Capital Adequacy and Risk Management

(Pillar III)

The Group of PKO Bank Polski SA

as at 31 December 2010

INTRODUCTION

The Report "Capital Adequacy and Risk Management (Pillar III)" (the "Report") of the Group of Powszechna Kasa Oszczędności Bank Polski SA (the "PKO Bank Polski SA Group" or the "Group") as at 31 December 2010 was prepared in accordance with the provisions of Article 111a clause 1 of the Act of 29 August 1997 – Banking Law[1] and the requirements set forth in Resolution No. 385/2008 of the Polish Financial Supervision Authority of 17 December 2008 *concerning the detailed principles and manner of publication by banks of qualitative and quantitative information relating to capital adequacy and the scope of required disclosure* ("Resolution No. 385/2008 of the Polish Financial Supervision Authority as amended").

Pursuant to § 6.1 of Resolution No. 385/2008 of the Polish Financial Supervision Authority, Powszechna Kasa Oszczędności Bank Polski SA ("PKO Bank Polski SA", "the Bank") which is the controlling entity within the meaning of § 3 of the Resolution, discloses annually information on its capital adequacy in a separate document, which is published no later than within 30 days of the approval of annual financial statement by the General Shareholders' Meeting.

This Report was prepared in accordance with the Principles of information policy of PKO Bank Polski SA regarding capital adequacy[2], as adopted by the Bank, which contain detailed information on the scope of disclosures concerning capital adequacy, manner of their verification and publication.

The Report covers the year ended 31 December 2010. Unless stated otherwise, the Report includes consolidated data of the PKO Bank Polski SA Group. Since the risk profile of the PKO Bank Polski SA Group is predominantly affected by PKO Bank Polski SA (94.7%[3] of the Group's consolidated balance sheet total and 94%[4] of its consolidated profit/loss on banking activities), some of the information contained in the Report pertains specifically to individual data of PKO Bank Polski SA. Unless stated otherwise, the figures presented in the Report have been expressed in PLN million. Any differences in the totals and proportions result from the rounding off to PLN million and to one decimal place respectively.

The data on capital adequacy as of 31 December 2009 were presented in the report entitled „Capital Adequacy and Risk Management (Pillar III)" of the Group of Powszechna Kasa Oszczędności Bank Polski SA as at 31 December 2009".

This Report has been subject to internal verification by the Bank's internal audit.

1 Journal of Laws 2002, No. 72, item 665 with subsequent amendments.

2 The principles of information policy of PKO Bank Polski SA regarding capital adequacy are available on the Bank's website (www.pkobp.pl).

3 The share of subsidiaries in the consolidated balance sheet total was calculated in relation to the consolidated balance sheet total before consolidation adjustments and exclusions for the year ended 31 December 2010.

4 The share of subsidiaries in the consolidated profit/loss on banking activities was calculated in relation to the consolidated profit/loss on banking activities of the PKO Bank Polski SA Group before consolidation adjustments and exclusions for the year ended 31 December 2010.

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1. INFORMATION ON THE BANK AND THE GROUP

The controlling entity of the Group is PKO Bank Polski SA whose share in the consolidated balance sheet total amounts to 94.7%[3], and in the consolidated profit/loss on banking activities – 94.0%[4].

The Group operates in the Republic of Poland and through its subsidiaries, KREDOBANK SA and UKRPOLINWESTYCJE Sp. z o.o. – in Ukraine and through its subsidiary PKO Finance AB in Sweden.

Beside PKO Bank Polski SA, the PKO Bank Polski SA Group comprises also other subsidiaries; in the subsidiaries of the Bankowy Fundusz Leasingowy SA Group (the "BFL SA Group") and KREDOBANK SA – a significant level of banking risk occurs.

The Bankowy Fundusz Leasingowy SA Group ("BFL SA Group") – together with its subsidiaries – operates in the leasing area in the territory of the Republic of Poland. The share of Bankowy Fundusz Leasingowy SA (together with its subsidiaries) in the consolidated balance sheet total is 1.5%[3], and in the consolidated profit/loss on banking activities – 1.0%[4].

KREDOBANK SA pursues banking operations in the territory of Ukraine and is subject to Ukrainian banking supervision. The share of KREDOBANK SA in the consolidated balance sheet total is 1.0%[3], and in the consolidated profit/loss on banking activities – 1.0%[4].

Other subsidiaries of the Group covered by the consolidation include:
1) PKO BP BANKOWY Powszechne Towarzystwo Emerytalne SA (management of a pension fund),
2) Centrum Finansowe Puławska Sp. z o.o. (management and operation of Centrum Finansowe Puławska),
3) PKO BP Inwestycje Sp. z o.o. (property development activity) – together with its subsidiaries,
4) PKO Towarzystwo Funduszy Inwestycyjnych SA (investment funds' management),
5) Inteligo Financial Services SA (technical servicing of Internet banking) – together with its subsidiary (transfer agent services),
6) Centrum Elektronicznych Usług Płatniczych „eService" SA (handling and settlement of transactions made with the use of cards),
7) Bankowe Towarzystwo Kapitałowe SA (staffing and payroll as well as bookkeeping services for the Group's subsidiaries) – together with its subsidiary (factoring services),
8) Fort Mokotów Inwestycje Sp. z o.o. (property development activity),
9) PKO Finance AB (generating funds for PKO Bank Polski SA from the issue of Eurobonds).

Detailed information on the subsidiaries of the Group, the method of consolidation, and the Bank's interest in the share capital of individual subsidiaries is contained in the consolidated financial statements of the Group of Powszechna Kasa Oszczędności Bank Polski Spółka Akcyjna for the year ended 31 December 2010, published 7 March 2011.

At the consolidation level, own funds of the Group are reduced by the Bank's capital exposure in the following entities:
1) Bank Pocztowy SA and Poznański Fundusz Poręczeń Kredytowych Sp. z o.o. (associated entities valued under the equity method i.e. not subject to consolidation under the full method) which amounted to the total of PLN 131.4 million as at 31 December 2010,
2) Bank Ochrony Środowiska SA and "2020 European Fund For Energy, Climate Change and Infrastructure" (investment securities available for sale and valued at fair value) which amounted to the total of PLN 105.1 million as at 31 December 2010.

At the individual level, own funds of the Bank are reduced by the Bank's capital exposure in KREDOBANK SA, PKO BP BANKOWY PTE SA, PKO TFI SA, BFL SA, PKO Finance AB, Bank Pocztowy SA, Poznański Fundusz Poręczeń Kredytowych Sp. z o.o., Bank Ochrony Środowiska SA and "2020 European Fund For Energy, Climate Change and Infrastructure" amounting to the total of PLN 1,135.2 million as at 31 December 2010. The revaluation write-off of the Bank's credit exposure in KREDOBANK SA amounted to PLN 423.7 million as at 31 December 2010.

Within the PKO Bank Polski SA Group, there are limitations on the transfer of funds (dividends) to the investor between KREDOBANK SA and the Bank. In accordance with the decision of the Extraordinary General Shareholders' Meeting of KREDOBANK SA commenced 29 January 2009 and continued 23 February 2009, a moratorium was introduced with respect to dividend payments. The moratorium is valid until revoked under an appropriate resolution. In 2010 the moratorium on dividend payment remained in force.

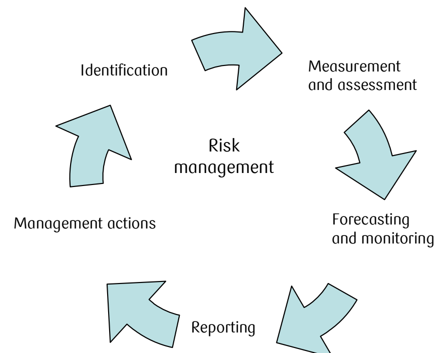
2. RISK MANAGEMENT

Banking activity is exposed to many types of risk, including such as credit, interest rate, foreign exchange, liquidity, price risk of equity securities, operational, compliance, business (including strategic), reputation and derivatives (due to the specific nature of those instruments it is subject to special control) risks. Controlling the effect of those types of risk on the functioning of the PKO Bank Polski SA Group is one of the main objectives of the Bank's and the Group's management, and the risk level is an important factor of the planning process.

Risk management at the Bank is based on the following principles:
1) organisational separation of the risk and debt collection functions from business functions is maintained,
2) risk management is integrated with the planning and controlling systems,
3) the risk and debt collection function supports, on the ongoing basis, the achievement of business objectives while maintaining the acceptable risk level,
4) the risk level is regularly monitored,
5) the risk management model is regularly updated to accommodate new risk factors and sources.

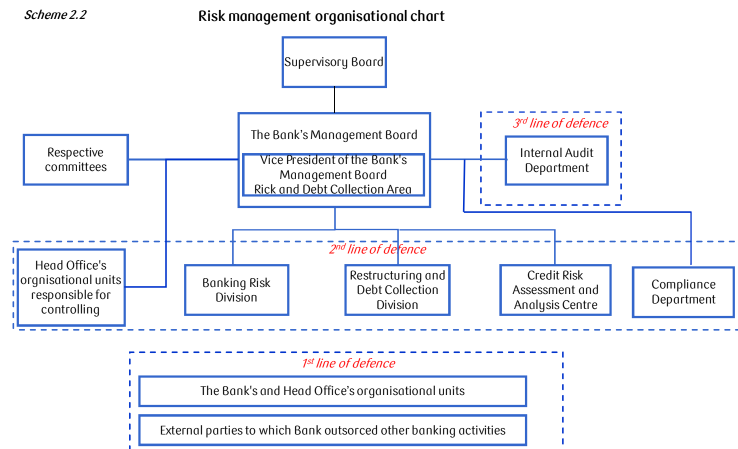
The banking risk management process in the Group includes the following activities:
1) risk identification which consists in defining both current and potential risk sources, which result from the Bank's current and planned activity,
2) risk measurement and assessment – defining risk assessment tools adequate to the type, significance of the risk, data availability and quantitative risk assessment by means of defined tools, as well as risk assessment aimed at identifying the scale or scope of risk, taking into account the achievement of goals of risk management. Within risk measurement, stress-test are being conducted on the basis of assumptions providing a fair risk assessment,
3) risk forecasting and monitoring – consisting in preparation of risk level forecasts and monitoring differences between execution and forecasts or assumed references (e.g. limits, threshold values, plans, previous measurements, issued recommendations and suggestions). Risk monitoring is performed at a frequency appropriate for significance and volatility of a given type of risk,
4) risk reporting – periodic informing the Management of the Bank about the results of risk assessment, taken actions and recommendations. Scope, frequency and the form of reporting is adjusted to the managing level of recipients,
5) management actions – including, among others, issuing internal regulations, establishing the level of risk tolerance, establishing limits and thresholds, issuing recommendations, making decisions about the use of tools supporting risk management. The aim of taking management actions is to form the risk management process and risk level.

Scheme 2.1



The risk management process takes place in the environment that comprises the following:
1) the applied methods and methodologies forming a system of internal regulations,
2) the Bank's IT environment, which permits the flow of information required for risk assessment and control (including central IT systems which support risk assessment, and central databases),
3) internal organisation which includes organisational units, their tasks, scope of responsibilities and mutual relations.

Scheme 2.2 **Risk management organisational chart**



The risk management process is supervised by the Bank's Supervisory Board, which regularly receives information on the risk profile of the Bank and of the PKO Bank Polski SA Group and on the most important activities undertaken within risk management.

The Management Board of the Bank is responsible for the strategic risk management, which includes the supervision and monitoring of activities taken by the Bank within risk management. The Management Board of the Bank takes major decisions affecting the Bank's risk profile and approves internal regulations which define the risk management system.

The risk management process is carried out in three, mutually independent lines of defence:
1) the first line of defence – internal functional control that ensures using risk controls and compliance of the activities with the generally applicable laws. The function is being performed in the organizational Bank's units, the organizational units of the Head Office and the external

entities that are contracted by the Bank to perform actions related to bank activities and it refers to those units and entities that may generate risk;
2) second line of defence – the risk management system, including the risk management methods, tools, process and organisation. This function is performed in particular in the Risk and Debt Collection Area, the Bank's specialist organizational units responsible for credit analyses, the organizational unit of the Head Office managing the compliance risk and as well as the organizational units of the Head Office responsible for controlling;
3) third line of defence – an internal audit. The function performed as part of internal audit, including audit on the effectiveness of the system of managing the risk relating to the Bank's activities.

The independence of the lines of defence consists of preserving organizational independence in the following areas:
1) the function of the second line of defence as regards creating system solutions is independent of the function of the first line of defence,
2) the function of the third line of defence is independent of the functions of the first and second lines of defence,
3) the function of compliance risk management is subordinate directly to the President of the Bank's Management Board.

The Bank's Head Office organizational units that are grouped within in the Banking Risk Division, Restructuring and Debt Collection Division and the Credit Risk Assessment and Analysis Centre manage risk within the limits of competence assigned to them.

The purpose of the Banking Risk Division is to prepare and implement systemic solutions for managing risks that have been defined as significant, such as credit, operational, interest rate, foreign exchange, liquidity and business risk as well as capital adequacy. The most important tasks of the Division consist In:
1) identification of risk factors and sources,
2) risk measurement and assessment and cyclical monitoring and reporting of the risk level,
3) measurement and assessment of capital adequacy,
4) taking decisions and developing recommendations for the Assets and Liabilities Committee and the Management Board of the Bank as to the acceptable risk level,
5) developing internal regulations relating to risk and capital adequacy management,
6) developing IT systems to support risk and capital adequacy management.

The purpose of the Restructuring and Debt Collection Division is to ensure effective and efficient collection and restructuring of bad debts. The most important tasks of the Division consist in:
1) efficient collection of bad debts and increasing the efficiency of such activities,
2) effective early monitoring of late payment of debts by retail clients using telephone contacts and other generally utilized means of communication as well as direct visits at the clients,
3) effective sale of bad debts and outsourcing of its tasks realised as well as effective management of the assets taken over as a result of Bank debt collection.

The purpose of the Credit Risk Assessment and Analysis Centre is to assess and verify the credit risk assessment level of individual credit exposures, which require special attention due to the scale of exposure, client segment or the risk level involved. Due to the implementation of Recommendation T in the Bank, the Credit Risk Assessment and Analysis Centre takes credit decisions in cases of individual clients.

The market and credit risk management at the Bank is supported by the following committees:
1) the Assets and Liabilities Committee ("ALCO"),
2) the Bank's Credit Committee ("BCC"),
3) the Head Office's Credit Committee ("HOCC"),
4) the Operational Risk Committee ("ORC"),
5) credit committees which operate in the regional retail and corporate branch offices.

ALCO and BCC are committees chaired by Vice-President of the Management Board of the Bank who supervises the Risk and Debt Collection Function.

ALCO takes decisions within the scope of its respective competencies and issues recommendations to the Management Board of the Bank as regards interest rate, foreign exchange, liquidity risk and portfolio credit risk management and the Bank's assets and liabilities management.

BCC takes credit decisions in respect of individual significant credit exposures of considerable value or issues recommendations in this respect to the Management Board of the Bank.

HOCC supports with its recommendations decision-taking by relevant managing directors and members of the Management Board of the Bank, while the credit committees operating in the regions support directors of branches and directors of Regional Corporate Branches in relation to issues involving greater risk level.

ORC supports the Bank's Management Board in the operational risk management processes through issuing recommendations, for instance as regards the Management Board of the Bank acceptance of the level of operational risk tolerance, operational risk limits reserved for the competences of the Bank's Management Board, defining operational risk stress tests and other activities related to systemic management of operational risk. ORC participates in the decision making process concerning threshold values and critical key risk indicators (KRI), operational risk limits reserved for the competence of ORC, values of key parameters used for the purpose of calculation of operational value at risk and individual approach to outliers. Moreover, ORC prepares operating risk management recommendations for member subsidiaries of the PKO Bank Polski SA Group, which are submitted to the Group member as part of the Bank's corporate governance.

The Bank supervises the functioning of individual subsidiaries of the PKO Bank Polski SA Group. Within this supervisory function, the Bank defines and approves the subsidiaries' development strategies, also within the scope of risk level; oversees their risk management systems and supports the development of such systems; and also takes the risk level of the activity of individual subsidiaries into account as part of the risk monitoring and reporting system at the Group level.

The priority of the PKO Bank Polski SA Group in 2010 was to keep its strong capital position and increase its financing sources, which together condition a growth of the Bank's credit portfolio.

As a consequence, in 2010, the Bank:
1) continued its activities to obtain new deposits from its clients,
2) in October the Bank received, through its subsidiary - PKO Finance AB, funds in the amount of EUR 800 million from an issue of 5-year EMTN bonds,
3) included in its banking risk measurement methods the financial crisis conditions (such as e.g. the stress test scenarios).

In 2010 the Bank implemented requirements of Recommendation T, in particular the ones related to:
1) separation of sales related functions from functions related to assessment of credit transaction risk,
2) monitoring timely repayments of credits by borrowers who incurred liabilities in other banks,
3) implementation of new principles of assessment of collateral of credit transactions executed with individual clients, taking account of collateral liquidity, value, access and control in a crediting period,
4) introducing an obligation to inform clients about the risk and all costs related with a credit agreement before such agreement is concluded,
5) changes of the client credit score algorithm through an implementation of the applicant's net income debt burden ratio and adding payments under charge cards to credit debts.

The Bank monitors on a cyclical basis the level of banking risk and develops appropriate methods for its measurement.

The competent units of the Banking Risk Division participate in credit risk management in the subsidiaries of the Group, since they prepare opinions on drafts of and periodically review internal provisions of these subsidiaries in relation to credit risk assessment and they prepare recommendations of changes in the draft provisions. The Bank supports implementation of the recommended changes in the credit risk assessment principles in the Group subsidiaries.

The General Shareholders' Meeting of PKO Bank Polski SA in its resolution no 39/2010 dated 23 July 2010 decided that the dividend for 2009 would amount to PLN 2,375 million that is PLN 1.90 gross per share. (Details are presented in the consolidated financial statement of the PKO Bank Polski SA Group for year ended 31 December 2010 on page 54 in section 16 entitled "Paid Dividends (the Total Amount or Per One Share) as Divided into Ordinary and Other Shares").

2.1. Identifying significant types of risks

The significance of individual types of risk is defined in the level of the Bank and the level of particular subsidiaries of the PKO Bank Polski SA Group level.

The following types of risks were deemed to be significant in the Bank:
1) credit default risk,
2) foreign exchange risk,
3) interest rate risk,
4) liquidity risk,
5) operational risk,
6) business risk.

Operational and business risks were considered significant in the Group subsidiaries.

The assessment of significance of the individual types of risks is determined on the level of the Bank and particular subsidiaries of the PKO Bank Polski SA Group level in compliance with the Bank's internal provisions. When determining criteria of classifying a given type of risk as significant, an influence of a given type of risk on the Bank's as well as on a given entity's of the Group and the whole Group`s activities is are taken into account and there are three types of risk are recognised:
1) considered as significant a priori – being managed actively,
2) potentially significant risks – performed for which significance monitoring is being made,
3) other non-defined or non-occurring in the Bank types of risk (insignificant and non-monitored).

Based on quantitative and qualitative information, an assessment of significance of given types of risk is performed in the Bank periodically. As a result of assessment, a given type of risk is being classified as significant/insignificant. A similar assessment is conducted periodically in the subsidiaries of the Group. In particular, monitoring is conducted if significant change in activities took place or the profile of the Bank or the Group changed.

2.2. Credit risk

2.2.1. Introduction

Credit risk is understood as the risk of incurring losses as a result of counterparty default in the settlement of liabilities towards the bank or the risk of decrease in the economic value of the bank's receivables as a result of deterioration of the client's ability to service its liabilities.

The purpose of credit risk management is to limit losses arising from the credit portfolio and minimize risk of occurrence of credit exposures which may be subject to impairment, while maintaining the expected level of profitability and value of the credit portfolio.

The Bank and the subsidiaries of the Group apply the following credit risk management principles:
1) a credit transaction requires a comprehensive credit risk assessment, expressed in the internal rating or scoring,
2) credit risk measurement of credit transactions is made at the stage of consideration of the loan application and on a cyclical basis as part of monitoring, and takes into account both the changing external conditions and changes in the financial standing of the borrowers,
3) the credit risk assessment of exposures significant for reasons of their risk level or value is additionally verified by credit risk assessment units, irrespective of business units,
4) the terms and conditions of credit transactions offered to clients depend on the assessment of credit risk level generated by the transaction concerned,
5) credit decisions may be taken only by authorised persons,
6) credit risk is diversified by geographical areas, industries, products and clients,
7) the expected level of credit risk is secured by legal collateral accepted by the Bank, credit spreads charged to clients as well as by provisions for impairment of credit exposures.

The application of the above principles is ensured by the fact that the Bank uses advanced methods of credit risk management both at the level of individual credit exposures and at the level of the entire credit portfolio of the Bank. The methods are verified and developed for compliance with the requirements of the internal rating based (IRB) approach, i.e. an advanced method of measuring credit risk, which may be

used to calculate the capital requirement for credit risk following the obtaining by the Bank of the Polish Financial Supervision Authority's approval.

The project of internal rating based (IRB) approach implementation was launched in the Bank for this purpose. In 2010 the works of the project focused on:
1) establishment and validation of models of portfolio risk parameters for the Bank's main rating systems,
2) introduction of respective internal provisions that governing the definition of default, risk parameter assessment and updating process, rating system reviews and validations,
3) an extension of the scope of use of risk parameters for the purpose of credit risk management (e.g. in the field of reporting, internal capital assessment).

2.2.1.1. Credit risk of financial institutions

PKO Bank Polski SA cooperates on the wholesale market with financial institutions having their registered offices in the territory of nearly 50 countries. Within the limits set, the Bank may enter into transactions with over 200 counterparties, including Polish and foreign banks, insurance subsidiaries, pension funds and investment funds subsidiaries. The transactions made include loan and deposit transactions, securities transactions, foreign exchange operations and derivative transactions.

The Bank monitors the financial standing of its counterparties on an ongoing basis and sets exposure limits adequate to the risk incurred for pre-settlement and settlement exposures of individual counterparties. The integral tools for the management of credit risk of financial institutions are framework agreements signed with counterparties on the basis of ISDA and the PBA standards. The exposure to financial institutions on the wholesale market is of high quality and low credit risk generated, as confirmed by external ratings granted by rating agencies and also by internal ratings granted to the counterparties by the Bank.

2.2.1.2. Derivatives risk

The derivatives risk is a risk of incurring losses arising from the Bank taking up a position in financial instruments which meet all of the following conditions:
1) the value of an instrument changes with the change of the underlying instrument,
2) it does not require any initial net investment or requires only a small initial net investment compared with other types of contracts which similarly respond to changes in market terms,
3) it is to be settled at a future date.

The derivatives risk integrated with the process of other risks management, however, due to the specific nature of derivatives it is subject to special control specified in the internal regulations of the Bank.

During the course of its business activity, the Bank uses various types of financial derivatives to manage the risk resulting from the conducted business activity. The Bank enters into derivative transactions mainly with other banks.

The majority of derivatives used by the Bank for the purpose of risk management and offered to clients are: IRS, FRA, FX Swap, CIRS, FX Forward, FX options (table 2.1).

Table 2.1

FINANCIAL DERIVATIVES*

	The PKO Bank Polski SA Group			
	2010			
	Nominal value		Fair value	
	Purchase	Sale	Negative	Positive
Currency transactions (over-the-counter market)	35 937	36 975	840	253
FX Swap	8 874	8 893	84	62
FX Forward	3 689	3 733	43	18
Options	4 365	4 389	25	46
Cross Currency IRS	19 009	19 960	688	126
Interest rate transactions	197 974	199 162	1 564	1 459
Interest Rate Swap (IRS)	152 358	152 358	1 553	1 447
Forward Rate Agreement (FRA)	45 616	46 804	11	12
Credit Default Swaps	0	0	0	0
Other (including stock market index derivatives)	2 234	2 237	1	7
Total derivatives	236 145	238 373	2 405	1 719

*Nominal values of underlying instruments and fair value of derivative financial instruments.

A derivative becomes an asset if its fair value is positive and it becomes a liability if its fair value is negative.

The fair value of financial instruments that are traded on the market is their market price. In other cases, such instruments' fair value is the fair value determined based on the valuation model for which input data was taken for which data has been collected from an active market. Valuation techniques applied are based, among other things, on models of discounted cash flows, option models and yield curves.

In order to assess capital requirements for derivatives (credit risk and counterparty credit risk) the Bank uses the mark-to-market valuation method.

In the Bank there are embedded derivatives that are elements of concluded financial and non-financial agreements and the whole or part of cash flows related to such agreements changes in a way similar to an independent derivative.

2.2.2. Credit risk measurement and assessment

2.2.2.1. Credit risk measurement methods

In order to assess the level of credit risk and credit portfolio profitability, the Bank uses various credit risk measurement and assessment methods, including the following:
1) probability of default (PD),
2) expected loss (EL),
3) credit value at risk (CVaR),
4) accuracy ratio,
5) share and structure of irregular loans (according to IAS),
6) coverage ratio of credits with impairment recognized with write offs,
7) risk cost.

The Bank systematically extends the scope of its credit risk measures, taking into account the requirements of the IRB approach, as well as the scope of application of risk measures so as to fully cover the Bank's credit portfolio with those methods.

The portfolio credit risk measurement methods allow, among other things, to include credit risk in the price of products; to determine the optimum amount of cut-off points; and to determine rates for making impairment write-offs.

The Bank carries out analyses and stress tests of the impact of potential changes in its macroeconomic environment on the Bank's credit portfolio quality and reports the results thereof to the Bank's Management. The aforementioned information makes it possible to identify the negative effects of unfavourable market conditions on the Bank's result and to take action to limit such effects.

2.2.2.2. Rating and scoring methods

Risk assessment of individual credit transactions is made by the Bank using scoring and rating methods developed, enhanced and supervised by the Banking Risk Division. The functioning of those methods is supported by specialised IT applications. The manner of credit risk assessment is defined in the Bank's internal regulations whose main purpose is to ensure uniform and objective credit risk assessment in the process of awarding credit facilities.

The Bank assesses credit risk for individual clients at two levels: client's borrowing capacity and creditworthiness. Client's borrowing capacity assessment consists in verifying the financial standing of a prospective borrower, while creditworthiness assessment covers the client score and credit history obtained from the Bank's internal records and from external databases.

In 2010, the Bank continued to develop the aforementioned principles of credit risk assessment for individual clients, in particular with respect to validation of scoring models dedicated to SME clients.

Credit risk assessment for institutional clients is conducted at two levels: the level of the client and of the transaction. The assessment is expressed in the following ratings: of the client and of the transaction. The synthetic measure of credit risk, reflecting both risk factors, is the joint rating. As of 1 September 2010 the Bank implemented the scoring method of for credit risk evaluation of clients in the SME segment, and a dedicated software application. In case of those clients, there is the scoring method besides the rating method and within the scope of the scoring method the Bank assesses credit risks on two levels: client's borrowing capacity and creditworthiness.

The introduction of the scoring method for SME clients resulted in a reduction of time of credit application examination and an increase of credit risk management efficiency.

The rating and scoring information is used widely by the Bank in the process of credit risk management, within the system of competencies in the area of credit decisions, when determining the criteria for activation of the credit risk assessment units, and within the system for credit risk measurement and reporting.

In order to reduce the response time to the observed warning signs signalling an increase of the credit risk level, in August 2010 the Bank implemented IT application of the Early Warning System (EWS). In 2010, the Bank improved solutions with respect to the functioning of the Early Warning System (EWS) and prepared support for this system in the form of a dedicated IT application.

2.2.3. Monitoring of credit risk

2.2.3.1. Exposure amount

Table 2.2 shows the balance sheet and off-balance sheet items taken into account in the calculation of capital adequacy of the PKO Bank Polski SA Group as at 31 December 2009 and 31 December 2010.

Table 2.2

	The PKO Bank Polski SA Group		
	2010	2009	Average
ASSETS	169 661	156 479	163 070
Net credits and loans*	130 668	116 573	123 620
Securities	22 481	22 528	22 505
Receivables from banks	2 307	2 023	2 165
Financial fixed assets	173	229	201
Other assets**	14 031	15 126	14 579
OFF-BALANCE SHEET LIABILITIES	36 785	32 882	34 834
Financial	29 505	27 385	28 445
Guarantees granted	7 280	5 497	6 389
DERIVATIVES***	474 518	335 425	404 972

* Including financial lease receivables.
** Including: cash, funds at the National Bank of Poland, valuation of financial derivatives, fixed assets for sale, inventories, intangible assets, tangible fixed assets, current and deferred tax receivables and assets, other assets.
*** Nominal value.

The instruments that generate the biggest credit risk for the Group include credits and loans granted as well as off-balance sheet financial liabilities (mainly unused credit facilities).

Table 2.3

CREDITS AND LOANS* - STRUCTURE BY PORTFOLIO

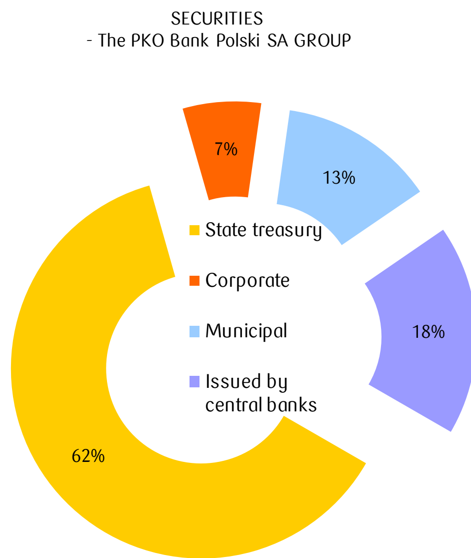
The PKO Bank Polski SA Group

	2010	2009
Net credits and loans	130 668	116 573
consumer loans	24 129	22 296
housing loans	61 696	51 938
corporate loans	44 843	42 338

* Including financial lease receivables.

A much smaller credit risk level of the Group is related to derivatives, interbank deposits and the Group's holdings of securities (of which 80% are securities issued by the Treasury or the central banks).

Chart 2.1



In 2010, the greatest proportion of the exposure structure of the Group was accounted for by retail and corporate exposures (59.4 % in total). The proportions of other exposure classes range between 0.0% to 15.3% (Table 2.4).

Table 2.4

Exposure class*	The PKO Bank Polski SA Group 2010 Total exposure**	Average exposure**
Retail	54 341	61 380
Corporate	52 004	47 220
Central governments and central banks	20 692	22 109
Secured on real estate property	27 399	20 078
Other exposures	10 853	10 141
Institutions (banks)	7 202	7 075
Regional governments and local authorities	3 801	3 486
Past due	2 726	2 763
Administrative bodies and non-commercial undertakings	0	477
Other classes***	86	87
Total	179 105	174 815

* Pursuant to § 20 of Appendix no 4 to Resolution no 76/2010 of PFSA as amended.
** The value of balance sheet exposures and balance sheet equivalents of liabilities and off-balance sheet transactions before application of the credit risk mitigation techniques. The average amount of exposure has been calculated as the arithmetic mean of exposures from individual quarters of 2010.
*** Includes: exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.

A considerable proportion of the Group's exposures with defined maturity date (86%) are exposures with the original maturity of over 1 year; for over 70.5 % of exposures with fixed maturity date the original maturity exceeds 5 years (Table 2.5).

Table 2.5
EXPOSURE STRUCTURE* BY ORIGINAL MATURITY

The PKO Bank Polski SA Group 2010

Exposure class	PKO BP SA, KREDOBANK SA and the BFL SA Group: 0 - 1 month	1 - 3 months	3 - 12 months	1 - 5 Years	Over 5 years	Other***	Other Group subsidiaries	Adjustments and exclusions	Total
Retail	1	1	7 611	8 313	36 913	1 501	0	0	54 341
Corporate	10	109	13 626	14 063	25 526	451	355	-2 137	52 004
Central governments and central banks	0	7	154	94	17 751	2 512	174	0	20 692
Secured on real estate property	1	0	232	366	26 800	0	0	-1	27 399
Other exposures	0	0	18	8	531	10 385	1 110	-1 198	10 853
Institutions (banks)	227	59	166	1 095	2 312	3 624	3 466	-3 747	7 202
Regional governments and local authorities	1	2	84	403	3 311	0	0	0	3 801
Past due	5	15	411	933	1 475	99	0	-211	2 726
Administrative bodies and non-commercial undertakings	0	0	0	0	0	0	0	0	0
Other classes**	0	0	0	0	0	258	25	-197	86
Total	244	192	22 304	25 276	114 619	18 831	5 129	-7 490	179 105

* The value of balance sheet exposures and balance sheet equivalents of liabilities and off-balance sheet transactions before application of the credit risk mitigation techniques.
** Includes: exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.
*** Includes items with unspecified maturity (e.g. fixed assets, stocks).

2.2.3.2. Impairment of credit exposures

The PKO Bank Polski SA Group reviews each month its credit exposures to identify credit exposures threatened with impairment; measures the impairment of its credit exposures; and establishes write-offs and provisions. The process of establishing write-offs and provisions comprises the following stages:

1) identification of the conditions of impairment and of events material for such identification,

2) recording in the Bank's IT systems of events material for identification of the conditions of impairment of credit exposures,
3) definition of the method for impairment measurement,
4) measuring the impairment and deciding on a write-off or provision,
5) verification and aggregation of the impairment measurement findings,
6) recording of the impairment measurement findings.

The method for defining the amount of the write-offs depends on the type of impairment conditions identified and the individual importance of the credit exposure concerned. The following events are specifically treated as the conditions of individual impairment:
1) delay in loan repayment of at least 3 months,
2) significant deterioration of a client's internal rating,
3) conclusion of a restructuring agreement or applying concessions as regards debt repayment (a premise is identified if facilities granted to a client have been imposed by economic or legal factors resulting from the client's financial problems).

In determining the period of delay in loan repayment, the outstanding amounts of interest or principal instalments above defined threshold values are taken into account.

The PKO Bank Polski SA Group uses three methods for impairment assessment:
1) the individualised method for individually significant loans which meet the condition of individual impairment or which require individual assessment due to the specific nature of a transaction from which they result and events that condition repayment of an exposure,
2) the portfolio method, applied in the case of individually insignificant loans for which the condition of individual impairment has been identified,
3) the collective method (IBNR), used in the case of loans where no conditions of individual impairment have been identified, but there is the possibility of occurrence of incurred but not identified losses.

The write-off for impairment of the balance sheet value of a credit exposure is the difference between the balance sheet value of that exposure and the current value of the expected future cash flows from that exposure:
1) when defining the write-off under the individualised method, the expected future cash flows are assessed for each credit exposure individually, the possible scenarios of performance of the agreement taken into account and weighed with the probability of their fulfilment,
2) the write-off for credit exposure impairment defined under the portfolio or collective method equals the difference between the balance sheet value of those exposures and the current value of the expected future cash flows, assessed with statistical methods on the basis of historical monitoring of exposures from homogeneous portfolios.

The provision for off-balance sheet credit exposures is established in the amount equal to the expected (assessable) loss of economic benefits resulting from such exposures.

When defining the provision for off-balance sheet credit exposures of the PKO Bank Polski SA Group:
1) with respect to individually significant credit exposures that are unconditional off-balance sheet liabilities and meet the conditions of individual impairment or pertaining to debtors whose other exposures meet such conditions – the individualised method is used,
2) with respect to the remaining off-balance sheet credit exposures – the portfolio method (if the exposure meets the conditions of individual impairment) or the collective method (if the exposure meets only the conditions of collective impairment).

The provision is set as the difference between the expected value of the balance sheet exposure to arise from the off-balance sheet liability awarded (from the date as at which assessment is made to the date of occurrence of the overdue debt that is identified as the condition of individual impairment) and the current value of the expected future cash flows generated from the balance sheet exposure arising from the awarded liability.

When determining the provision under the individualised method, the expected future cash flows are assessed for each credit exposure individually.

When determining the provision under the portfolio or collective method, portfolio parameters are used that are assessed by means of statistical methods on the basis of historical exposures of the same characteristics.

The structure of the credit portfolio and of established write-offs for credit exposure impairment of the Group is shown in Table 2.6. In 2010, the gross value of loans granted by the Group valued under the individualised method increased by PLN 308 million, while valued using the portfolio method – by PLN 1,236 million.

The increase in the value of loans valued under the individualised method by 4.9% as of 31 December 2010 resulted from the fact that the individualised method covered entities with significant exposures against the Bank mainly due to delays in payments up to over 3 months and intensified restructuring activities. The catalogue of impairment conditions applicable in the Bank complies with Recommendation R.

The increase in the value of loans valued under the portfolio method by 32.9% in 2010 resulted mainly from bigger delays in the repayment in the portfolio of consumer and housing loans extended to individual clients.

Table 2.6

CREDITS AND LOANS*

The PKO Bank Polski SA Group

	2010	2009
Gross credits and loans	135 525	120 510
individualised method	6 562	6 254
portfolio method	4 988	3 752
collective method (IBNR)	123 974	110 503
Write-offs (balance)	-4 857	-3 937
individualised method	-1 766	-1 366
portfolio method	-2 593	-1 990
collective method (IBNR)	-498	-582
Net credits and loans (gross-write-off)	130 668	116 573

* Including financial lease receivables.

The result of impairment write-offs is a consequence of the conservative policy of PKO Bank Polski SA in regard of credit risk recognition and assessment and of an increase of the credit base. The growth of the impairment write-offs in 2010 in the amount of PLN 920 million in line "Credit and loans" was influenced mainly by a change of write-offs in economic credits in the amount of PLN 520 million. The result of write-offs increased as a consequence of the deterioration of the credit portfolio quality. Impairment write-offs on the exposures in the other groups had an insignificant impact on the profit and loss account (table 2.7).

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Table 2.7

IMPAIRMENT WRITE-OFFS

The PKO Bank Polski SA Group

	Balance as at		Change in	Additional write-offs	Release of write-offs	Depreciation chargd to write-offs	Other changes, including FX differences	Cost of write-offs input to profit and loss account
	2010	2009	2010					
Credits and loans*	4 857	3 937	920	4 360	-2 614	-870	43	-1 746
consumer loans	1 514	1 363	151	1 729	-915	-668	5	-814
housing loans	983	735	249	797	-528	-44	24	-269
corporate loans	2 360	1 840	520	1 834	-1 170	-158	14	-664
Receivables from banks	29	27	2	1	0	0	1	-1
Financial instruments	82	27	55	63	-7	-1	0	-56
Other	469	458	11	299	-234	-42	-12	-65
Total	5 436	4 449	988	4 723	-2 854	-913	32	-1 868

*Including financial lease receivables.

The coverage ratio amounted to 43.2% as at 31 December 2009 and to 44.6% as at 31 December 2010 (table 2.8).

Table 2.8

EXPOSURES WITH RECOGNISED IMPAIRMENTS AND TOTAL WRITE-OFFS

The PKO Bank Polski SA Group

	2010	2009
Exposures with recognised impairment	11 069	9 316
receivables from banks	29	27
credits and loans*	10 887	9 108
debt securities (AFS)	21	21
other financial assets	132	160
Write-offs (balance)**	-5 032	-4 122
receivables from banks	-29	-27
credits and loans*	-4 857	-3 937
debt securities (AFS)	-21	-19
other financial assets	-125	-139

* Including financial lease receivables.

** Apply to exposures with recognised impairment. For credits and loans with respect to which the IBNR method has been applied, the write-offs pertain also to exposures without recognised impairment.

Table 2.9

Geographical structure of credits and loans* and revaluation write-offs
Grupa PKO Banku Polskiego SA
2010

Region	With recognised impairment **	
	Exposure	Impairment write-offs
Poland (PKO Bank Polski, Grupa BFL)***, of which:	9 490	3 786
mazowiecki	2 185	867
śląsko-opolski	1491	602
małopolsko-świętokrzyski	994	328
zachodniopomorski	898	526
łódzki	656	255
podlaski	446	67
pomorski	563	183
wielkopolski	591	233
dolnośląski	462	220
kujawsko-pomorski	620	199
lubelsko-podkarpacki	290	104
warmińsko-mazurski	184	91
Poland (other subsidiaries)	230	78
Ukraine (Kredobank)	1 179	378
Adjustments, exclusions and IAS receipts	99	228
Total	10 887	4 359

* Including financial lease receivables.
** Applies to exposures with identified condition of individual impairment (without IBNR).
*** The totals include IAS receipts in the amount of ca. 111 million.

Table 2.10

Structure of credits and loans* and revaluation write-offs by industry
The PKO Bank Polski SA Group
2010

	Type of client/branch	With recognised impairment**	
		Exposure	Impairment write-offs
	Institutional clients, of which:	9 379	3 675
D	Industrial processing	177	177
G	Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household appliances	394	83
K	Real property maintenance, rental and services related to pursuit of business activity	2	1
F	Construction	120	24
L	Public administration and national defence, obligatory social security and public health insurance	142	6
E	Generation and supply of power, gas and water	1	0
	Other exposures	5 146	1 463
	Banks	0	0
	Governments	7	6
	Individuals	3 390	1 915
	Poland (other subsidiaries)	230	78
	Ukraine (Kredobank)	1 179	378
	Adjustments, exclusions and IAS receipts	99	228
	Total	10 887	4 359

* Including financial lease receivables.
** Applies to exposures with identified condition of individual impairment (without IBNR).

2.2.3.3. Risk concentration

The Bank monitors the credit risk concentration in respect of:
1) exposures to individual clients or groups of related clients,
2) exposures to groups of clients or credit portfolios exposed to a single risk factor.

In particular, the Bank monitors credit portfolios by:
1) geographical region,
2) loan currency,
3) industry sector,
4) mortgage-backed exposure,
5) largest entities,
6) largest capital groups.

The risk of concentration of exposures to individual clients or groups of related clients is monitored pursuant to Article 71 of the Banking Law in respect of:
1) the exposure concentration limit (the total amount of individual exposure may not exceed 25% of the Bank's own funds in the case of entities not related to the Bank and 20% of own funds in the case of entities related to the Bank),
2) the large exposure limit (the sum of individual exposures in excess of 10% of the Bank's own funds may not exceed 800% of the Bank's own funds).

As at 31 December 2010, the level of concentration risk of the PKO Bank Polski SA Group for individual exposures was rather low, the largest exposure to an individual entity not exempt from the exposure concentration limit amounting to 5.1 % of consolidated own funds.

Table 2.11

EXPOSURE TOWARDS THE 10 BIGGEST CLIENTS*

The PKO Bank Polski SA Group

No	2010		2009	
	exposure	% own funds	exposure	% own funds
1	891	5,1%	2 698**	15,1%
2	819	4,6%	844	4,7%
3	800	4,5%	802	4,5%
4	645	3,7%	645	3,6%
5	613	3,5%	636	3,6%
6	568	3,2%	585	3,3%
7	530	3,0%	500	2,8%
8	486	2,8%	475	2,7%
9	394	2,2%	447	2,5%
10	340	1,9%	420	2,3%
Total	6 086	34,5%	8 052	45,0%

* Total (balance sheet and off-balance sheet) exposure to non-banking sector clients for comparison to the exposure concentration limit.

**Exposure to entities exempt from the exposure concentration limit under Article 71 clause 3 of the Banking Law.

As at 31 December 2010 the biggest concentration of exposure of the PKO Bank Polski SA Group in the group of subsidiaries amounted to 6.7% of its consolidated own funds (entities not exempt from the exposure concentration limit).

Table 2.12

EXPOSURE TOWARD THE 5 BIGGEST CAPITAL GROUPS*

	The PKO Bank Polski SA Group			
	2010		2009	
No	exposure	% own funds	exposure	% own funds
1	1 183	6,7%	1 440	8,1%
2	899	5,1%	1 356	7,6%
3	872	4,9%	1 078	6,0%
4	849	4,8%	737	4,1%
5	690	3,9%	678	3,8%
Total	4 492	25,5%	5 288	29,6%

* Total (balance sheet and off-balance sheet) exposure to non-banking sector clients for comparison to the exposure concentration limit.

As at 31 December 2010, the sum of large exposures of the Group amounted to 0% of consolidated own funds, as compared to the limit of 800% of own funds.

The credit concentration risk in respect of geographical regions is monitored for:

1) financial institutions – by the country of origin of the counterparty's head office,
2) for other clients – by regional division of the Bank's organisational units extending the loan.

In order to ensure geographical diversification of the Bank's exposures to financial institutions, the Bank applies limits of joint exposure for individual countries.

As at 31 December 2010, there was no significant geographical concentration level in the Group's credit portfolio (Table 2.13). The KREDOBANK SA portfolio of loans extended to Ukrainian clients accounted for approx. 1.14% of the Group's total portfolio.

Table 2.13

GEOGRAPHICAL STRUCTURE OF EXPOSURES*

The PKO Bank Polski SA Group

2010

Country/region	No of exposure class**										Total
	A	B	C	D	E	F	G	H	I	Other***	
Poland, of which:	54 140	53 151	20 365	27 204	10 667	4 484	3 801	2 421	0	258	176 492
mazowiecki	9 985	11 186	81	3 087	340	38	282	64	0	0	25 062
śląsko-opolski	8 356	5 947	3	2 892	8	0	519	28	0	0	17 753
wielkopolski	4 195	5 363	0	4 671	21	0	312	27	0	0	14 591
małopolsko-świętokrzyski	4 981	4 816	53	2 741	9	0	609	12	0	0	13 223
dolnośląski	4 996	3 547	2	1 690	5	0	469	21	0	0	10 730
lubelsko-podkarpacki	3 387	3 160	2	2 793	50	0	288	45	0	0	9 725
zachodniopomorski	2 847	3 148	5	2 702	48	0	237	14	0	0	9 001
łódzki	3 134	3 592	0	1 663	1	0	454	19	0	0	8 863
pomorski	3 399	3 533	0	1 595	2	0	160	16	0	0	8 705
kujawsko-pomorski	2 799	2 437	230	1 348	6	0	166	19	0	0	7 004
warmińsko-mazurski	1 962	1 919	73	1 158	0	0	101	15	0	0	5 228
podlaski	1 726	2 298	9	461	7	0	75	31	0	0	4 606
Other ****	2 373	2 205	19 907	402	10 170	4 446	128	2 111	0	258	42 000
Ukraine	123	449	153	101	275	452	0	514	0	0	2 067
United Kingdom	47	0	0	78	0	677	0	1	0	0	804
France	2	0	0	1	0	490	0	0	0	0	493
Italy	2	0	0	1	0	396	0	0	0	0	399
Germany	8	1	0	5	0	310	0	0	0	0	323
Austria	1	0	0	1	0	275	0	0	0	0	277
USA	3	0	0	1	0	146	0	0	0	0	150
Norway	1	124	0	1	0	6	0	0	0	0	132
Denmark	0	0	0	0	0	112	0	0	0	0	112
Cyprus	0	51	0	0	0	0	0	0	0	0	52
Other	12	8	0	8	0	136	0	1	0	0	165
Total (PKO BP SA, KREDOBANK SA and the BFL SA Group)	54 341	53 785	20 519	27 400	10 942	7 483	3 801	2 937	0	258	181 466
Other subsidiaries	0	355	174	0	1 110	3 466	0	0	0	25	5 129
Adjustments and exclusions	0	-2 137	0	-1	-1 198	-3 747	0	-211	0	-197	-7 490
Total	54 341	52 004	20 692	27 399	10 853	7 202	3 801	2 726	0	86	179 105

*The value of balance sheet exposures and the balance sheet equivalent of liabilities and off-balance sheet transactions before application of the credit risk mitigation technique.

** A - retail exposures,
B - corporate exposures,
C - exposures to central governments and central banks,
D - exposures secured on real estate property,
E - other exposures,
F - exposures to institutions (banks),
G - exposures to regional governments and local authorities,
H - past due exposures,
I - exposures to administrative bodies and non-commercial undertakings.

***Includes: exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.

****Exposures managed at the Head Office level include the following, among other items: cash, tangible fixed assets, intangible assets, assets from securities valuation, securities.

The credit concentration risk is monitored also with respect to industry sectors determined based on the PCBA (Polish Classification of Business Activity), maintained for institutional clients. In the case of industry sectors with higher risk levels, the Bank applies limits restricting its exposure to those sectors.

As at 31 December 2010, there was no significant credit concentration level with respect to industry sectors (Table 2.14).

Table 2.14

EXPOSURE STRUCTURE BY INDUSTRY*

Type of client/branch		The PKO Bank Polski SA Group 2010 – No. of exposure class**										Total
		A	B	C	D	E	F	G	H	I	Other***	
Institutional clients, of which:		0	44 845	0	1 298	447	0	3 673	1 521	0	0	51 785
D	Industrial processing	0	12 030	0	155	32	0	0	470	0	0	12 688
G	Wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household appliances	0	6 096	0	270	0	0	0	321	0	0	6 687
K	Real property maintenance, rental and services related to pursuit of business activity	0	6 132	0	126	0	0	0	156	0	0	6 414
F	Construction	0	3 278	0	118	0	0	0	140	0	0	3 536
L	Public administration and national defence, obligatory social security and public health insurance	0	5	0	0	0	0	2 975	0	0	0	2 980
E	Generation and supply of power, gas and water	0	1 758	0	22	385	0	0	38	0	0	2 203
	Other exposures	0	15 547	0	606	31	0	697	395	0	0	17 277
Banks		0	0	0	0	0	7 482	0	0	0	0	7 482
Governments		0	0	20 519	0	0	0	0	0	0	0	20 519
Individuals		54 315	7 031	0	26 101	0	0	0	1 304	0	0	88 751
Other***		26	1 909	0	0	10 494	0	128	112	0	258	12 929
Total (PKO BP SA, KREDOBANK SA and the BFL SA Group)		54 341	53 785	20 519	27 400	10 942	7 483	3 801	2 937	0	258	181 466
Other subsidiaries		0	355	174	0	1 110	3 466	0	0	0	25	5 129
Adjustments and exclusions		0	-2 137	0	-1	-1 198	-3 747	0	-211	0	-197	-7 490
Total		54 341	52 004	20 692	27 399	10 853	7 202	3 801	2 726	0	86	179 105

*The value of balance sheet exposures and the balance sheet equivalent of liabilities and off-balance sheet transactions before application of the credit risk mitigation technique.

** A - retail exposures,
B - corporate exposures,
C - exposures to central governments and central banks,
D - exposures secured on real estate property,
E - other exposures,
F - exposures to institutions (banks),
G - exposures to regional governments and local authorities,
H - past due exposures,
I - exposures to administrative bodies and non-commercial undertakings.

***Includes: exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.

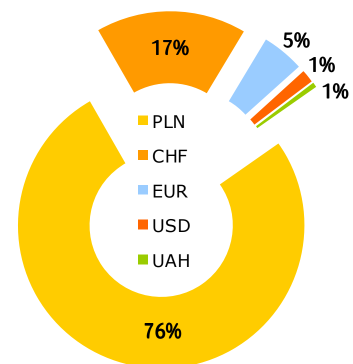
****Exposures managed at the Head Office level include the following, among other items: securities, other assets.

As at 31 December 2010, the share of exposures in currencies other than PLN in the Group's total portfolio amounted to 23.6%. The biggest portion of the Group's currency exposure is the exposure in CHF pertaining to the Bank's credit portfolio. The situation is different in the case of the subsidiaries of the Group, i.e. exposures in EUR prevail in the currency portfolio of the BFL SA (74.1% of the currency portfolio), while in KREDOBANK SA – loans extended in USD account for approximately 78.0% of the currency portfolio and 40.8% of the total portfolio of the subsidiary.

The 2010 drop in the share of loans denominated in foreign currencies resulted from concentration of the new sales of housing loans in the Polish currency.

Chart 2.2

CURRENCY STRUCTURE
OF THE CREDIT PORTFOLIO
The PKO Bank Polski SA GROUP



2.2.3.4. Monitoring of derivatives

Contracts including embedded derivatives are monitored by the Bank in addition, separated embedded derivatives are subject to periodic valuation.

Derivatives intended for separation from major contracts and separate recognition in the books of account are valued at their fair value. Their valuation is presented in the balance sheet in the line entitled "Financial derivatives". The changes in valuation of the fair value of derivatives are referred to in the profit and loss account in the line entitled "Result of financial instruments valued at fair value".

The separated embedded derivatives were not a significant risk factor for the Bank in 2010.

As at 31 December 2010 the Bank had signed general agreements in ISDA/PBA standards with 26 polish banks and 45 foreign banks and credit institutions. Moreover, the Bank was a party of 45 CSA agreements / PBA Collateral Agreements facilitating collateralisation of exposures related to derivatives and 3 ISMA/GMRA agreements enable to set off liabilities resulting from REPO and BSB/SBB transactions. The coverage ratio of the nominal value of transactions on involving derivatives with Framework Agreements and Collateral Agreements/CSA was 99.7% and 95.4% respectively.

The positive gross fair value of contracts with financial institutions as at 31 December 2010 was PLN 1.67 billion. The above amount was calculated as the total of positive market values of all open transactions. The net credit exposure, after taking into account the netting of transactions, for counterparties with framework agreements was approx. PLN 194 million. Netting benefits amounted to approx. PLN 1.48 billion (these were not accounted for in the calculation of capital requirements for credit risk, as presented in Chapter 4 "Capital requirements (Pillar I)"). The value of collateral accepted from the counterparties within the CSA and Collateral Agreements was PLN 180 million.

As at 31 December 2010, the Bank had no derivative credit transactions (CDS).

As at 31 December 2010, the Bank recognized adjustments for credit valuation in the valuation of financial derivatives concluded with non-financial business entities based on an analysis of recoverability of its exposures. The Bank's adjustment included the market value of credit risk as assessed by the Bank. Analyse covered all significant exposures on account of the Bank's positive valuation of financial derivatives contracted with non-financial business entities. In particular, the adjustment included the risk of non-performance of agreements executed with the counterparty, based e.g. on the analysis of the business and financial standing of entities, the probability of repayment of specific contracts, and the recoverable value of collateral.

The majority of financial institutions – the Bank's business partners on an interbank market – were awarded high external ratings – A or AA (Table 2.15).

Table 2.15

THE QUALITY OF EXPOSURES*
TO FINANCIAL INSTITUTIONS**

Rating	PKO Bank Polski SA 2010
AA	3%
A	51%
BBB	13%
B	0%
Lack of rating	33%
Total	100%

* Exposure is the total of the nominal exposure on account of bank deposits and securities and the total of derivatives valuations after netting them for counterparties with whom there have been concluded currently binding framework agreements for set-off.

** Exposures to institutions from outside the Group.

The above listing is based on external rating granted by Moody's, Standard&Poor's and Fitch rating agencies, mapped into a uniform rating scale.

2.2.4. Credit risk reporting

The Bank prepares monthly and quarterly credit risk reports for the following among other recipients: ALCO, BCC and the Management and Supervisory Boards of the Bank. Credit risk reporting comprises periodical information on the exposure level to the credit portfolio risk. Beside information on the Bank, the reports also include the credit risk data for the Group's two subsidiaries: KREDOBANK SA and the BFL SA Group, which both report significant credit risk level.

Moreover, the Bank prepares daily, weekly, monthly, quarterly and semi-annual reports on derivatives, and the monthly reports for months ending quarters as well as quarterly and semi-annual reports refer to the whole Group. The reports comprise information on the risk exposure of derivatives and information on the use of risk limits. The recipients of the reports are mainly: ALCO, the Bank's Management Board and the Bank's Supervisory Board.

2.2.5. Management actions related to credit risk

2.2.5.1. Collateral policy

The purpose of the collateral policy followed by the Bank and the subsidiaries of the Group is to appropriately secure the interests of the Group, and in the first place to establish collateral that offers the best possible level of debt recovery if the recovery procedure proves necessary. The policy concerning legal collateral is defined in the internal regulations of the subsidiaries of the Group.

The specific types of collateral that are actually established depend on the product and client type.

In granting housing loans, collateral is obligatorily established on the financed real property in the form of a mortgage. Until the mortgage is effectively established (depending on the loan type and amount), a raised credit spread is applied or a temporary collateral is accepted in the form of a transfer of receivables under the apartment construction agreement, a bill, guarantee or insurance of liabilities.

When granting retail loans to individual clients, the Bank usually accepts personal collateral (a guarantee under civil law or a bill of exchange) or establishes collateral on the client's bank account, car or securities.

Collateral on loans financing small and medium-sized enterprises as well as corporate clients is established, among other things, on business liabilities, bank accounts, movables, immovables or securities.

In accepting legal collateral for loans, the Bank applies the following principles:
1) in the case of big loans, the Bank establishes several types of collateral, combining personal and tangible collateral whenever possible,
2) liquid collateral is preferred, such as property collateral, for which there is a high probability that the Bank will quickly satisfy its debt achieving prices approximating the value of assets determined at the time of collateral acceptance,
3) collateral exposed to a risk of significant unfavourable value fluctuations is treated as ancillary,
4) in the case of acceptance of property collateral, as an additional security the Bank accepts transfer of cash receivables under insurance policy for the subject of collateral, or insurance policy issued in favour of the Bank,
5) effective establishment of collateral in accordance with clauses of the agreement is a prerequisite to release of the loan funds.

Established collateral is subject to periodic monitoring in order to determine the current credit risk level of the transaction. The following factors are monitored:
1) property/financial standing of the entity that issues a personal collateral,
2) the condition and value of the object serving as a property collateral,
3) other circumstances affecting the possibility of debt recovery by the Bank.

Collateral in the form of a mortgage is subject to special assessment. The Bank performs periodic monitoring of real properties accepted as collateral (the LtV ratio taken into account), and monitors the prices on the real estate market. If the analysis shows a significant drop in prices on the real estate market, the Bank activates emergency procedures.

Concluding the lease agreements, the BFL SA Group as the owner of the leased assets treats them as collateral for the transaction. Where the liquidity (demand for a given fixed asset on the secondary market), pace of loss of the market value of the asset or client financial standing are not acceptable according to internal procedures, additional legal collateral is accepted in the form intended and used by banks. These include property collateral such as mortgages, registered pledges, transfer of ownership rights, agreements for repurchase of the leased goods concluded with suppliers, and financial collateral such as transfers of receivables, powers of attorney to access bank accounts as well as security deposits.

2.2.5.2. Credit risk management tools

The main credit risk management tools used by the Bank are as follows:
1) threshold values that condition availability of financing for clients, including cut-off points – the minimum number of points in the process of creditworthiness assessment made using the scoring system (for retail clients) or the client's rating class or cumulative rating class (for corporate clients), from which the loan transaction can be made with a given client,
2) credit risk conditions of a credit transaction defined for a given type of transaction (e.g. the minimum value of collateral ratio, the minimum value of the LtV rate, the maximum loan amount, the required collateral),
3) the minimum credit spreads – credit risk spreads related to the Bank's specific credit transaction concluded with an institutional client, with the provision that the client may not be offered interest rate lower than that resulting from reference rate increased by the credit risk spread,
4) limits defining risk appetite, including the following limits:
   a) concentration limits – the limits defined in Article 71 clause 1 of the Banking Law,
   b) branch limits – the limits defining the risk level related to financing of institutional clients that conduct their businesses in branches characterised by a high level of credit risk,
   c) resulting from Recommendations S and T, related to the credit exposures of the Bank's clients,
   d) transactional limits – limits that confine the activities on the interbank market and activities on the market of corporate clients in the field of derivatives,
   e) competence limits – define the maximum level of powers required to take credit decisions with respect to the Bank's clients; the limits depend mainly on the Bank's credit exposure amount to a given client (or a group of related clients) and the period of credit transaction; the competence limits depend on the credit decision-making level (within the Bank's organisational structure).

A particular role in determination of minimum conditions of a transaction is played by the collateral policy within the scope of credit risk. The purpose of the collateral policy followed by the Bank and the subsidiaries of the Group is aimed at ensuring sufficient collateral of credit risk to which the Group is exposed, including in particular an establishment of collateral ensuring possibly highest recovery level in case it is necessary to undertake actions aimed at collection of debts.

In accepting legal collateral for loans, the Bank applies the following principles:
1) in the case of big loans, the Bank establishes several types of collateral, combining personal and tangible collateral whenever possible,
2) liquid collateral is preferred, such as property collateral, for which there is a high probability that the Bank will quickly satisfy its debt achieving prices approximating the value of assets determined at the time of collateral acceptance,
3) collateral exposed to a risk of significant unfavourable value fluctuations is treated as ancillary,
4) in the case of acceptance of property collateral, as an additional security the Bank accepts transfer of cash receivables under insurance policy for the subject of collateral, or insurance policy issued in favour of the Bank,
5) effective establishment of collateral in accordance with clauses of the agreement is a prerequisite to release of the loan funds.

The policy concerning legal collateral is defined in the internal regulations of the subsidiaries of the Group.

The specific types of collateral that are actually established depend on the product and client type. In granting housing loans, collateral is obligatorily established on the financed real property in the form of a mortgage. Until the mortgage is effectively established (depending on the loan type and

amount), a raised credit spread is applied and/or a temporary collateral is accepted in the form of a transfer of receivables under the apartment construction agreement, a bill, guarantee or insurance of liabilities.

When granting retail loans to individual clients, the Bank usually accepts personal collateral (a guarantee under civil law or a bill of exchange) or establishes collateral on the client's bank account, car or securities.

Collateral on loans financing small and medium-sized enterprises as well as corporate clients is established, among other things, on business liabilities, bank accounts, movables, immovables or securities. While entering into leasing agreements, the BFL SA Group, being the owner of leased items, treats them as transaction collaterals.

2.2.5.3. Credit risk management in the subsidiaries of the Group

The subsidiaries of the Group with significant credit risk level (KREDOBANK SA, the BFL SA Group) manage credit risk individually, with the provision that the applied methodologies for credit risk assessment and measurement are adjusted to the method used by PKO Bank Polski SA, while observing the specific nature of the business activity conducted by those entities.

Change in the solutions applied by the subsidiaries of the Group is each time agreed with units responsible for risk management within the Bank.

The BFL SA Group and KREDOBANK SA measure credit risk and report the results of that measurement to the Bank on a cyclical basis.

The organization structures of KREDOBANK SA and the BFL SA Group include risk units that are specifically in charge of the following:

1) development of the methods of credit risk assessment and establishing provisions and write-offs,
2) credit risk control and monitoring in the credit process,
3) the quality and efficiency of restructuring and the debt collection process.

The credit decision limits depend in those subsidiaries specifically on the following factors: the amount of the credit exposure to a client, the amount of a single credit transaction, and the term of such transaction.

The credit decision-making process in KREDOBANK SA and the BFL SA Group is supported by credit committees activated in the case of credit transactions generating an enhanced credit risk level.

The competent units of the Banking Risk Division contribute to credit risk management in the subsidiaries of the Group in that they give opinions on drafts and periodically review those subsidiaries' internal regulations on credit risk assessment and prepare recommendations as to changes in draft regulations. The Bank supports implementation in the subsidiaries of the Group of the recommended changes in the principles of credit risk assessment.

In 2010, KREDOBANK SA centralized the credit risk assessment and implemented the Early Warning System (EWS) covering credits for legal entities. The Bank implemented the client SMS notification system: a preventing SMS – 3 days before due date and an SMS on the third day of credit repayment delay. It also performed activities aimed at systematisation of credit operation monitoring, in particular through a preparation of the base of information on valid credit insurance agreements. It appointed the Restructuring Committee in order to increase the efficiency of actions in the course of making decisions on credit restructuring and it centralised the credit decision making process.

In 2010, the BFL SA Group continued activities aimed at mitigating credit risk, which consisted in creation of a safe leasing portfolio that would guarantee positive consolidated results of the BFL SA Group, capital safety and driving at a reduction of the share of debts at risk in the portfolio. For instance, the policy defines the criteria of determining branches, clients and entities as not acceptable, as well the concentration limits for individual branches and concentration limits for clients. The purpose of the BFL SA Group is the development of the leasing business through the Bank's distribution channel.

2.2.5.4. Management actions related to derivatives

In order to limit credit risk relating to derivative transactions, the Bank enters into framework agreements which are aimed at collateralising the Bank's claims towards counterparties, resulting from derivative transactions, by setting off due and payable liabilities (mitigation of settlement risk) and liabilities which are not due and payable (mitigation of pre-settlement risk).

Framework agreements with foreign counterparties are made in accordance with standards developed by ISDA (International Swaps and Derivatives Association) and ISMA (International Securities Market Association), while those made with Polish counterparties – in accordance with the standards developed by PBA (Polish Banks Association). Framework agreements with Polish financial institutions for transactions involving debt securities are made based on the Bank's internal standard. To mitigate credit risk, in the case of a planned increase in the scale of operations with a financial institution under a framework agreement, the parties enter into a collateral CSA (Credit Support Annex) agreement. Based on the collateral agreement, each of the parties, after meeting certain criteria specified in the agreement, undertakes to establish appropriate collateral along with the right to set it off.

The Bank has developed a standard for signing ISDA framework agreements, which defines the manner of activities during the course of negotiations and during the course of signing and administering framework agreements and collateral agreements made with Polish banks and financial institutions as well as framework agreements and credit support annexes with foreign banks and credit institutions.

The ISMA and CSA agreements concluded by the Bank contain provisions defining the allowed difference between credit exposure and collateral value.

The CSA agreements, which are annexes to the ISDA agreements, allow two types of collateral: cash and securities.

The Bank requires that its counterparty establishes additional collateral, for example in the form of blocked securities account, where the planned scope of cooperation with that given counterparty exceeds the level of the limit granted. Subject to collateral are also transactions under the CSA agreement where the value of exposure exceeds the threshold amount specified in the agreement.

Entering into a framework agreement with counterparty is the basis for verification of internal limit per counterparty and of

the length of period of the Bank's exposures to forward or repurchase agreement transactions. The client limit is based on the internal assessment (internal rating) as well as on the amount of own funds of the Bank and the client.

Where credit transactions are made with financial institutions having their registered office outside the territory of the Republic of Poland, the international standards of loan agreements of the Loan Market Association are applied.

Collateralisation of transactions made on an interbank market is executed as part of the CSA agreements. The agreements signed by the Bank determine, separately for each counterparty, a fixed amount of allowed non-collateralised exposure. The agreements concluded by the Bank to date do not include any provisions that would require additional collateral if the rating of one of the parties deteriorated.

If a client/counterparty did not meet its liability under such instrument, the settlement amount would be recorded as a receivable valued at the nominal value adjusted by the interest due and reduced by the amount of impairment write-offs.

Every month the Bank reviews derivative transactions concluded with economic entities in order to identify transactions threatened with impairment in relation to credit risk and includes recognized impairment in the valuation of such transactions.

The identification of transactions threatened with impairment consists in recognition of events that indicate a threat to payments under such transactions, in particular:

1) delays in making payments under such transactions,
2) no cover of a transaction from foreseeable cash flows from client's economic activities or accepted transaction collateral,
3) significant deterioration of a client's internal rating or missing information on current rating.

The following methods are applicable while determining adjustments of derivative transaction valuations:

1) individualised in relation to:
   a) active transactions that do not have a cover from foreseeable cash flows from client's economic activities or established transaction collateral
   b) closed unsettled transactions passed to the management by Restructuring and Debt Collection,
2) portfolio – in relation to other derivative transactions if they refer to clients whose internal rating means a failure to fulfil liabilities or that do not have a rating or that are not timely settled (except transactions covered by established collateral).

In order to mitigate credit risk, the Bank enters into credit derivatives or other agreements, based on which a transfer is made of all or part of risk relating to the Bank's receivables.

Due to the specific nature of derivatives, the derivatives management process is subject to particular control defined in the internal provisions.

The derivatives risk management in the subsidiaries of the Group is defined in the internal regulations of such subsidiaries, that are subject to opinions prepared by the Bank and include the Bank's recommendations. The regulations define the methods and manner of taking positions in derivatives by subsidiaries.

In 2010, the only subsidiaries of the Group beside the Bank to use derivatives within market risk management were subsidiaries of the Group of BFL SA.

KREDOBANK SA does not make any transactions with the use of derivatives due to the fact that this is prohibited by Ukrainian banking supervision authority. However, other subsidiaries of the Group may enter into transactions with the use of derivatives only to hedge the risk resulting from core business activity of a given subsidiary (banking book).

2.3. Interest rate risk, foreign exchange risk and liquidity risk

2.3.1. Introduction

Interest rate risk is the risk of loss on the Bank's balance sheet and off-balance sheet items sensitive to the interest rate changes, resulting from unfavourable interest rate changes on the market.

The purpose of interest rate risk management is to mitigate the possible losses on account of changes in the market interest rates to an acceptable level through shaping of the structure of the balance sheet and off-balance sheet items.

FX risk is the risk of loss due to changes in the foreign exchange rates and it is generated through maintaining open currency positions in individual currencies.

The purpose of FX risk management is to mitigate possible losses resulting from changes of FX rates to an acceptable level through structuring of balance sheet and off-balance sheet items.

Liquidity risk is the risk of inability of timely discharge of liabilities due to absence of liquid means. The lack of liquidity may result from an improper balance sheet structure, cash flows mismatch, non-payment by contractors, sudden withdrawal of funds by the clients or other market events.

The purpose of liquidity risk management is to secure necessary means to discharge the current and future (also potential) liabilities with due account to the nature of business activity and any needs that may result from a changing market environment, through structuring of balance sheet and off-balance sheet items.

The Bank and the subsidiaries of the Group apply the following interest rate, FX and liquidity risk management principles:

1) activities are undertaken with a view to keeping the level of risk within the accepted risk profile,
2) an acceptable level of liquidity is maintained, which depends on keeping the appropriate level of liquid assets,
3) the main sources of financing of the Bank's assets are stable sources of financing such as in particular a stable deposit base,
4) the FX position is closed within the accepted limits for FX risk.

2.3.2. Interest rate, foreign exchange and liquidity risk measurement and assessment

In order to determine the level of interest rate, foreign exchange and liquidity risk, the Bank uses various methods of its measurement and assessment, including:

1) for interest rate risk: the value at risk model (VaR), interest income sensitivity measure, stress tests and reassessment gaps;
2) for FX risk: the value at risk model (VaR) and stress tests;

3) for liquidity risk: contractual and real-terms liquidity gap method, surplus liquidity method, verification of stability of deposit portfolio and credit portfolio and shock analyses.

The value at risk (VaR) is the potential loss resulting from maintained structure of balance sheet and off-balance sheet items and changes in interest rates or as potential value of loss on the maintained currency positions due to changes in interest rates or foreign exchange rates, with an assumed probability level and taking account of a correlation between risk factors. In order to determine VaR for market risk management purposes, the variance-covariance method is applied with the 99% confidence level. For interest rate and FX risk management purposes, the following, among other things, are applied: the VaR value determined for individual financial instruments and for the Bank's portfolios, and by individual types of business activity of the Bank.

The interest income sensitivity is a measure defining a change in the interest income resulting from stepwise interest rate changes. The measure takes into account the different reassessment dates of individual interest items in each of selected time horizons.

The reassessment gap is the difference between the current value of the active and passive positions exposed to interest rate risk, reassessed in a given time interval, with the items shown as at the transaction date.

Stress tests for interest rate risk are used to assess potential losses resulting from the maintained structure of the balance sheet and off-balance sheet items where market situation occurs that is not described in a standard manner using the statistical measures. The following scenarios are applied at the Bank:
1) hypothetical scenarios – within which the scale of fluctuations in interest rates is assumed arbitrarily, e.g. parallel movement of the interest rate curves in the following currencies: PLN, EUR, USD, CHF and GBP by ±50 BPS and by ±200 BPS,
2) historical scenarios – within which fluctuations in interest rates are assumed on the basis of fluctuations in interest rates in the past, including: the biggest historical change, deflection of the profitability curve with due account to portfolio positions, peak- and twist-type deflections of the profitability curve, the biggest historical non-parallel shift of interest rates for securities and for derivatives guaranteeing those securities.

In the process of interest rate risk measurement, the Bank assumed that the value of future earlier repayments of loans and withdrawal of deposits with unspecified maturity date will be replaced, respectively, by future sales of loans and future unspecified maturity dates of the placements made. The assumption results from implemented types of interest rates for loan and deposit products at the Bank

Stress tests and crash tests for FX risk are used to assess potential losses on currency positions where extraordinary market situation occurs that is not described in a standard manner using the statistical measures. The following two scenarios are applied at the Bank:
1) hypothetical scenarios – within which the historical appreciation or depreciation of foreign exchange rates is assumed (by 15% and 50%),
2) historical scenarios – scenarios of fluctuations in exchange rates observed in the past.

For the purposes of liquidity risk management, the Bank defines the following:
1) contractual liquidity gap – listing of all balance sheet items by their maturity,
2) real-terms liquidity gap – listing of individual balance sheet categories by their real-terms maturity,
3) liquidity reserve – the difference between the most liquid assets and expected and potential liabilities that mature in a given period.

Stress tests for liquidity risk are used to assess the minimum number of business days over which the Bank could fully pay funds to non-financial entities and to verify if the Bank's funds would be enough to cover the liabilities should the shock scenario be fulfilled. The following two scenarios are applied at the Bank:
1) scenarios of mass withdrawal of deposits by non-financial clients,
2) scenarios of sensitivity of in- and outflows to changing market conditions.

2.3.3. Monitoring of the interest rate, foreign exchange and liquidity risks

2.3.3.1. Interest rate risk

In 2010, interest rate risk of the PKO Bank Polski SA Group remained within agreed limits. It was determined mainly by the risk of mismatch of dates of reassessment of assets and liabilities.

As at 31 December 2010 the exposure of the PKO Bank Polski SA Group to PLN interest rate risk – as well as the exposure to EUR and CHF interest rate risk - consisted mainly of the exposure of the Bank. The PLN, EUR and CHF interest rate risk generated by other subsidiaries of the Group did not significantly influence the interest rate risk of the entire Group and hence did not materially change its risk profile.

The Group's exposure to USD interest rate risk consisted of both the Bank's exposure and the exposures of individual subsidiaries of the Group. The interest rate risk of the subsidiaries reduced the interest rate risk of the Group in the time frame of up to 6th month. In the remaining time frames, the subsidiaries' interest rate risk increased the Group's exposure to interest rate risk.

The tables 2.16 – 2.19 present the reassessment gaps of the Group as at 31 December 2010 by currencies.

Table 2.16

PLN reassessment gap (in PLN million)

2010	0-1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
PKO Bank Polski SA								
Periodic gap	40 603	16 992	-23 910	-13 446	-2 969	498	329	18 098
Cumulative gap	40 603	57 596	33 686	20 240	17 271	17 769	18 098	0
Group subsidiaries								
Periodic gap	-529	-120	52	-463	102	41	0	-917
Cumulative gap	-529	-649	-597	-1 060	-958	-917	-917	0
TOTAL - Periodic gap	40 074	16 872	-23 857	-13 909	-2 867	538	329	17 180
TOTAL - Cumulative gap	40 074	56 946	33 089	19 180	16 313	16 851	17 180	0

Table 2.17

USD reassessment gap (in USD million)

2010	0-1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
PKO Bank Polski SA								
Periodic gap	350	-118	-140	-138	-1	0	0	-46
Cumulative gap	350	233	93	-45	-46	-46	-46	0
Group subsidiaries								
Periodic gap	-46	-44	-27	-1	13	55	94	44
Cumulative gap	-46	-90	-117	-118	-105	-50	44	0
TOTAL - Periodic gap	304	-161	-167	-139	12	55	94	-2
TOTAL - Cumulative gap	304	143	-24	-163	-151	-96	-2	0

Table 2.18

EUR reassessment gap (in EUR million)

2010	0-1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
PKO Bank Polski SA								
Periodic gap	659	-306	88	-220	10	-605	26	-348
Cumulative gap	659	353	441	221	231	-375	-348	0
Group subsidiaries								
Periodic gap	2	-3	-9	-3	10	13	14	24
Cumulative gap	2	-1	-10	-13	-4	9	24	0
TOTAL - Periodic gap	661	-308	78	-223	20	-592	41	-325
TOTAL - Cumulative gap	661	353	431	208	227	-365	-325	0

Table 2.19

CHF reassessment gap (in CHF million)

2010	0-1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
PKO Bank Polski SA								
Periodic gap	312	-563	-4	-4	0	2	7	-250
Cumulative gap	312	-250	-254	-258	-258	-257	-250	0
Group subsidiaries								
Periodic gap	-10	4	0	0	0	0	0	-6
Cumulative gap	-10	-6	-6	-6	-6	-6	-6	0
TOTAL - Periodic gap	303	-559	-4	-4	0	2	7	-256
TOTAL - Cumulative gap	303	-256	-259	-264	-264	-262	-256	0

The VaR and analysis of stress test scenarios in respect of financial assets of the Bank and of the Group (jointly for the banking and trading books) exposed to interest rate risk as at 31 December 2010 and 31 December 2009 respectively are presented below:

Table 2.20

Sensitivity of financial assets
Exposed to interest rate risk

	2010		2009	
	10-day VaR	Stress-test ±200 base points	10-day VaR	Stress-test ±200 base points
PKO Bank Polski SA	39,0	475,1	17,1	164,4
Group subsidiaries	-	94,7	-	117,3
Total	-	522,6	-	233,3

As at 31 December 2010, the 10-day VaR on the Bank's interest rate was PLN 39 million and accounted for approx. 0.24% of the Bank's own funds.

The results of stress tests showing changes in the market value resulting from shifts of the yield curves by individual currencies are presented in the table below:

Table 2.21

Stress tests results* - parallel shift of interest rate curves by ±200 base points

	Bank		Group Subsidiaries		Total	
Currency	2010	2009	2010	2009	2010	2009
PLN	255,4	148,8	1,4	7,2	256,8	156,0
EUR	216,2	8,6	17,4	12,8	198,7	21,4
USD	2,3	2,1	75,9	97,3	66,0	99,4
CHF	0,4	4,2	0,0	0,1	0,3	4,3
GBP	0,8	0,6	0,0	0,0	0,8	0,6

* Foreign currency values have been shown in PLN equivalents.

Given the nature of business activity of the subsidiaries of the Group generating the largest interest rate risk (the BFL SA Group and KREDOBANK SA) and the specific nature of the market on which those subsidiaries operate, the Bank does not determine the consolidated VaR sensitivity measure in respect of the interest rate. The subsidiaries use their own risk measures to manage interest rate risk. The 10-day VaR measure for main currencies is used by KREDOBANK SA. Its value as at 31 December 2010 was PLN 30.2 million.

2.3.3.2. FX risk

In 2010, the FX risk of the Group was low as it is the Bank's policy to close currency positions. 10-day VaR for FX position of the Bank at the end of 2010 amounted to PLN 3.2 million, which accounted for approx. 0.02% of the Bank's own funds. The VaR and stress-test analysis in respect of the Bank's and the Group's financial assets (jointly for all currencies) exposed to FX risk as at 31 December 2010 and 31 December 2009 respectively was as follows:

Table 2.22

Sensitivity of financial assets
exposed to FX risk

	2010		2009	
	10-day VaR	Stress-test ±15%	10-day VaR	Stress-test ±15%
PKO Bank Polski SA	3,2	4,0	1,1	4,4
Group subsidiaries	-	2,1	-	3,7
Total	-	6,1	-	0,7

As in the case of interest rate risk, given the nature of business activity of the subsidiaries of the Group generating the largest FX risk (the BFL SA Group and KREDOBANK SA) and the specific nature of the market on which those subsidiaries operate, the Bank does not determine the consolidated VaR sensitivity measure for FX risk. The subsidiaries use their own risk measures to manage FX risk. The 10-day VaR measure is used by KREDOBANK SA. As at 31 December 2010, its value was PLN 0.18 million.

2.3.3.3. Liquidity risk

The real-terms liquidity gaps presented below include a list of matured assets, payable liabilities, and additionally selected balance sheet items for a realistic presentation of the liquidity status of the Bank and the subsidiaries of the Group. Put in real terms were in particular the following:

1) the core deposits (interbank market excluded) and their pay ability – clients' deposits (current accounts, savings accounts and fixed term deposits) have been classified to appropriate time frames with due account to their stability (maintenance of an appropriate balance or revolving after pay ability),
2) the core deposits on the current accounts of non-financial entities and their maturity – overdrafts have been classified to appropriate time frames with due account to their possibility of revolving,
3) liquid securities and their maturity – liquid securities have been classified into the time frame of up to 1 month according to the possible date of their liquidation (pledging, sale).

The table below presents data concerning periodic gap and cumulative periodic gap of the Bank and of the subsidiaries of the Group as at 31 December 2010 and 31 December 2009 respectively.

Table 2.23

REAL-TERMS LIQUIDITY GAP* - ASSETS AND LIABILITIES

2010	a'vista	0-1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years
PKO Bank Polski SA								
Periodic gap	3 221	14 310	-711	-66	3 965	5 019	-1 317	-24 421
Cumulative gap	3 221	17 531	16 819	16 754	20 719	25 738	24 421	0
Group subsidiaries								
Periodic gap	-13	-207	-239	-41	-165	141	303	220
Cumulative gap	-13	-221	-459	-500	-665	-523	-220	0
TOTAL - Periodic gap	3 207	14 103	-950	-107	3 801	5 160	-1 014	-24 200
TOTAL - Cumulative gap	3 207	17 310	16 360	16 254	20 054	25 215	24 200	0

2009**	a'vista	0-1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years
PKO Bank Polski SA								
Periodic gap	6 682	15 885	-3 041	590	3 842	7 812	-1 169	-30 601
Cumulative gap	6 682	22 567	19 526	20 116	23 958	31 770	30 601	0
Group subsidiaries								
Periodic gap	163	-559	-431	-114	48	24	486	382
Cumulative gap	163	-396	-827	-941	-893	-868	-382	0
TOTAL - Periodic gap	6 845	15 326	-3 472	476	3 890	7 837	-683	-30 218
TOTAL - Cumulative gap	6 845	22 171	18 699	19 175	23 065	30 902	30 218	0

* Set as a sum of real-terms liquidity gap of PKO Bank Polski SA and contractual liquidity gaps of the other companies of the Group.

** Values brought to comparability under the liquidity gap real-terms methodology in force as at 31 December 2010.

In all time frames, the cumulative real-terms liquidity gap of the PKO Bank Polski SA Group showed positive values. This means a surplus of matured assets over matured liabilities.

The table below shows data concerning contractual off-balance sheet liquidity gap of derivatives of the Group.

Table 2.24

CONTRACTUAL OFF-BALANCE SHEET LIQUIDITY GAP FOR DERIVATIVES

The PKO Bank Polski SA Group

2010	0-1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
TOTAL - Periodic gap	123	183	471	527	515	101	-30	1 889
TOTAL - Cumulative gap	123	306	777	1 304	1 818	1 919	1 889	0

2009*	0-1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
TOTAL - Periodic gap	161	524	131	352	553	1 033	109	2 863
TOTAL - Cumulative gap	161	685	816	1 168	1 721	2 754	2 863	0

* Values brought to comparability pertaining to intervals in force on 31 December 2010.

The table below shows the Bank's liquidity reserve as at 31 December 2010 and 31 December 2009.

Table 2.25

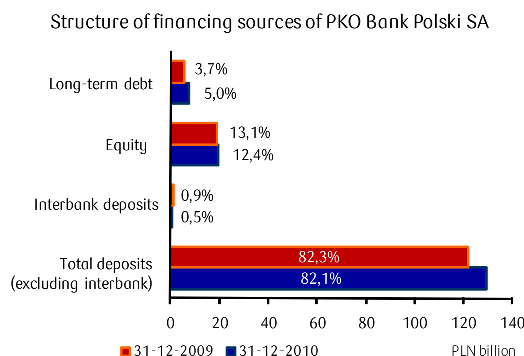
LIQUIDITY RESERVE
PKO Bank Polski SA

Sensitivity measure	31.12.2010	31.12.2009
Liquidity reserve for up to 1 month	10 151	16 030

As at 31 December 2010, core deposits amounted to approx. 95.2% of all deposits held by the Bank (the interbank market excluded), which was an decrease of approx. 0.3 percentage points compared to 31 December 2009.

The following chart present the structure of the Bank's financing sources as of 31 December 2009 and 31 December 2010.

Chart 2.3



2.3.4. Interest rate, FX and liquidity risk reporting

In 2010 reporting on the levels of interest rate, FX and liquidity risk was carried out in the following cycles:
1) on a daily and weekly basis – for operational purposes,
2) on a monthly, quarterly and half-year basis – for management purposes.

The recipient of monthly reports is mainly ALCO, of quarterly reports - the Management Board of the Bank, and of half-year reports – the Management and Supervisory Boards of the Bank. The reports contain information on interest rate, FX and liquidity risks, to which the Bank and the PKO Bank Polski SA Group (in a quarterly cycle) are exposed.

2.3.5. Management actions related to interest rate, FX and liquidity risks

The basic interest rate, FX and liquidity risk management tools used by the Bank are as follows:
1) limits and threshold values by individual market risk types,
2) defining the allowed types of transactions exposed to specific market risks,
3) transactions ensuring long-term financing of credit activities.

As regards mitigating interest rate risk, the Bank defined limits and threshold values relating to, among other things, the degree of price sensitivity and interest income sensitivity, the amount of losses and allowed derivatives sensitive to interest rate fluctuations. The limits have been set for individual portfolios of the Bank.

As regards FX risk mitigation, the Bank defined limits relating, among other things, to the value of currency position, value at risk calculated in the 10-day time horizon and daily loss on the FX market.

As for limiting liquidity risk, the Bank defined limits and threshold values for measures of the current as well as mid- and long-term liquidity.

The other subsidiaries of the PKO Bank Polski SA Group, which due to the nature of their business activity report a significant level of interest rate, FX and liquidity risks have their own internal regulations in place for management of these types of risk. These regulations have been developed after consultations with the Bank and after considering the recommendations of the Bank directed to the subsidiaries of the Group.

Transactions in the trading book are made exclusively by PKO Bank Polski SA. Other subsidiaries of the Group enter into transactions solely on the banking book.

2.4. Operational risk

2.4.1. Introduction

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The purpose of operational risk management is to optimize the operational efficiency by means of reducing operational losses, rationalizing costs, and also increasing the promptness and adequateness of response of the PKO Bank Polski SA Group to events beyond its control.

The Bank's internal regulations clearly define the distribution of duties and competencies in the area of operational risk management. In accordance with these regulations, all the issues relating to operational risk management are supervised by the Management Board of the Bank which:
1) sets the objectives for operational risk management,
2) defines policies for operational risk,
3) adopts resolutions on operational risk tolerance and operational risk limits,
4) accepts reports relating to operational risk.

Operational risk management is carried out in the area of systemic and "day-to-day" operational risk management solutions.

Systemic operational risk management consists in developing internal regulations and other solutions relating to operational risk and concerning, among other things, the following:
1) human resources,
2) organisation of the Bank,
3) accounting,
4) principles of preparation of the Bank's internal provisions,
5) IT,
6) security,
7) internal processes,
8) client service processes,
9) creation and implementation of internal operational risk models and systems of identification, assessment, monitoring and limiting of operational risk,
10) outsourcing of the operations ordered by the Bank to external parties.

Systemic operational risk management is centralised at the level of the Bank's Head Office. Each business and support line has a dedicated unit which is responsible for identification and

monitoring of operational risk in the products or internal processes supervised and for taking appropriate action to ensure acceptable operational risk level.

"Day-to-day" operational risk management consists in the following:
1) preventing the operational risk events arising while servicing products, during the course of realisation of internal processes or use of the systems,
2) taking action aimed at limiting the number and scale of threats (operational risk events),
3) liquidating the negative effects of operational risk events,
4) recording data on operational risk events,
5) complying with the operational risk limits.

"Day-to-day" operational risk management is carried out by each operational unit of the Bank.

A significant role in operational risk management is performed by the Banking Risk Division, which coordinates the identification, measurement, monitoring and reporting of operational risk in the entire PKO Bank Polski SA Group.

Three entities, i.e. PKO Bank Polski, the BFL SA Group and KREDOBANK SA, have a decisive impact on the operational risk profile of the Group. Other subsidiaries of the Group, due to a considerably lower scale and specific type of their businesses, generate only limited operational risk.

2.4.2. Operational risk measurement and assessment

Operational risk measurement in the Bank is aimed to define the scale of threats related to the operational risk by means of defined risk measures.

Operational risk measurement includes:
1) KRI calculation,
2) calculation of the threatened value for operational risk,
3) scenario analyses.

Operational risk assessment comprises operational risk arising in the existing products, processes and IT application of the Bank and it is conducted using the following:
1) collected data on operational risk events,
2) internal audit results,
3) results of internal functional control,
4) the key operational risk indicators (KRI).

2.4.3. Monitoring of operational risk

The Bank regularly monitors:
1) use of operational risk tolerance limits,
2) use of operational risk limits,
3) efficiency and timeliness of the activities undertaken in relation to operational risk reduction or transfer,
4) KRI values in relation to threshold and critical values,
5) operational events and their consequences,
6) results of activities undertaken subject to recommendations after external or internal audits,
7) the quality of functional internal control.

2.4.4. Operational risk reporting

Reporting operational risk-related information concerning the Bank and the subsidiaries of the Group is conducted on a quarterly basis. The recipients of such reports are the Operational Risk Committee, the Management and Supervisory Boards of the Bank. The reports contain information relating to the following:
1) the Bank's operational risk profile resulting from its process of identification and assessment of threats for products, processes and IT applications of the Bank,
2) results of operational risk assessment and monitoring,
3) operational events and their financial effects,
4) the most significant projects and undertakings as regards operational risk management,
5) recommended or proposed activities for the Operational Risk Committee or the Bank's Management Board,
6) information on the level of compliance with operational risk tolerance and limits.

Information on operational risk for the members of the Bank's Management Board and the Bank's units responsible for systematic operational risk management is prepared in monthly cycles. The scopes of information vary and are adjusted to the scope of responsibility of individual recipients of the information.

2.4.5. Management actions related to operational risk

In order to mitigate operational risk exposure at the Bank, various solutions are applied. These include, among other things, the following:
1) control instruments,
2) human resources management instruments (personnel selection and recruitment, employee qualifications enhancement systems and incentive systems),
3) threshold and critical values for key risk indicators (KRI),
4) contingency plans,
5) insurance,
6) outsourcing.

Selection of instruments used to mitigate operational risk is performed depending on the following, among other factors:
1) availability and adequacy of instruments mitigating the risk,
2) nature of the business or process, in which the operational risk has been identified,
3) risk materiality,
4) cost of use of an instrument.

In addition, internal regulations of the Bank provide for the obligation not to undertake any business activity subject to excessive risk, and if such business activity is conducted – to withdraw from such business activity or limit its scope. The level of operational risk is considered to be excessive, if potential benefits from conducting such business activity are lower than potential operational losses.

The subsidiaries of the Group manage operational risk in accordance with the operational risk principles binding in PKO Bank Polski SA, taking into account the specific nature and scale of their business activity.

In 2010, the subsidiaries of the Group continued works aimed at development of a system of the key operational risk indicators and conducted trainings on operational risk.

2.5. Compliance risk

2.5.1. Introduction

Compliance risk is the risk of incurring legal sanctions or occurrence of financial losses or a loss of reputation or credibility as a result of failure on the part of the Group, the

Group's employees or entities operating on its behalf to observe legal provisions, internal regulations and the standards of procedure adopted by the Bank, the ethical standards included.

The purpose of compliance risk management is to consolidate, through elimination of compliance risk, the image of the PKO Bank Polski SA Group as a group of entities operating in compliance with the law and the generally recognised standards of procedure, trustworthy, honest and reliable; to prevent the Group's loss of reputation or credibility; and to prevent financial losses or legal sanctions that might result from the violation of the law and norms of conduct.

2.5.2. Compliance risk measurement and assessment

The Bank identifies and assesses compliance risk. To identify compliance risk, the Bank uses information on cases of non-compliance and reasons of their occurrence, including information obtained in result of internal audits, functional controls and external audits.

During an assessment the Bank defines the nature and potential volume of losses and points out to the ways of mitigating or eliminating of compliance risk. The assessment has a form of workshops.

2.5.3. Monitoring of compliance risk

Compliance risk monitoring includes:
1) cases of non-compliance in the Bank and the banking industry – their reasons and consequences,
2) changes of the key legal provisions that have impact on the Bank's activities,
3) activities undertaken by the Bank under compliance risk management, fulfilment of recommendations after internal audits, functional controls and external audits, adjustment to new legal provisions and standards of operation and fulfilling recommendations of the Compliance Department.

2.5.4. Compliance risk reporting

Reporting compliance risk-related information concerning the Bank is conducted on a quarterly basis. The recipients of such reports are the Management and Supervisory Boards of the Bank. The reports contain information relating to the following:
1) compliance risk identification and assessment,
2) compliance risk monitoring,
3) adjustments to new regulations,
4) fulfilment of recommendations after audits conducted by the Polish Financial Supervision Authority,
5) correspondence with the Regulator.

2.5.5. Management actions related to compliance risk

Compliance risk management covers specifically the following issues:
1) prevention of the Group's involvement in illegal activities,
2) ensuring data protection,
3) propagation of the ethical standards and monitoring of their functioning,
4) management of conflicts of interests,
5) prevention of situations where the conduct of the Group's employees in official matters might seem self-interested,
6) professional, reliable and clear formulation of the product offer and the advertising and marketing messages,
7) immediate, honest and professional consideration of the clients' complaints, applications and suggestions.

The Group adopted zero tolerance approach to compliance risk which means that the Group focuses its activities on compliance risk elimination.

In 2010 the compliance risk management tasks were coordinated within the PKO Bank Polski SA Group by a unit in the Banking Risk Division.

In all entities of the PKO Bank Polski SA Group there function consistent compliance risk management principles.

2.6. Business risk

2.6.1. Introduction

Business risk is the risk of losses resulting from unfavourable changes in the business environment, unfavourable decisions, improper implementation of decisions or a failure to take appropriate action in response to changes in the business environment; it specifically includes the strategic risk.

Strategic risk is related to the possibility of occurrence of negative financial consequences of mistaken decisions, decisions made based on improper assessment, or an absence of proper decisions pertaining to the direction of the Bank's strategic development.

The purpose of strategic risk management is to take action aimed at maintaining that risk at an acceptable level.

2.6.2. Strategic risk measurement and assessment

The Bank's strategic risk level is measured through an assessment of the impact of groups of factors separated in the business and environment. Such groups of factors include in particular:
1) external factors,
2) factors relating to the increase growth and development of banking activity,
3) factors relating to human resources management,
4) factors relating to investing activities,
5) factors relating to organisation culture.

2.6.3. Monitoring of strategic risk

The monitoring of strategic risk is performed at least on an annual basis.

2.6.4. Strategic risk reporting

The recipients of the reports on strategic risk level are members of the Management Board and Managing Directors in the Bank's Head Office.

2.6.5. Management actions related to strategic risk

The strategic risk management in the Bank includes:
1) measurements of the strategic risk level,
2) reporting strategic risk level and its changes,
3) activities undertaken in case of a high strategic risk level.

2.7. Reputation risk

2.7.1. Introduction

Reputation risk is related to the possibility of occurrence of negative deviations from the Group's planned financial result due to deterioration of the Group's image.

The purpose of reputation risk management is to protect the Group's image and reduce the risk of occurrence and the amount of losses resulting from a deterioration of the Group's image.

2.7.2. Reputation risk measurement and assessment

Reputation risk ratios are calculated on the basis of an annual assessment of negative effects of image-related events identified in a given year for individual categories of image-related events. The main tools used to define the Group's reputation risk level are:

1) catalogue of categories of image-related events that includes a specification of categories of image-related events together with weights assigned to them,
2) records of occurred image-related events divided the by categories of image-related events.

2.7.3. Monitoring of reputation risk

Monitoring of image-related events is performed on an ongoing basis and it includes:

1) monitoring the external and internal channels of the Group's communication with its environment in order to identify adverse effects of image-related events,
2) gathering and analyzing information on the occurrence or potential occurrence of an image-related event,
3) recording data on identified negative effects of image-related events.

2.7.4. Reputation risk reporting

Reputation risk reporting is performed in the Bank on an annual basis. Information on reputation risk is submitted to the Banking Risk Division units.

2.7.5. Management actions related to reputation risk

Reputation risk management in the Group comprises in particular preventive activities aimed at limiting cases of or reducing the scale of image-related events and selection of effective tools for protective actions in order to eliminate, mitigate or reduce negative impact of image-related events on the Group's image.

2.8. Capital exposures in the banking book

The PKO Bank Polski SA Group's capital exposures in the banking book are divided into two groups depending on the purpose of their acquisition:

1) stocks and shares – exposures to co-subsidiaries and associated entities and to other entities with the minority interest of PKO Bank Polski SA and the Group's subsidiaries (except for stocks and shares reducing own funds of the Group). The reason behind acquisition of these assets is to obtain capital gains (dividend) and return on investment following the disposal of stocks and shares as well as the share of PKO Bank Polski SA in the development of the financial market;
2) participation units in collective investment undertakings – covering investments of PKO TFI SA in participation units of the new investment funds under its management. The reason behind the acquisition of those assets is to obtain, in accordance with the Statutes of PKO TFI SA, the means required to create such fund.

Table 2.26

CAPITAL EXPOSURES - BANKING BOOK

	The PKO Bank Polski SA Group			
	2010		2009	
	Carrying amount	Fair value*	Carrying amount	Fair value*
Total	97	98	107	108
Shares in other entities	43	43	51	51
Equity securities	54	55	56	57
Shares in entities listed on regular market **	11	11	15	15
Shares in entities not listed on regular market	18	19	19	20
Participation units in collective investment undertakings	25	25	22	22

* Assessed fair value

** Fair value of listed securities equals their market value.

Stocks and shares in co-subsidiaries and associated entities are valued using the equity method (acquisition cost adjusted by a change in the net assets of the subsidiary for the period from the acquisition to valuation date) less impairment write-offs.

The co-subsidiaries and associated entities' share in the financial result from the acquisition date is shown in the profit and loss account, and their share in the changes of other overall revenues from the acquisition date - under other overall revenues.

At the end of each reporting period, an assessment is made of whether impairment conditions exist for investments in associated entities and co-subsidiaries. If impairment conditions are identified, an assessment is made of the higher of the investment's value in use and fair value less selling expenses (that is impairment test is conducted). The forecast of the value in use is assessed using the discounted cash flow method under the assumption that the stocks or shares will continue to be held. Forecasts concerning cash flows are developed on the basis of financial plans of entities and cover the period from 3 to 5 years using varied discount rates adjusted to the specific nature of business activity of individual entities.

Additionally, impairment tests are performed at the end of every year regardless of whether impairment conditions exist for stock and shares in associated entities and co-subsidiaries.

Stocks and shares in other entities are valued as follows:

1) at fair value determined in the following manner:
   a) at market value for those stocks, for which there is an active market;
   b) as a received current offer of purchase or by way of valuation performed by specialised external entity providing this type of service, for stocks and shares, for which there is no active market;

2) at the acquisition cost less impairment write-off for those stocks and shares, for which reliable determination of fair value is not possible.

The effects of changes in the fair value of stocks and shares are taken to revaluation reserve, except for impairment write-offs, which are taken to the profit and loss account. The revaluation reserve item is taken to the profit and loss account at the time the asset is disposed of or impaired. In the case of permanent impairment of a given asset, the amounts recognised previously as an increase in the value due to reassessment to fair value decrease revaluation reserve. If the amount of previously recognised increases is not sufficient to cover the permanent impairment, the resultant difference is taken to the profit and loss account.

Impairment write-offs for the stocks and shares in other entities are not reversed through profit and loss account, i.e. any subsequent increases in their fair value are recognised in the revaluation reserve.

Participation units in collective investment undertakings are valued at fair value with an effect carried to the revaluation reserve.

Dividends on capital exposures are recognised in the profit and loss account at the time the entity's right to receive payment has been established.

A at 31 December 2010, the unrealised loss of the PKO Bank Polski SA Group relating to reassessment of capital exposures amounted to PLN 9.7 million, and the realised profit from the disposal of capital exposures amounted to PLN 31.7 million.

Additionally, on account of its capital exposure in the stocks held, the PKO Bank Polski SA Group received a gross dividend in 2010 in the total amount of PLN 5.5 million.

3. OWN FUNDS

For the purpose of capital adequacy, own funds were calculated according to the provisions of the Banking Law and Resolution no 381/2008 of the Polish Financial Supervision Authority dated 17 December 2008 concerning decreases of basic funds, amended with resolution no 367/2010 of the Polish Financial Supervision Authority dated 12 October 2010, in force as from the data for 31 December 2010. As at 31 December 2009 the own funds were presented in the report entitled "Capital Adequacy and Risk Management (Pillar III) of the PKO Bank Polski Group SA as at 31 December 2009".

Included in the basic funds (Tier 1) are the following:
1) core funds comprising:
   a) share capital – in the amount defined in the Bank's Statutes and entry in the Register of Entrepreneurs, at nominal value,
   b) reserve capital – established in accordance with the Bank's Statutes from write-offs of net profits and premiums on the issue of shares, assigned to absorb balance sheet losses that may arise within the Bank's activities; decisions concerning utilisation of the reserve capital are taken by the General Shareholders' Meeting,
   c) other reserve capital – to be utilised for the purposes defined in the Statutes, created from write-offs of net profits in the amount defined by the General Shareholders' Meeting,
2) general banking risk fund – created in accordance with the Banking Law from the net profit,
3) retained earnings,
4) net financial result prior to approval and net result for the current reporting period – calculated based on applicable accounting standards, decreased by any expected charges and dividends, in amounts not exceeding amounts audited by a certified public accountant.

In addition, the basic funds are reduced by the following items:
1) intangible assets valued at their carrying amount,
2) equity exposures[5] of the Bank to financial institutions, lending institutions, Polish and foreign banks and insurance subsidiaries, in the form of:
   a) shares or stocks held,
   b) amounts classified as subordinated liabilities,
   c) other equity exposure in items classified as own funds or capital of those entities, including additional contributions in favour of a limited liability subsidiary, in the amount of 50% of carrying amounts of such exposures,
3) unrealised losses on debt and equity instruments classified as available for sale.

Supplementary funds (Tier 2) comprise the following:
1) unrealised gains on debt and equity instruments classified as available for sale – in the amount of 80% of their pre-tax value,
2) subordinated liabilities understood as liabilities arising from acceptance by the Bank – in the amount and based on the principles defined by the Commission for Banking Supervision – of the funds, which together meet in accordance with the contract the following criteria:
   a) the funds have been accepted for a period of at least 5 years (term of contract),
   b) the funds may not be withdrawn from the bank prior to expiration of contract,
   c) the funds are to be returned as the last item in the case of the bank's bankruptcy or liquidation,
   d) the refund is not guaranteed by the bank, either directly or indirectly.

In addition, supplementary funds are reduced by 50% of the value of the Bank's equity exposures[5] in financial or lending institutions, Polish and foreign banks and insurance subsidiaries. Where the value of those reductions decreases the

5 Exposures in financial institutions meeting the requirements set forth in § 5.1 of Resolution No. 381/2008 of the Polish Financial Supervision Authority dated 17 December 2008 concerning other decreases to basic funds, their amount, scope and terms and conditions of decreasing the bank's basic funds by those amounts, other bank's balance sheet items included in supplementary funds, their amount, scope and terms and conditions of including them in the bank's supplementary funds, decreases to supplementary funds, their amount, scope and terms and conditions of decreasing the bank's basic funds by those amounts as well as the scope and manner of accounting for banks' activities in holdings in calculation of own funds (Official Journal of PFSA of 2008, No. 8, item 35).

amount of supplementary funds to below zero, the amount is deducted from the basic funds.

In addition, the following is included in the balance of consolidated own funds:
1) goodwill of the subsidiaries (acts to reduce own basic funds),
2) non-controlling interest (acts to increase own funds),
3) currency translation differences from foreign operations (negative differences decrease own funds, whereas positive differences increase own funds).

The value of short-term capital (Tier 3) reflects the total of daily market profits for the reporting year.

Information on the structure of the Bank's and the Group's own funds is presented in Table 3.1.

Table 3.1

	Group		Bank	
	2010	2009	2010	2009
OWN FUNDS	17 619	17 865	16 563	16 938
Basic funds (Tier 1)	15 960	16 254	15 450	15 756
core funds	16 874	16 805	16 632	16 574
general risk funds	1 070	1 070	1 070	1 070
retained profit/loss	112	249	0	0
profit/loss from the current period	0	0	0	0
intangible assets	-1 802	-1 573	-1 528	-1 269
capital exposures	-118	-142	-658	-568
unrealised losses on instruments available for sale	-67	-53	-66	-53
currency translation differences	-111	-109	0	0
minority interest	2	7	0	0
Supplementary funds (Tier 2)	1 513	1 481	967	1 053
subordinated liabilities	1601	1 601	1 601	1 601
unrealised profits on instruments available for sale	29	23	24	19
currency translation differences	1			
capital exposures	-118	-142	-658	-568
Short-term equity (Tier 3)	146	130	146	130

In 2010, the amount of the Group's own funds decreased by ca. PLN 248 million, which was mainly due the increase of items reducing the Group's own funds - that is intangible assets - by the amount of ca. PLN 229 million and unrealised losses on debt and capital instruments qualified to AFS portfolio by the amount of ca. PLN 15 million with simultaneous decrease of the value of the financial result for the previous year by the amount of PLN 137 million. Own funds included the net profit for 2010 minus the dividends paid.

According to resolution no 39/2010 of the Ordinary General Shareholders' Meeting of PKO Bank Polski SA dated 23 July 2010, the dividend for 2009 was agreed to be PLN 2,375 million that is PLN 1.90 gross per share. At the same time, according to resolution no 38/2010 dated 23 July, the Ordinary General Shareholders' Meeting decided to raise the reserve capital by PLN 50 million and other reserve capitals by PLN 7 million.

Table 3.1 in line of subordinate liabilities presents 10-year subordinate bonds issued in 2007 in the total value of PLN 1,600.7 million (redemption date on 30 October 2017 and option of early redemption by the Bank as from 30 October 2012). The bonds were included in the compensatory amounts after the Bank obtained the approval of the Polish Financial Supervision Authority.

4. CAPITAL REQUIREMENTS (PILLAR I)

Information on the structure of capital requirements of the Bank and the Group is presented in Table 4.1.

Table 4.1

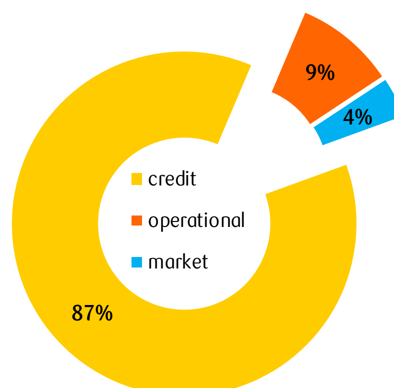
	Group		Bank	
	2010	2009	2010	2009
Total capital requirement	11 302	9 749	11 049	9 491
Credit risk	9 822	8 488	9 626	8 303
credit risk (banking book)	9 757	8 414	9 561	8 229
counterparty risk (trading book)	65	74	65	74
Market risk	422	204	466	230
foreign currency	0	0	0	0
commodities risk	0	0	0	0
equity securities risk	1	2	1	2
specific risk of debt instruments	341	168	380	192
general interest rate risk	80	34	85	35
Operational risk	1 058	1 057	958	957
Other types of risk*	0	0	0	0

* Includes requirements in regard to the settlement and delivery risk, the risk of extending the exposure concentration limit and the large exposure limit and the risk of exceeding the capital concentration threshold.

As at 31 December 2010, the biggest part of the Group's total capital requirement was the requirement on account of credit risk (approx. 87%) – chart 4.1.

Chart 4.1

STRUCTURE OF CAPITAL REQUIREMENT OF THE PKO BANK POLSKI SA GROUP BY RISK TYPES



As at 31 December 2010:
1) the capital requirement for credit risk and counterparty credit risk was calculated under the standardised approach (Appendices No. 4 and No. 16 to Resolution No. 76/2010 of PFSA as amended),

- the capital requirement for market risk was calculated under the basic methods (Appendices No. 6 to 10 to Resolution No. 76/2010 of PFSA as amended),
- the capital requirement for operational risk was calculated under the standardised approach for the Bank and under basic indicator approach for the subsidiaries of the Group (Appendix No. 14 to Resolution No. 76/2010 of PFSA as amended),

2) the capital requirement for:
   a) the settlement risk and delivery risk – was calculated under the method defined in Appendix No. 11 to Resolution No. 76/2010 of PFSA as amended,
   b) the risk of exceeding the exposure concentration limit and the large exposure risk – was calculated under the method defined in Appendix No. 12 to Resolution No. 76/2010 of PFSA as amended,
   c) the risk of exceeding the capital concentration threshold – was calculated under the method defined in Appendix No. 13 to Resolution No. 76/2010 of PFSA as amended.

The scale of trading activities of the Bank and the Group is considerable and hence the total capital requirement for market risk is the total of capital requirements for the following risks:
1) FX risk,
2) commodities risk,
3) equity securities risk,
4) specific risk of debt instruments,
5) general interest rate risk.

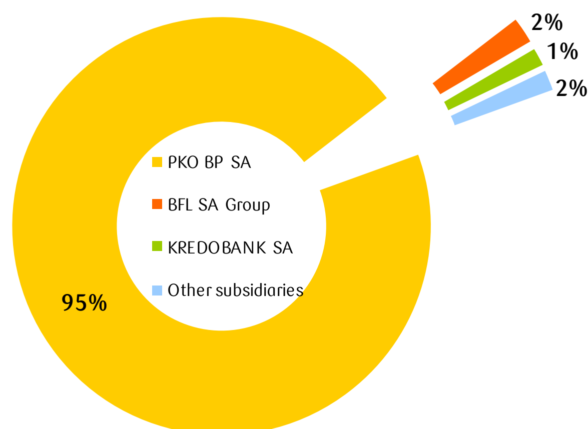
The 2010 significant increase in the credit portfolio (balance sheet and off-balance sheet exposures) of the Group (by 11.5%) contributed to the increased capital requirement for credit risk. The increased capital requirement for market risk results mainly from ca. twofold increase of the value of liabilities due for guarantees of securities issues.

The capital requirements of the Bank and the Group for settlement and delivery risks, the risk of exceeding the exposure concentration limit and the capital concentration threshold were zero as at 31 December 2009 and 31 December 2010 due to the fact that such events did not occur.

A significant portion (approx. 95%) of the total capital requirement of the Group represented capital requirements of the Bank (chart 4.2).

Chart 4.2

STRUCTURE OF CAPITAL REQUIREMENT
OF THE PKO Bank Polski SA GROUP
BY COMPANIES



A considerable proportion of the capital requirement of both the Group (Table 4.2) and the Bank (Table 4.3) results from exposure in the banking book especially within the requirement established for balance sheet exposures (over 80%).

Table 4.2

	The PKO Bank Polski SA Group		
	2010		
	Book		
	banking	trading	total
Capital requirement*	9 757	407	10 164
Balance sheet exposures	8 867	158	9 025
Off-balance sheet liabilities	853	184	1 037
Derivatives	37	65	102

* Covers credit risk, counterparty credit risk, price risk of equity securities and debt instruments. It does not cover general interest rate risk and operational risk.

Table 4.3

	PKO Bank Polski SA		
	2010		
	Book		
	banking	trading	total
Capital requirement*	9 561	446	10 007
Balance sheet exposures	8 648	159	8 807
Off-balance sheet liabilities	876	222	1 098
Derivatives	37	65	102

* Covers credit risk, counterparty credit risk, price risk of equity securities and debt instruments. It does not cover general interest rate risk and operational risk.

4.1. CREDIT RISK

The capital requirement for credit risk and the counterparty credit risk as at 31 December 2010 was calculated under the standardised approach in accordance with Appendices No. 4 and 16 to Resolution No. 76/2010 of PFSA as amended. The value of that capital requirement of the Group by exposure classes is shown in Table 4.4.

Table 4.4

STRUCTURE OF CAPITAL REQUIREMENT FOR CREDIT RISK
PKO Bank Polski SA Group
2010

TOTAL	9 822
Retail	3 257
Corporate	4 115
Central governments and central banks	12
Secured on real estate property	1 610
Other exposures	377
Institutions (banks)	135
Regional governments and local authorities	64
Past due	244
Administrative bodies and non-commercial undertakings	0
Other classes*	8

* Includes exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.

In 2010, the capital requirement of the Group for credit risk (the counterparty credit risk included) increased by PLN 1,334 million compared to 2009, which was mainly due to the Bank's increased crediting action.

The Group is obliged to maintain the highest capital requirement for the risk related to retail and corporate exposures, which results from the Bank's high exposure to such types of clients. The low capital requirement for exposures to central governments and central banks, despite the high value of such exposures, results from the low risk weights attached to such entities (a considerable proportion of such exposures is accounted for by securities of the State Treasury of Poland and the National Bank of Poland, for which the risk weight is 0%).

The value of exposures hedged with collateral types recognised under Basel II, which permit a reduction of the capital requirement, amounted to PLN 2.5 billion as at 31 December 2010 (Tables 4.5 and 4.6).

Table 4.5

EXPOSURES COLLATERALISED WITH GUARANTEES
The PKO Bank Polski SA Group
2010

TOTAL	268
Retail	0
Corporate	223
Central governments and central banks	7
Secured on real estate property	0
Other exposures	8
Institutions (banks)	15
Regional governments and local authorities	14
Past due	1
Administrative bodies and non-commercial undertakings	0
Other classes*	0

* Includes exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.

As part of the credit risk mitigation techniques, the Bank, in accordance with Basel II, uses guarantees (84% of the guarantees accepted by the Bank are guarantees issued by the State Treasury of Poland) and financial collateral as funded credit protection (mainly registered pledges on securities, irrevocably blocked funds on a bank account or a deposit account at the Bank or payment of cash to the account of the Bank). The Bank applies the Financial Collateral Comprehensive Method, which makes use of collateral haircuts. Apart from financial collateral and guarantees, the Bank uses mortgages to classify its exposures as belonging to the class of exposures secured on real properties. The value of the portfolio of those exposures was PLN 27.4 billion as at 31 December 2010.

In 2010 and in the previous years, the Bank did not conclude any securitisation transaction within the meaning of the Banking Law and supervisory regulations.

In the 1st half of 2010 the Bank conducted a package sales of 58 thousand items of retail receivables classified as lost, due from individuals who do not run economic activity. The sales covered a package of debts of the total value of PLN 634 million. In the 2nd half of 2010 the Bank conducted further package sales:

1) 1.4 thousand items of receivables due from institutional clients, classified as lost, of the total value of PLN 307 million and
2) 62 thousand items of retail receivables, classified as lost, due from individual persons who do not run economic activity. The sales covered a package of debts of the total value of PLN 493 million.

Table 4.6

EXPOSURES COLLATERALISED WITH RECOGNIZED FINANCIAL COLLATERAL*
The PKO Bank Polski SA Group
2010

TOTAL	2 194
Retail	75
Corporate	560
Central governments and central banks	8
Secured on real estate property	0
Other exposures	0
Institutions (banks)	1 531
Regional governments and local authorities	0
Past due	20
Administrative bodies and non-commercial undertakings	0
Other classes**	0

* After volatility haircuts.

** Includes exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.

The tables below show the value of exposures (before and after the application of the credit risk mitigation techniques) by exposure classes and the counterparty credit quality steps as at 31 December 2010. Approximately 87% of the exposures lack the credit quality step. This results from the small number of entities operating on the Polish market that have been awarded the creditworthiness rating by recognised rating agencies. The exposures that involve the credit quality step are mainly: securities of and receivables to the State Treasury of Poland and the National Bank of Poland as well as transactions with other banks.

Table 4.7

VALUE OF EXPOSURES* BEFORE APPLICATION OF THE CREDIT RISK MITIGATION TECHNIQUES
The PKO Bank Polski SA Group
2010

	PKO BP SA, KREDOBANK SA and the BFL SA Group							Other Group subsidiaries	Adjustments and exclusions	Total
	Counterparty's credit quality step									
	1	2	3	4	5	6	none			
Retail	0	0	0	0	0	0	54 341	0	0	54 341
Corporate	0	3	0	0	0	0	53 783	355	-2 137	52 004
Central governments and central banks	0	19 907	0	0	153	0	459	174	0	20 692
Secured on real estate property	0	0	0	0	0	0	27 400	0	-1	27 399
Other exposures	0	0	0	0	0	0	10 942	1 110	-1 198	10 853
Institutions (banks)	1 957	2 400	760	2	3	0	2 360	3 466	-3 747	7 202
Regional governments and local authorities	0	0	0	0	0	0	3 801	0	0	3 801
Past due	0	0	0	0	0	0	2 937	0	-211	2 726
Administrative bodies and non-commercial undertakings		0	0	0	0	0	0	0	0	0
Other classes**	0	0	0	0	0	0	258	25	-197	86
Total	1 957	22 309	760	2	156	0	156 280	5 129	-7 490	179 105

* The value of balance sheet exposures and balance sheet equivalent of liabilities and off-balance sheet transactions before application of the credit risk mitigation techniques.

** Includes exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.

Table 4.8

VALUE OF EXPOSURES* AFTER APPLICATION OF THE CREDIT RISK MITIGATION TECHNIQUES
The PKO Bank Polski SA Group
2010

	PKO BP SA, KREDOBANK SA and the BFL SA Group							Other Group subsidiaries	Adjustments and exclusions	Total
	Counterparty's credit quality step									
	1	2	3	4	5	6	brak			
Retail	0	0	0	0	0	0	54 286	0	0	54 286
Corporate	0	3	0	0	0	0	53 222	355	-2 137	51 443
Central governments and central banks	0	19 907	0	0	153	0	666	174	0	20 900
Secured on real estate property	0	0	0	0	0	0	27 400	0	-1	27 399
Other exposures	0	0	0	0	0	0	10 934	1 110	-1 198	10 846
Institutions (banks)	1 957	2 400	760	2	3	0	829	3 466	-3 747	5 670
Regional governments and local authorities	0	0	0	0	0	0	3 818	0	0	3 818
Past due	0	0	0	0	0	0	2 916	0	-211	2 705
Administrative bodies and non-commercial undertakings		0	0	0	0	0	0	0	0	0
Other classes**	0	0	0	0	0	0	258	25	-197	86
Total	1 957	22 309	760	2	156	0	154 330	5 129	-7 490	177 154

* The value of balance sheet exposures and balance sheet equivalent of liabilities and off-balance sheet transactions after application of the credit risk mitigation techniques.

** Includes exposures on account of regulatory high risk categories and exposures on account of claims in the form of collective investment undertakings.

In 2010, the transactions that had the greatest influence on the amount of the Group’s capital requirement for derivatives were the IRS and CIRS transactions (Table 4.9).

Table 4.9

CAPITAL REQUIREMENT
FOR DERIVATIVES *
2010
The PKO Bank Polski SA Group

	Book		
	banking	trading	Total
Derivatives	37	65	102
IRS	10	53	63
CIRS	24	4	28
Options	0	4	4
Forward	0	4	4
FRA	2	0	2
SWAP	0	1	1
Revers Repo	1	0	1

* Credit risk and counterparty credit risk.

In 2010, within the calculation of capital requirement for derivatives, no netting of the balance sheet and off-balance sheet items was used.

Within the calculation of its capital requirements, the Bank utilizes the credit assessments assigned by the following external credit assessment institutions (rating agencies):

1. Moody's Investors Service,
2. Standard and Poor's Ratings Services,
3. Fitch Ratings.

The Bank implemented the process of carrying the issuer's and issue's rating to off-trading book items for the purposes of calculation of the capital requirements in accordance with the provisions of Annexes No. 4 and No. 15 to Resolution No. 76/2010 of PFSA of 10 Arch. 2010 as amended and Resolution No. 387/2008 of PFSA of 17 December 2008[6].

4.2. Market risk

The market risk of the PKO Bank Polski SA Group is determined primarily by the Bank. The Group's capital requirement for its market risk is calculated in accordance with the provisions of Resolution No. 76/2010 of PFSA as amended. To calculate the capital requirement for FX risk, equity securities risk and specific risk of debt instruments, the Bank uses basic methods. To calculate the capital requirement for general interest rate risk, the Bank uses the duration method.

The total capital requirement for market risk increased significantly in 2010. The largest share in the value of requirement for market risk falls to the specific risk of debt instruments (approx. 81%), which results from the corporate and municipal debt securities held in the Bank's trading book and from underwriting by the Bank of the issue of those securities. Another type of capital requirement that is significant in terms of value is the capital requirement for the general interest rate risk (approx. 19%).

The change in the amount of the capital requirement for interest rate risk and FX risk in the consolidated statements for 2010 resulted from the scale of exclusions of the mutual transactions in the capital requirement calculations.

The capital requirement for all other types of market risk is approx. PLN 1 million. The capital requirement for FX risk is zero due to the fact that the total currency position does not exceed 2% of the Bank's own funds, and that for the commodities risk is also zero due to the absence of this type of instruments in the Bank's portfolio.

4.3. Operational risk

PKO Bank Polski SA has a decisive influence on the operational risk profile of the Group. Other subsidiaries of the Group, due to considerably lower scale of their business activity, only generate limited operational risk.

Starting from January 2009, the capital requirement for operational risk is calculated at the Bank under the standardised approach in accordance with the Appendix No. 14 of Resolution No. 76/2010 of PFSA as amended.

The value of the Group's capital requirement for operational risk was PLN 1.1 billion (including PLN 958 million of the capital requirements for the Bank's operational risk).

In 2010, the Bank started to prepare for implementation of the advanced operational risk measurement methods (AMA). In January 2011 the Bank applied to PFSA for an approval of use of the advanced operational risk measurement methods (AMA).

6 Resolution No. 387/2008 of the Polish Financial Supervision Authority of 17 December 2008 defining the creditworthiness ratings awarded by external rating agencies that may be used by a bank to determine the capital requirements, the scope of utilization of such ratings and their relation to the credit quality ratings (Official Journal of the Polish Financial Supervision Authority of 2008 No. 8, item 41).

5. INTERNAL CAPITAL (PILLAR II)

Internal capital is the amount of capital, as assessed by the Bank, that is required to cover all identified significant types of risk present in the Bank's business activity and the effect of changes in the business environment, the anticipated risk level taken into account.

The purpose of internal capital assessment is to define the minimum level of own funds ensuring the safety of operations, taking account of changes in the profile and volume of conducted activities and unfavourable stress conditions.

The internal capital of the PKO Bank Polski SA Group is calculated to cover each significant risk type:
1) credit risk, including default and concentration risk,
2) FX risk,
3) interest rate risk,
4) liquidity risk,
5) operational risk,
6) business risk (including strategic risk).

The Bank monitors on a cyclical basis the significance of individual types of risk related to the business activity of the Bank and other subsidiaries of the Group.

The total internal capital of the Group is the sum of internal capital required to cover all significant risk types that occur in the subsidiaries of the Group. The Bank has a conservative approach to risk aggregation and does not use the diversification effect.

The amount of internal capital for credit risk is determined for exposures subject to credit risk at the level of unexpected loss for the portfolio of exposures, covered by the portfolio risk measures and is calculated based on the VaR model. The unexpected credit loss (UL) is the difference between the credit value at risk (CVaR) and the amount of the expected loss (EL). For credit portfolios not covered by the portfolio risk measures, it is assumed that internal capital for credit risk equals capital requirement for credit risk, calculated under the approaches defined in resolution no 76/2010 of PFSA as amended.

The total internal capital to cover the credit default risk is the total internal capital established for separated exposure portfolios.

The internal capital to cover the credit risk of concentration is determined as the product of:
1) the multipliers of the internal capital surcharge for each material risk concentration type and
2) the internal capital to cover the credit of default risk.

The value of exposure to a counterparty being a financial institution is determined on the basis of the market value of balance sheet transactions (deposits and bonds) and of the balance sheet equivalent understood as the sum of the cost of replacement and the future potential credit exposure, for off-balance sheet transactions, less the recovery rate. The value of the recovery rate and probability of default for exposures to financial institutions is calculated from data of the Moody's rating agency. The internal capital to cover the counterparty credit risk is assessed on the basis of CVAR approach, but in case of derivatives the volume of credit exposures adopted for the purpose of the approach is defined on the basis of the appendix no 11 to resolution on 76/2010 of PSFA as amended.

To calculate the internal capital for interest rate risk and FX risk, the Bank uses the VaR methodology, the results of stress tests taken into account.

Starting from 2010, the internal capital to cover the liquidity risk is equal to the sum of the internal capital to cover the shortage of liquid assets as compared to the required amount defined by the Bank, and the internal capital to cover the risk of spread related to a sale of the entire securities portfolio.

The internal capital for the Bank's operational risk is equal to the level of the Bank's operational risk calculated by means of AMA. The internal capital for the operational risk of the subsidiaries of the Group is adopted as follows:
1) for the Group's financial subsidiaries - as the additional capital requirement for operational risk, calculated under the basic indicator approach,
2) for non-financial subsidiaries – as equal to the maximum amount of the annual losses related to operational risk for the last 3 years, as suffered by a given subsidiary.

The internal capital for business risk is determined as the product of:
1) ratio of internal capital calculation for business risk and
2) result on banking activities.

The internal capital calculation approaches are defined in internal regulations. To assess internal capital based on statistical models, the time horizon of one year and 99.9% confidence level is applied.

The chart below presents the structure of internal capital by risk type, as assessed as at 31 December 2010 for the Group.

Chart 5.1

INTERNAL CAPITAL
OF THE PKO Bank Polski SA GROUP

Allocation of the total internal capital is made by business lines and by the subsidiaries of the Group.

In order to assess the amount of capital required to safely conduct business activity in unfavourable economic conditions, the Bank carries out stress tests.

6. CAPITAL ADEQUACY

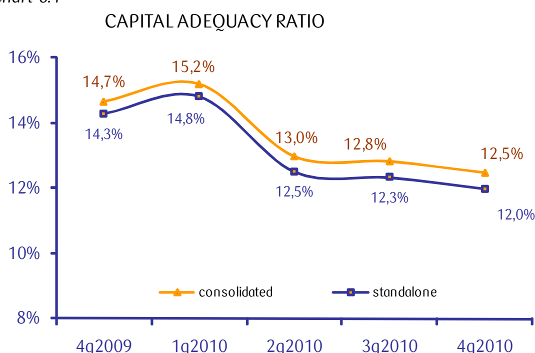
Capital adequacy is the condition under which the amount of own funds of the Bank and the PKO Bank Polski SA Group is higher than total capital requirements (the so-called Pillar I) and total internal capital (the so-called Pillar II). The objective of capital adequacy management is to maintain, on an ongoing basis, the level of capital that is adequate to the scale and risk profile of business activity of the Group.

The process of capital adequacy management at the Bank comprises:
1) identifying and monitoring significant types of risk,
2) assessing the amount of internal capital for individual significant types of risk and of total internal capital,
3) monitoring, reporting, forecasting and limiting of capital adequacy,
4) allocating internal capital to business areas, client segments and subsidiaries of the Group for the purpose of profitability analyses,
5) using tools influencing the capital adequacy level (including: tools changing the level of own funds, the scale of deductions of own funds and the amount of credit portfolio).

The main measures of capital adequacy are as follows:
1) the capital adequacy ratio of at least 8% as required by the Banking Law,
2) the own funds to internal capital ratio of at least 1.0 pursuant to the Banking Law.

The chart below presents changes in the capital adequacy ratio calculated for the Bank and the PKO Bank Polski SA Group.

Chart 6.1



In 2010, the Bank's and the Group's capital adequacy ratio remained at a safe level above both the statutory and internal limits.

As at 31 December 2010, compared to 31 December 2009, the Group's capital adequacy ratio decreased by 2.2 percentage points, to the level of 12.5%. It was caused mainly by an increased of the capital requirements for the credit risk resulting mainly from the high dynamics of the credit portfolio of the Bank's Group.

The Bank monitors drafted changes in regulations (in particular requirements of so called Basel III and directives CRD 3 and 4) that in the future may have a significant impact on the operations of European banks. The Bank participates in preparation of opinions on such solutions.

In 2010 the Bank participated in two Stress Tests that were aimed at presenting the general resistance of the banking sector and ability of banks to absorb potential shocks that have an impact on the growth of credit and market risks. On the EU level the tests were prepared and coordinated by the Committee of European Banking Supervisors (CEBS) in cooperation with the European Central Bank (EBC) and the Office of the Polish Financial Supervision Authority (PSFA). On the national level, the tests were prepared by the Polish Financial Supervision Authority (PSFA).

7. GLOSSARY OF TERMS AND ABBREVIATIONS

Accuracy Ratio (AR) – a measure of effectiveness of the scoring tables, expressed as the ratio of effectiveness of the actual scoring table to effectiveness of the optimum table; the measure can assume values from 0 to 1, where the value 0 means the table's inability to discriminate (i.e. the scoring table assesses the borrower's readiness to discharge its liabilities in a manner that is next to random); the value 1 means that the table is 100% capable of identifying a client about to become insolvent

AFS – available for sale – a securities portfolio type under IAS

AMA (Advanced Measurement Approach) – operational risk advanced measurement approach for the purpose of defining the capital requirements for operational risk

Application scoring system – a system for assessing the Bank's credit risk involved in the financing of clients from scores awarded on the basis of information provided by the client

Banking book – operations not included in the trading book, specifically credit facilities and loans extended and deposits accepted within the bank's business activity or for the purposes of liquidity management

Basel II – a set of external provisions defining a new approach to the calculation of capital requirements and management of the banking risk; in Poland, Basel II was implemented by way of amendment of the Banking Law and adoption of Resolutions No. 1-6/2007 of CFBS of March 2007, which became binding upon Polish banks as of 1 January 2008 (with the assumption of exercise of the option contained in § 14 clause 1 of Resolution No. 1/2007 of CFBS)

Behavioural scoring system – a system for assessing the Bank's credit risk involved in the financing of clients mainly on the basis of transactions on the current account, used for defining the revolving credit limits

BSB (Buy-Sell-Back) – a transaction of purchase of securities with the promise that they will be sold back upon expiration of a specified period before their maturity at a price agreed in advance

Business risk – the risk of loss resulting from unfavourable changes in the business environment, unfavourable decisions, improper implementation of decisions or a failure to take appropriate action in response to changes in the business environment; it specifically includes the strategic risk

Capital adequacy ratio – the main measure of capital adequacy, calculated as the quotient of own funds and total capital requirements multiplied by 8%

Capital requirement – the minimum amount of capital that the bank is obliged, pursuant to Article 128 of the Banking Law and Resolution No. 1/2007 of the Commission for Banking Supervision, to maintain as coverage of the credit, market and operational risk (an element of the so-called Pillar I of Basel II Accord)

CDS (Credit Default Swap) – a credit swap (credit derivatives) relating to insolvency of one reference entity

CFBS – the Commission for Banking Supervision

CIRS (Currency Interest Rate Swap) – a currency interest rate swap transaction

Compliance risk – the risk of incurring legal sanctions or occurrence of financial losses or a loss of reputation or credibility as a result of failure on part of the Bank, the Bank's employees or entities operating on the Bank's behalf to observe legal provisions, internal regulations and the standards of procedure adopted by the Bank, the ethical standards included

Concentration risk – the risk resulting from the Bank's significant exposure to individual entities or groups of entities, whose debt repayment ability depends on one and the same factor (e.g. the industry situation, geographical location, relations between business entities etc.)

Confidence level – the probability, expressed usually as a proportion, that the variable (Bank's loss) under analysis will not exceed a specific value

Coverage ratio – the ratio of the revaluation write-offs on account of impairment on credits and loans to the value of credits and loans assessed under the individualised and portfolio methods

Credit exposure – an asset, awarded off-balance sheet liability or concluded off-balance sheet (derivative) transaction

Credit risk – the risk of incurring losses as a result of a counterparty's default in settlement of liabilities towards the Bank or the risk of decrease in the economic value of the Bank's receivables as a result of deterioration of the counterparty's ability to service its debt

Credit Value-at-Risk, CVaR – a potential loss, not to be exceeded, on the credit risk of a maintained credit portfolio, at an assumed (high) confidence level and period of maintaining the position

CRM (Credit Risk Mitigation) – a credit risk mitigation technique (recognised by Basel II)

CSA (Credit Support Annex) – a collateral agreement – annex to the framework agreement

Cumulated contractual liquidity gap – the sum of all partial contractual liquidity gaps from the first a'vista interval to the interval for which the cumulated contractual liquidity gap is calculated

Cumulated real-terms liquidity gap – the sum of all partial real-terms liquidity gaps from the first a'vista interval to the interval for which the cumulated real-terms liquidity gap is calculated

Cut-off point – the minimum number of points awarded as a result of client creditworthiness assessment made using the scoring system (for individual clients) or the client or joint rating class (for institutional clients), starting from which a loan transaction may be concluded with a specific client

Expected Loss, EL – a statistically assessed value of the mean (expected) credit risk loss that the bank expects to incur on the portfolio within one year

Fair value – an amount for which a specific asset might be exchanged, and a liability discharged, within a market transaction between interested and informed unrelated parties

FRA (Forward Rate Agreement) – a forward agreement for the interest rate

Framework agreement – an agreement between parties regulating the principles of the Bank's co-operation with counterparties on the financial market with respect to forward financial transactions

Funded credit risk protection – a credit risk mitigation technique, where the bank's credit risk related to exposure is reduced by that bank's right – in the case of the counterparty's default in the discharge of its liabilities, insolvency, bankruptcy or another credit event affecting that counterparty and specified in the documentation of the transaction, and, if required for the depositary keeping the collateral – to liquidate, transfer, acquire, or retain specific assets or amounts

FX Swap – a foreign currency exchange swap

GMRA (Global Master Repurchase Agreement) – a framework agreement used within the REPO and BSB/SBB transactions

IAS – the International Accounting Standards

IBNR (incurred but not reported) – a collective method for assessment of the impairment of credit exposures

Individual position for a specific foreign currency (the currency position) – the difference between total assets in a currency, off-balance sheet liabilities received and assets indexed to that currency on the one hand, and total liabilities in that currency, off-balance sheet liabilities awarded and liabilities indexed to that currency on the other hand

Internal capital – an amount, assessed by the Bank, that is required to cover all identified significant types of risk present in the Bank's business activity and the effect of changes in its business environment, taking into account the anticipated risk level (an element of the so-called Pillar II)

IRB (Internal Ratings Based Approach) – an internal ratings method used to determine the capital requirement for credit risk

IRS (Interest Rate Swap) – a transaction involving a swap of interest rates

ISDA – the International Swap and Derivatives Association

ISMA – the International Securities Market Association

Key Risk Indicators, KRI – an amount related to the operational risk profile, describing a specific risk, action or process in terms of frequency, susceptibility or loss; KRI are used for prompt risk measurement and monitoring, and also for projections of future threats

Liquidity reserve – the difference between the most liquid assets and expected and potential liabilities that mature in a given period for a given currency

Liquidity risk – the risk of inability to timely discharge of liabilities due to non-availability of liquid means

LMA – the Loan Market Association

LTV – ratio of the credit exposure amount to the value of the real property offered as collateral of that exposure

Market risk – the risk of loss due to unfavourable market parameters such as interest rate, foreign exchange rate or their volatility

NBP – the National Bank of Poland

Operational risk – the risk of losses resulting from inadequacy or unreliability of the internal processes, the human factor and systems, or from external events

Partial contractual liquidity gap – the difference between total assets and total liabilities, calculated for each maturity range; tells about a mismatch between matured assets and matured liabilities in a given time frame

Partial real-terms liquidity gap – the difference between total assets and total liabilities, calculated for each maturity range; tells about a mismatch between matured assets and matured liabilities in a given time frame, their real-terms maturity date taken into account

PBA – the Polish Bank Association

PCBA – the Polish Classification of Business activity

PFSA – the Polish Financial Supervision Authority

Pillar I – a part of the Basel II requirements containing provisions on the minimum capital requirements for credit, market and operational risk

Pillar II – a part of the Basel II requirements containing provisions on a bank's internal risk management and risk mitigation processes

Pillar III – a part of the Basel II requirements containing provisions on obligatory disclosures of risk profile information and the banks' capital adequacy

Pre-settlement risk – the risk of the counterparty's losing creditworthiness while its transaction with the Bank is pending

Probability of Default, PD – a statistical assessment of the probability of a borrower's insolvency on the annual scale (defines the portfolio-related credit risk to become materialised in the future)

Rating system – a system for assessing the Bank's credit risk involved in the financing of institutional clients, incurred when awarding or changing the essential terms of a loan transaction and in the period of performance of such transaction

REPO – an operation within which funds are borrowed on securities

Reputation risk – the risk relating to the possibility of occurrence of negative deviations from the planned financial result of the Bank due to deterioration of the Bank's image

SBB (Sell-Buy-Back) – a transaction of sale of securities with the promise that they will be bought back upon expiration of a specified period before their maturity at a price agreed in advance

Settlement risk – the risk resulting from the counterparty's default in the discharge of its liabilities at the moment of settlement of the contract

Strategic risk – the negative financial consequences of mistaken decisions, decisions made based on improper assessment, or an absence of proper decisions pertaining to the direction of the Group's strategic development

Stress test (shock analysis) – a risk management tool used for assessment of the potential impact on the bank's situation of a specific event and/or changes in the market parameters not described in the standard manner with statistical measures

Trading book – operations carried out on the bank's own account for trading purposes, i.e. with the intention of generating financial profit, usually within short periods, from the actual or expected differences between the market purchase and sale prices or from other price or price parameters deviations, including specifically interest rates, foreign exchange rates, and share indices, as well as operations carried out for hedging a risk of operations included in the trading book

Unexpected Loss, UL – the difference between the value affected by credit risk and the expected loss

Unfunded credit risk protection – a credit risk mitigation technique where the bank's credit risk related to exposure is reduced by a third party's obligation to pay a specified amount in the case of the debtor's default or of occurrence of other credit events listed in the agreement (guarantees or credit derivatives)

Value at risk (VaR) – a potential loss resulting from changes in the present value of cash flows from financial instruments, or a potential loss on the maintained currency positions due to changes in the foreign exchange rates, on the assumption that a defined confidence level and holding period of the position are kept