of core technologies, and the consolidation and cost optimisation of subscribed data services. Additional successful initiatives included the consolidation of the database environment.

IS/IT security measures included the implementation of a SW licence management system and related processes. To reduce operational risks, we significantly enhanced the system of operational and line controls and expanded monitored services. An extensive review of employees' access rights in all of the Bank's systems was conducted. The Bank also upgraded its monitoring tools and reviewed procedures related to monitoring and assessing operational incidents, which has a positive effect on the reliability of the IT environment's operation.

One major security incident – a one-day outage of internet banking and home banking – occurred last year. Other security incidents and events did not have a significant impact on the Bank and were eliminated as they occurred.

Human resources and personnel strategy

In 2016 the objective of our HR management efforts was to support the overall strategy of PPF banka/PPF Group through the proper recruitment, management, remuneration and development

of all of the Bank's employees, including top management as well as members of the board of directors, supervisory board and committees.

Open communication at all levels, professional corporate culture and mutual trust among employees continue to be our priorities. We strive to encourage efficiency, loyalty and teamwork through our reward and benefit scheme and by following equal opportunity principles.

In 2016, the Bank continued to be a highly sought-after employer for job seekers. The recruitment process is designed to select candidates with the best professional and personal profiles and to maintain staff diversity. We also hire young graduates with no previous work experience.

The average number of employees in 2016 was 217, and the headcount at 31 December 2016 was 219 employees.

Principles of remuneration of the issuer's executives and supervisory board members

Remuneration principles are set in compliance with applicable legislation. They have been determined by the board of directors and approved by the supervisory board. Their definition takes into consideration PPF banka's performance and links to possible risks. Compliance with these principles is reviewed annually by the Internal Audit Department, which reports the findings to the supervisory board and the board of directors.

For 2016, only approved cash remuneration was paid out and no in-kind income was provided.

Fees paid to auditors

Fees paid to the external auditor for services provided in 2016 amounted to CZK 7 million (2015: CZK 6 million). All services of the external auditor related to the audit of the financial statements, annual report, group reporting package, corporate governance report and MiFID report.

Corporate social responsibility

PPF banka has been donating the most to THE KELLNER FAMILY FOUNDATION, which supports, among other things, educational projects for talented pupils and students from socially disadvantaged families and children's homes.

With regard to culture, the Bank, along with PPF Group, financially supports the operation of the Jára Cimrman Theatre, which has been providing joy and humour for 50 years. Another project long supported by us as part of PPF Group is the Summer Shakespeare Festival, a highlight of Prague's summer culture that continues to attract visitors thanks to both the immortal work of William Shakespeare and the beautiful setting of Prague Castle.

Other information

In 2016 and 2015 the Company incurred no expenditure on research and development or environmental protection.

The Company has no branch abroad.

Subsequent events

The Bank's management is not aware of any events subsequent to the balance sheet date that would require adjustment to the annual report.