

CAPITAL ADEQUACY OF BANK BGŻ 2009.12.31

WARSAW 2010

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A. INTRODUCTION

According to article 111 a. of the Banking Law from the 29th of August 1997 (called “the Banking Law” in this document) and according to Res. No 385/2008 of the Polish Financial Supervisory Commission from the 17th of December 2008 concerning detailed rules and the way of disclosing qualitative and quantitative information about capital adequacy by banks as well as the scope of information that should be disclosed, Bank Gospodarki Żywnościowej S.A. (referred to in this document as: the Bank or Bank BGŻ), is obliged to publish, in widely accessible form, quantitative and qualitative information about capital adequacy – excluding irrelevant information or information that, when disclosed, could have an disadvantageous impact on the Bank’s position on the market, as it is understood by the law concerning protection of the competition and consumers as well as information that is confidential under the law. The values in the report are presented on the highest consolidation level of the group in Poland.

Bank Gospodarki Żywnościowej Spółka Akcyjna is a universal bank operating in Poland and offering services to retail and corporate customers, especially banking services to the food and agriculture sector. Bank BGŻ is the parent entity of the capital group. As on the 31st of December 2009 the Bank’s capital group includes: Bank BGŻ and Bankowy Fundusz Nieruchomościowy Actus sp. z o.o. which does not run any operating activity and does not have any important impact on the Bank’s financial condition nor Bank BGŻ’s capital position.

As on the 31st of December 2009, the Bank had due receivables from BFN Actus equalling to PLN 27.6m. All subsidiaries were consolidated as on the 31st of December 2009.

Tab. Fully consolidated subsidiaries – 31.12.2009 in PLN thou.

name of a subsidiary	statutory capital in PLN thou.	share in statutory capital	activity
BFN Actus Sp. z o.o	1510	100%	real estate purchase & sale
total	1510	100%	

Tab. Equity reducing subsidiaries - 31.12.2009 in PLN thou.

entity	amount of reduction (PLN thou.)	activity	reason for reduction
BGŻ Leasing Sp z o.o.	19 367	działalność leasingowa	udziały
Bank spółdzielczy w Trzebnicy	800	działalność bankowa	pożyczka podporządkowana
Bank Spółdzielczy w Puławach	950	działalność bankowa	pożyczka podporządkowana
total	21 117		

B. AIMS AND RULES FOR RISK MANAGEMENT

B1. CREDIT RISK

Strategies and processes in credit risk management

The basic goal of the credit policy of Bank BGŻ (as defined in internal regulations) is the growth of the credit portfolio while maintaining a stable and acceptable level of impaired exposures. Moreover, a goal of the credit policy is to assure the compliance of procedures and credit products with key values of the Bank's strategy, i.e. transparency, honesty and commitment. The above mentioned goal is reflected in the realized policy of risk management which has the following principles: pursuing transparency of processes and procedures for credit risk assessment of a single transaction, and assuring reliable assessment of credit portfolio quality. The policy of credit risk management and tools used for its realizations are accepted by the Bank's Board.

Organization of the credit risk management process

In order to ensure the efficient execution of tasks in the area of credit risk management in the Bank Finance and Risk area of management has been created. It includes Risk Management Division. Within the Division there are organizational units that are responsible, among other things, for:

- calculation of the internal capital and impairment of the financial assets,
- policy, procedures and methodology as well as monitoring of the credit portfolio,
- credit risk assessment and monitoring of the large exposure transactions,
- loan administration and loan documentation,
- support to the employees from sales units in the area of credit risk issues.

Specialized organizational units are responsible for restructuring and recovery of loan receivables.

In the organizational structure of regional units of the Bank there is a Risk Division responsible for applying and realization of credit risk management rules and goals in regions.

Scope and types of risk reporting and measuring systems

In order to efficiently manage risk in the Bank a system has been introduced which delivers information about credit portfolio quality for the management. Based on information from Data Warehouse and transaction systems monthly, quarterly and semi-annual reports on credit portfolio quality are prepared. Information buckets about corporate and retail obligors include data about rating or scoring, among others. Moreover, the Bank regularly monitors concentration limits, estimates provisions and calculates capital requirements.

Basic tools supporting the credit risk management process are:

- methodology for setting decision levels,
- credit limits which set maximal acceptable credit exposure at particular decision levels,

- methods of assessment of economical and financial situation of clients,
- rating and scoring system,
- system for monitoring of the Bank's exposure to risk,
- application for impairment calculation for financial assets,
- concentration analysis, standard credit risk cost calculation, credit value at risk estimation, RAROC.

Rules within policies for using collaterals and risk mitigation techniques as well as strategies and processes of monitoring efficiency of collaterals and credit risk mitigation techniques

Principles of evaluation, establishing and monitoring of collaterals are defined in internal Bank's regulations approved by the Management Board. These principles aim to ensure:

- equivalent Bank's position in relation to other entities providing financing to a client,
- determination of market value of collateral,
- independent professional appraisal in case of mortgage,
- possibility to use collateral to reduce capital requirements or the basis for creating reserves,
- update of collateral value within the whole crediting period.

Bank's internal regulations, especially statements of specimen forms of collateral agreements, ensure legal certainty of accepted collateral and possibility to recover loan receivables.

B2. MARKET RISK

Market risk comprises foreign currency risk, interest rate risk, price risk, volatility and correlation risk. Existence of market risk is an imminent feature of trading book, where it is a main purpose of having the book in the first place, but it is present also in the banking book, as the effect of offering to the clients of products in different currencies, with different maturities and repricing schemes.

Interest rate risk is primarily associated with mismatch between repricing dates of Bank's assets and liabilities, but it is also connected with the risk of changes in shape of the yield curve, impacting directly net present value of current and future cash flows – fair value and interest streams – and in consequence changing the value of Bank's net equity; and basis risk, being the result of using non-market reference rates as a basis for pricing of selected products.

Price risk is connected with possibility of Bank incurring a loss as a result of change of market price of instruments that are quoted on organised financial market (e.g. exchange), in particular this concerns capital and debt securities. Market value of such instruments is not exclusively driven by e.g. interest rates levels, but is as well dependant on the way the market is organised, its liquidity and by specific (e.g. credit, reputation) risks connected with particular issuer.

Foreign exchange risk it's a risk of change in value of assets, liabilities and off-balance transactions denominated or indexed to foreign currencies, taking place as a consequence of change in market quoted rates of exchange.

Volatility and correlation risk is expressed through instability of financial market that fluctuates in a response to internal factors: supply and demand for particular instruments or risk types; and external: economical and political situation, changes in regulatory environment. Volatility risk, understood as an underlying instrument, is eliminated in Bank BGŻ through the policy of back-to-back hedging of non-linear positions. Correlation risk can be associated with instability of direction and strength of interdependencies between different risk factors that can lead to inefficiency of hedge strategies and changes in risk profile.

Risk management strategies and processes

Bank BGŻ, operating as a universal bank, services all types of clients: retail, corporates, public and budget entities, non-banking financial institutions as well as other banks. Apart from typical banking products (loans and deposits), it offers as well intermediation in trading financial market instruments for the clients and – in limited scope – runs its own investment and trading books.

In order to properly reflect specifics of positions, i.e. their purpose, dominant risks and applied book keeping rules; Bank BGŻ assigns all on-balance positions and off-balance transactions to either banking book or trading book. Precise criteria of this division are laid out in documents (“policies”) introduced with appropriate Management Board resolutions; that specify purpose of the books, approved size, profile and types of taken risks, methods to estimate and limit those risks as well as competences and placement of various organizational units within the Bank in the process of generating, measuring, limiting and reporting of risk. Those documents are in line with recommendations of KNF and requirements of New Capital Accord.

Banking book is composed from – transferred to Treasury Dept.'s management from the branches – credits and deposits, strategic positions (long term investments, obligatory reserve conversion bonds, own bonds issues), financial market operations connected with liquidity management (interbank deposits, liquid debt securities, FX Swaps), interest rate risk hedging transactions (derivatives) and non-accrual positions (e.g. equity, fixed assets, intangible assets, taxes, provisions, current financial result). Bank's policy with regard to banking book is to exercise additional income above the product margin, without compromising excessively stability of deposits placed by the clients, of Bank's capital and its results; through retaining or adjustment – within approved risk limits – of Bank's natural risk profile in order to benefit from expected mid- and long term financial market trends.

Trading book has a supplementary character, supporting sale of financial market products to corporates (directly) and retail (indirectly, in structured products). By opening own positions to facilitate above needs, Bank is able to generate additional income from short-term change in market parameters (foreign exchange rates, interest rates, quoted prices of debt instruments, etc), staying within approved risk limits. Trading book also includes Bank's total on- and off-balance foreign exchange position. In accordance with approved risk policy, Bank BGŻ is not involved in credit risk trading (e.g. CDS, ABS and corporate debt below Poland credit rating) nor does run non-linear positions in options.

Management Board, following Bank's long term strategy and financial plan, established accepted risk profile distributing available capital to business lines that further – in a form of risk limits – is assigned to different books by Balance Sheet and Risk Management Committee (BRMC), acting on behalf and under authorization of the Board.

Current operational management of trading and banking books is under Treasury Dept.'s responsibility, that's acting within prescribed risk limits and with respect to particular positions of banking book is realizing strategies outlined by the BRMC. Risk measurement, reporting and limit breach monitoring, independent valuation and management P&L calculation, booking and processing of the deals is performed by units independent from Treasury Dept., under supervision of Board members responsible for Finances & Risk Area and IT & Operations Area. Acceptance of limit breaches is also organized in hierarchical way: depending on type of limit (its "importance") and size of the excess (technical, minor, major) the acceptance is given on a levels from director or risk reporting unit to the Board member supervising Finance & Risk Area.

Scope and types of risk reporting and measuring systems

Main risk measures, used to assess risks in banking book, are interest rate gaps: repricing gap and sensitivity gap, indicating respective size and distribution of mismatches of repricing/maturity dates and sensitivities of assets, liabilities and off-balance positions to interest rate changes. Based on this information, the Bank's analysing and limiting: sensitivity of Bank's interest income (Interest at Risk) and sensitivity of present value of Bank's net equity (Equity at Risk) to parallel shifts of the yield curves. Risk monitoring also takes into consideration other parameters, such as types of allowed instruments / transactions, currency pairs, max maturities and minimum rating for debt securities for specified parts of banking book.

Separate monitoring is conducted to verify risk levels expressed in terms of Value at Risk, amended by the stress test programme, comprising scenarios exceeding statistically expected volatility of the market. Dedicated stress tests to identify and quantify basis risk in banking book are carried out.

Funds transfer system, being a main source of information on risk profile generated by Bank's core credit & deposit activity in the branches, is based on the replication mechanism, working on a daily basis at the level of single transaction. In case of market benchmark based products (e.g. WIBOR, LIBOR loans) or fixed rate products, risk profile is directly available from repricing schedule or maturity date. For products with unspecified maturity / repricing profile (current accounts, overdrafts), products where the price changes arbitrarily (e.g. by the Board decision), products who's price is indirectly correlated with observed market rates (e.g. average market rates, NBP rediscount rate), as well as for overdue loans; Bank uses replicating portfolios, trying to best reflect the risk profile. In such cases, the exposure is being split into floating part, which usually is being assigned an O/N repricing, and core ("sticky") part, whose structure and maturity can differ from product to product, e.g. for current accounts it's 12 yearly deposits, maturing and rolling over consecutively every month. Remaining products are usually being assigned 1M repricing cycle, depending on the character of the product anchored to the end of the month to reflect correlation with changes of interest rates by the Monetary Policy Council, or spread in time in line with the actual distribution of repricings.

Value at Risk is a main risk measure in trading book. The Bank's using parametric method with exponential weighting, kurtosis adjustment, 99% confidence interval and 1-day holding period. The

VaR is limited both with respect to end of day position as well as intraday. Additional risk limits comprise sensitivity limits (delta/BPV), open position limits, stop-loss limits as well as stress-test limits, basing on theoretical as well as historical scenarios. Further constrains include max maturity of transactions, allowed instruments as well as currencies.

Current reporting on market risk in trading and banking books is prepared daily and distributed to employees directly managing the positions, to their supervisors and to Board members. Periodical reports: monthly, quarterly and annual (for BRMC, Management Board and Supervisory Board) present analysis and explanation for the changes that took place, split in different risk types, books / portfolios, currencies etc., as well as specify recommendations and suggestions as to the steps to be taken in order to improve risk profile.

B3. COUNTRY AND COUNTERPARTY RISK

Counterparty credit risk and country risk are understood as risks of Bank incurring loss as a result of default or increased likelihood of default on whole or part of payments expected from the counterparty, coming from worsening of its financial situation, substantial adverse change in market or economic environment or limitations resulting from deterioration of economic or political situation, or changes in legal system of the country of their residence.

Counterparty risk discussed here concerns financial market transactions: interbank deposits, purchase and sale of debt securities, spot foreign deals as well as derivatives.

Risk management strategies and processes

Bank's policy with regard to country and counterparty risk is to minimize the likelihood of situation, where substantial loss is generated as a result on default on full or partial payment of expected from single or group of connected counterparties.

With regard to financial counterparties, Bank's policy is to concentrate on cooperation with institutions with at least investment grade rating as well as to diversify total exposure with respect to clients and countries. In terms of corporate counterparts, the Bank only supports their needs with regard to transactions hedging their market risk profile generated from core business; and precedes granting of the limit with full and thorough analysis of credit and market risk profile of the client.

Country and counterparty risk is controlled with the system of exposure limits, established for all Bank's counterparts – each transaction uses the counterparty limit and in case he's not a resident, also a country limit.

Organization of risk management process

Counterparty risk assessment process is separated from operational duties, trading deals in particular – design of structure and size of particular exposure limits towards financial counterparties (banks, insurers, investment and pension funds, etc) and countries, as well as periodical monitoring and review of already existing limits are within the scope of responsibilities of unit supervised by Board member responsible for Finance & Risk Area, however final approval of the limits is with BRMC. Size of

the limit is established based on methodologies developed internally for individually homogenous groups of clients, that take into account financial situation (dynamic and structure of results, liquidity), size of capital available to cover for risk, external credit ratings, ownership structure and – if available – history of cooperation. With regard to countries, specific additional factors include assessment of economical and political stability. In this process Bank BGŻ is following recommendations from and considers risk profile accepted by majority shareholder.

In case of non-financial counterparties, process of establishment of transactional limit is a part of credit process, i.e. it is based on assessment of financial standing of the client, recognition of specifics of its operations (e.g. amounts, currencies and schedule of payments, likelihood of payments actually happening, hedging transactions made with other banks, etc) and in consequence fitting of financial market instruments to client's risk profile, in order to mitigate identified risks and stabilize the results. Bank BGŻ excludes possibility of intentional speculative transactions, even if the cooperation is based under cash collateral. Final sizing of the limit, specification of non-monetary constraints (types of allowed transactions, allowed currencies, max maturities, etc), establishment of conditions needed to be met before the limit can be made available as well as decision on the list of applicable collaterals is within scope of responsibility of Credit Committee of 1st of 2nd degree in Bank's headquarter.

Scope and types of risk reporting and measuring systems

As a main tool to mitigate counterparty risk Bank's using exposure limits: presettlement and settlement limits. Presettlement limit controls the size of credit exposure during the life of transactions: in Bank BGŻ it is composed of current NPV of the transaction and risk add-on, reflecting the expected, statistically justified adverse change of that NPV until the maturity date of the deal. Settlement limit is used to reduce concentration of cash flows due from the counterparties on a single date (at reporting date and in all future dates) and is utilized by all expected cash flows, taking into account specific settlement mechanisms of various instruments (i.e. cash settlement vs. delivery).

In case of financial institutions Bank BGŻ specifies a catalogue of available instruments, including additional limit on transactions that engage Bank's actual funding (e.g. interbank deposits, purchase of debt securities issued by the counterparty); and in case of non-financial clients limits allowed currencies/pairs, max maturities, possibility to roll over on historical prices, max open FX position. Limits are being established for max 12 months, but even during that time financial situation of the counterparty is under monitoring.

Utilization of available limits as well as overview of remaining constraints is available on-line in the front office system for Bank's employees authorized to deal transactions with financial and non-financial clients. Independent verification of limits' utilization and adherence to non-monetary restrictions (allowed instruments, currencies, maturities, etc) is carried out by independent unit under supervision of Board member responsible for Finance & Risk Area, that reports daily on the size and structure of exposures in various analytical dimensions to the dealers, to their supervisors and to Board members; as well as requests explanation and acceptance – according to approved authority hierarchy – of limit breaches. In case of non-financial counterparties the unit also prepares information of client's advisors in branches, regions and corporate centers, in order to allow them to agree hedging or collateralization strategy with the client once the exposure gets close to the limit, limit expired or was closed.

Monthly reports summarizing Bank's activity, size and structure of exposure are being prepared for BRMC; quarterly information for Management Board and Supervisory Board.

B4. OPERATIONAL RISK

Strategies and processes in operational risk management

Operational risk is defined by the Bank as the possibility to incur losses or an unjustified cost resulting from inadequate or failed internal processes, people and systems or from external events. Legal risk and compliance risk (partly including legal risk) are included into the operational risk. Compliance risk is the risk of occurrence of legal sanctions, financial losses or damage in the Bank's reputation as a result of the non-compliance of the Bank's business with the commonly binding laws and the Bank's internal regulations, including the best practice standards. The compliance risk shall be also generated by the inconsistency of the Bank's internal regulations with the regulations inside the capital group, faulty agreements and change in the laws or the interpretation thereof. Strategic risk is excluded from the operational risk.

The objective of the operational risk management is to ensure the top quality standards of services rendered by the Bank, to ensure their security and compliance with the binding regulations and the best standards and lowering the losses and costs caused by the operational risk at the same time. Organizational culture in operational risk management plays an important role for the Bank. Key element is employees' awareness about the risk and their share in the responsibility for its reduction. Operational risk is commonly present in the banking activity, what means that each of the employees and each of the organizational units are responsible for operational risk identification within their scope of responsibilities and taking actions aimed at risk reduction.

Operational risk management system is integrated. It means that all actions and functions concerning operational risk management are combined in one, consistent, transparent, complete and efficient system. In order to avoid a potential conflict of interests and in order to ensure objectivity, operational risk assessment function in the Bank is separated from the function responsible for making business decisions. Operational risk control function is autonomous and placed in Bank Management Division.

Operational risk management process included the following stages:

- a. risk identification,
- b. defining risk causes (sources),
- c. assessment of the risk amount and setting its acceptable level,
- d. analysis of possible solutions to reduce the identified risk,
- e. taking a decision to reduce risk,
- f. taking necessary actions,
- g. control and assessment of applied risk reduction tools (feedback).

Organization of the operational risk management process

Operational risk management is carried out in an integrated form, within the dedicated operational risk management structure, that is separated both in organizational and functional form. It includes:

- a. Operational Risk and Compliance Subcommittee acting as part of the Balance Sheet and Risk Management Committee – responsible for supervision, coordination of the processes and allocation of tasks and resources within the operational risk management system,
- b. dedicated unit in Head Office of the Bank – responsible for development, coordination and control of the basic operational risk management processes, as well as development and implementation of tools, procedures and operational risk management rules,
- c. operational risk management positions in Regions – responsible for operational risk management in Regions.

Operational risk management is closely connected to the management of other kinds of risk due to the fact that a substantial part of the operational risk losses occur between operational risk and credit risk or operational risk and financial risk, as well as other banking risks.

Actions directly aimed at operational risk mitigation are taken by units responsible for individual areas exposed to operational risk.

Scope and types of risk reporting and measuring systems

One of the operational risk management stages is taking actions aimed at risk reduction. Those actions mean preventing the threat or reducing the consequences of the event as well as carrying out system actions aimed at elimination of causes of the events. Systems actions are e.g. eliminating the gaps in internal regulations and procedures, preparing new or changing the existing tools, introducing changes to work organization, improving control mechanisms and introducing changes to IT systems. Before taking such actions, their costs are analyzed as well as potential losses that can be borne without implementing the suggested solution.

For the operational risk monitoring and assessment the Bank applies among others: the self-assessment method, Key Operational Risk Indicators (KRI) as well as the data about identified operational risk events and threats, incl. operational risk losses. The Bank decides on its risk tolerance and takes appropriate actions when the allowed risk level is exceeded.

The Bank's Management is regularly informed (decade, monthly and quarterly reports and if necessary also reports on an ad-hoc basis) about the level of operational risk as well as about actions taken due to identified operational risk events and threats.

C. OWN FUNDS

Bank BGŻ presented its own funds as on the 31st of December 2009 according to Art. No. 127 of the Banking Law, Resolution No. 380/2008 of Polish Financial Supervisory Commission of the 17th of December 2008 and Resolution No. 381/2008 of the Polish Financial Supervisory Commission of the

17th of December 2008. The own funds of the Bank's capital group as at the end of 2009 amounted to PLN 2,189,306 thousand and are presented in details in the table below.

Tab. Own funds and short term capital - 31.12.2009 in PLN thou.

	type of funds	PLN thou.
	share capital	43 137
	supplementary capital	2 112 164
	reserve capital with undivided profits from previous years	40 835
	current period net profit with undivided profits from previous years	100 643
	current period net profit with unverified profits in the acceptance process	(100 643)
	general risk fund	90 000
	own funds from revaluation update	(2 838)
	decrease in own funds due to intangible assets	(88 573)
	decrease in own funds due to exposure to financial clients	(21 117)
	short term capital	15 697
	total own funds	2 189 306

Bank's share capital as on the 31st of December 2009 amounted to PLN 43,137 thou. and is divided into registered shares of nominal value of PLN 1 per share, out of which:

- 21,297,584 belong to Rabobank International Holding B.V. in Utrecht,
- 16,065,570 belong to National Treasury represented by the Minister of National Treasury,
- 4,303,695 belong to Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A.
- 1,469,915 belong to other entities.

Registered shares of "B" series in the amount of 7,807,300 are preferred shares. The privilege covers the right to receive the entire face amount upon the liquidation of the Bank, after creditors fulfilment, before payout reserved for common shares. Most of "B" series shares is held by Rabobank International Holding B.V., i.e. 7,785,594 shares.

Reserve capital is created from annual write-offs from revenue or other sources, regardless of supplementary capital. Reserve capital covers a part of revaluation fund, concerning liquidated, sold or conveyed free of charge fixed assets, which were subject to the revaluation update through an increase of revaluation fund. It is allocated to cover balance losses of the Bank or held for other purposes, including shareholders dividend payout. The way of use of the reserve capital is decided during the Annual Shareholder's Meeting.

General banking risk fund was created according to Banking Law of the 29th of August 1997 from revenues after taxation. General banking risk fund is subject to allocation on approval of shareholders during the Annual Shareholders' Meeting exclusively.

Short-term capital includes market revenue as specified in article 4 point 1 of Resolution No. 380/2008 of the Financial Supervisory Commission and is calculated increasingly to the report date, reduced with liabilities, including dividends, within the scope that was not included in the Bank's own funds or allocated in any another way.

In 2009 the process of concluding agreements on behalf of the State Treasury was continued. The process concerned free disposal of Bank BGŻ S.A. shares to entitled persons, based on the Resolution on the functioning of cooperative banks, their associations and central banks of a conglomerate updated on the 16th of February 2007 and a Directive of the Ministry of State Treasury of the 2nd of August 2007 changing the directive on the detailed rules and mode of distribution of the 15% of the shares of Bank BGŻ S.A., belonging to the State Treasury, among entitled persons. In 2009 133 agreements were concluded. They concerned 6,819 shares; however the agreements concluded in December 2009, because of existing procedures were registered in the share register of BGŻ in January 2010. Those transactions had an insignificant impact on the State Treasury's share in the share capital of the Bank. As at the end of December 2009 the share amounted to 37.24% (at the end of 2008 it equalled 37.26%).

D. ADHERENCE TO THE CAPITAL REQUIREMENTS

D1. CAPITAL ADEQUACY ASSESSMENT METHOD

In 2009 Bank BGŻ calculated regulatory capital requirements in line with the Resolution No. 380/2008 by the Financial Supervisory Commission of the 17th of December 2009. As far as the credit risk is concerned, the Bank made use of the standardized approach. In case of operational risk the basic indicator approach was used, and for market risk the standardized methods in line with Basel II were implemented.

Within the process of regulator capital requirement calculation the Bank made use of the credit ratings assigned by FitchRatings and Moody's Investors Services. The Bank did not include ratings by Standard & Poor's and export credit insurance companies. All the ratings used by the bank were implemented in the process of the regulatory capital requirement calculation for credit risk of exposures to governments and central banks, to institutions and to companies.

In order to reduce the regulatory capital requirements, the Bank made use of credit risk mitigation techniques, including: a) collaterals - the reduction in credit risk results from the rights to liquidate, transfer, take over or keep specified assets or amounts in case of a client's default; b) guarantees - the reduction in credit risk results from a third party's commitment to repay a specified amount in case of a client's default or other specified credit events.

D2. REGULATORY CAPITAL REQUIREMENTS AND CAPITAL ADEQUACY RATIO

Regulatory capital requirements

The following tables present regulatory capital requirements per risk types as well as the division of regulatory capital requirements for credit risk per category of an exposure.

Tab. Consolidated regulatory capital requirements – 31.12.2009 in PLN thou.

	PLN thousand
credit risk, settlement risk & counterparty credit risk	1 352 719
market risk including:	5 335
FX risk	-
commodity risk	-
price risk of equities	-
specific risk of debt instruments	-
general interest rate risk	5 335
exceeding of the limit of exposure concentration and the limit of big exposures	-
exceeding of capital concentration's threshold	-
operational risk (BIA)	149 292
total	1 507 346

Tab. Capital requirements for credit risk – 31.12.2009 in PLN thou.

category	PLN thousand
claims on sovereigns	-
claims on local authorities	3 048
claims on non-central government public sector entities (PSEs)	2 848
claims on multilateral development banks (MDBs)	-
claims on international organizations	-
claims on institutions	14 620
claims on corporates	317 496
claims included in the regulatory retail portfolios	286 401
claims secured by real estate mortgage	639 477
past due loans	26 154
higher-risk categories	1 460
secured bonds	-
short term exposures to banks and corporates	1 721,57
investments units	-
other	59 492
total	1 352 719

Capital adequacy ratio

Capital adequacy ratio is calculated as a quotient of own funds increased with a short term capital (in the amount that must not be higher than regulatory capital requirements for market risk) and the total capital requirements multiplied by 12.5. As on the 31st of December 2009, Bank's capital adequacy ratio amounted to 11.62% on consolidated basis.

D3. RISK MITIGATION TECHNIQUES

Policy and procedures for netting on-balance and off-balance sheet

Bank BGŻ does not use compensation of on- and off- balance exposures in normal operational activities and therefore does not take such effects into account calculating its regulatory capital requirements.

However, the Bank takes into account that framework agreements signed with particular clients (see: "G. Counterparty credit risk") that allow for compensation of mutual liabilities in case of early termination and settlement of transactions, if the client breaks the agreement or his financial situation deteriorates significantly; and therefore is including this netting effect while calculating size of exposure to manage its counterparty credit risk, for estimation of economic capital and adjustment of fair value.

Policy and procedures for collateral valuation and collateral management

Bank's internal regulations determine requirements concerning principles of assessment of entities that establish personal collaterals and general rules for material collaterals' valuation.

The acceptance of personal collateral has to be preceded by the assessment of credibility and financial standing of collateral issuer. In case of material collateral, e.g. register pledge and transfer of ownership, the assessment of current market value of collateral is required.

In case of mortgage-backed transactions, Bank BGŻ determines market value of real estate at the basis of professional appraiser valuation, subject to small exposures and selected types of real properties when the Bank accepts internal valuations basing on statistics and transactional prices.

The update of collateral value is an element of monitoring.

Types of credit collaterals, guarantors and counterparties within credit derivatives

According to the Banking Law art. 93, to secure bank's receivables a bank may request a client to establish collateral which is governed by the rules of Civil Code, law on bills of exchange or customs being in force in domestic or international market. Following the general statement of the Banking Law, Bank BGŻ accepts personal collaterals where the whole property of a debtor titled from collateral may be used to meet Bank's claims and material collaterals - where Bank's claims may be realized from property being the subject of collateral agreement. From the catalogue of personal collaterals the most often used collateral by Bank BGŻ is civil guarantee. From the catalogue of material collaterals the most often used collaterals by Bank BGŻ are transfer of ownership, register pledge and mortgage.

Bank doesn't use credit derivatives with reference to non financial clients. As far as the guarantees are concerned, the main guarantors are: Rabobank Nederland with AAA rating, and unrated Polish banks.

Tab. Exposures protected with recognized collaterals and guarantees –31.12.2009 in PLN thou.

exposure class	PLN thou.
claims on sovereigns	-
claims on local authorities	-
claims on non-central government public sector entities (PSEs)	1 130
claims on multilateral development banks (MDBs)	-
claims on international organizations	-
claims on institutions	-
claims on corporates	28 966
claims included in the regulatory retail portfolios	91 830
claims secured by real estate mortgage	49 806
past due loans	2 486
higher-risk categories	-
secured bonds	-
short term exposures to banks and corporates	-
investments units	-
other	-
total	174 218

Tab. Exposures protected with guarantees defined under New Basel Capital Accord – 31.12.2009 in PLN thou.

exposure class	PLN thou.
claims on sovereigns	-
claims on local authorities	-
claims on non-central government public sector entities (PSEs)	386
claims on multilateral development banks (MDBs)	-
claims on international organizations	-
claims on institutions	-
claims on corporates	16 181
claims included in the regulatory retail portfolios	66 198
claims secured by real estate mortgage	36 473
past due loans	2 484
higher-risk categories	-
secured bonds	-
short term exposures to banks and corporates	-
investments units	-
other	-
total	121 721

E. IMPAIRMENT OF FINANCIAL ASSETS

The following chapter presents only the values of assets that are tested for impairment under International Accounting Standards (IAS39), which differs from values in Financial Statement where all assets are presented. Impairment assessment of financial assets in line with the International Accounting Standards (IAS 39) is performed for such assets that are valued in line with amortized cost. Those assets include:

- a. credit and loans to non financial obligors,
- b. receivables from banks, including those resulting from *reverse repo i buy sell back* transactions,
- c. debt securities classified as held till maturity
- d. off-balance sheet commitments resulting from guarantees, letters of credit, unused credit limits, with the exception for those off-balance sheet commitments that result from derivatives.

The impairment assessment concerns also unlisted capital instruments and capital commitments classified as “available for sale” for which the loss is directly reflected in own funds and there no objective evidence for impairment of such an asset. Furthermore, the impairment assessment is not performed for derivatives that are priced in line with the fair value method.

Bank BGŻ performs monthly calculation of impairment of financial assets. The calculations are performed according to IAS 39 with the use of an IT application. During the calculation individually significant and individually insignificant assets are distinguished. The main indication for an asset to be recognized as individually significant is an exposure value exceeding PLN 1 million. Exposures that have been recognized as individually significant are analyzed on an individual basis for the impairment identification by the Bank’s employees. The impairment is mainly identified based on a delay in principal or interests payments (for individually insignificant assets) and based on the judgment of an employee responsible for monitoring (for the individually significant assets). Generally following situations are considered as impairment evidence:

- a. delay or lack of principal, interests or other payments resulting from credit agreement; the delay must be longer than 90 days;
- b. preferential treatment of a client as a consequence of economic or legal reason, also including restructuring in a form of signing a new annex or any changes to the initial agreement (e.g. extension of the crediting period, changes to payment schedule, changes to collaterals, changes to interests rates) that in any other case would not be accepted by the bank;
- c. a write off of the credit exposure or interests as a consequence of, for example, agreement with the client, or transferring the exposure to off-balance-sheet records.
- d. termination of an agreement by the bank and/or beginning of internal restructuring or recovery procedures, especially passing of the credit exposure to the Bad Loan Department’s portfolio;
- e. bankrupcty, liquidation or beginning of the liquidation process of the client;

- f. disadvantageous changes in financial and economic standing of the client, especially recognition of the early warning signals.

When the impairment's evidence is recognized, a Bank's employee responsible for the exposure estimates the value of the future cash flows that, after discounting, represent current value of the exposure and allows for calculation of impairment of the asset. Individually significant financial assets for which impairment was not recognized, as well as all individually insignificant financial assets are assessed on a collective basis. Within collective approach the value of impairment provision for exposures with recognized impairment evidence is calculated. The collective approach covers also the calculation of IBNR provision (incurred but not reported losses) for those exposures that were not recognized as impaired.

Tab. Exposures per impairment assessment method – 31.12.2009 in PLN thou.

assessment method	number of exposures	average exposure value	gross exposure value		impairment provision	nett exposure value	
individual - impaired exposures	305	2 525	770 225	3,5%	269 765	500 460	2,3%
collective - impaired exposures	39 543	10	402 504	1,8%	282 858	119 646	0,6%
collective - not impaired exposures	434 706	48	20 954 527	94,7%	57 412	20 897 116	97,1%
total	474 554	47	22 127 257	100,0%	610 035	21 517 222	100,0%

The exposure is understood as a sum of on-balance and off-balance sheet exposure.

Tab. Exposures and impairment provisions per region – 31.12.2009 in PLN thou.

region	exposures			impairment provision for exposures				
	not impaired	impaired	total	not impaired	impaired	total		
Head Office	427 371	33,7%	842 516	66,3%	1 269 887	5 601	486 038	491 639
Central	2 792 036	98,2%	52 081	1,8%	2 844 117	6 985	11 742	18 727
Central-Western	2 665 835	99,0%	27 720	1,0%	2 693 555	7 304	8 561	15 864
South-Eastern	2 153 527	99,6%	8 627	0,4%	2 162 154	6 253	3 351	9 604
South-Western	1 618 871	96,9%	51 400	3,1%	1 670 271	4 088	11 698	15 786
Southern	1 542 231	99,4%	9 061	0,6%	1 551 292	4 428	4 455	8 883
North-Eastern	1 902 738	99,7%	5 195	0,3%	1 907 933	3 558	2 124	5 683
North-Western	1 017 599	99,1%	9 235	0,9%	1 026 834	2 690	3 960	6 650
Northern	4 392 317	97,7%	104 534	2,3%	4 496 851	10 922	9 628	20 550
Eastern	2 442 003	97,5%	62 361	2,5%	2 504 364	5 584	11 066	16 650
total	20 954 527	94,7%	1 172 729	5,3%	22 127 257	57 412	552 623	610 035

Remark: The exposure is understood as a sum of on-balance and off-balance sheet exposure; the regional structure is in line with Bank's structure that is in force from 01.01.2010.

Tab. Exposures and impairment provisions per time to maturity – 31.12.2009 in PLN thou.

residual maturity	exposures					impairment provisions for exposures		
	not impaired		impaired		total	not impaired	impaired	total
up to 1 year	4 912 259	89,4%	582 890	10,6%	5 495 149	12 633	339 635	352 268
from 1 to 3 years	2 674 177	94,1%	168 743	5,9%	2 842 921	7 232	45 627	52 860
from 3 to 5 years	2 272 268	94,6%	130 687	5,4%	2 402 955	9 224	56 314	65 539
from 5 to 10 years	3 196 353	94,5%	185 449	5,5%	3 381 803	8 260	66 467	74 726
over 10 years	7 895 635	98,8%	97 238	1,2%	7 992 873	19 898	40 149	60 047
unspecified	3 835	33,2%	7 721	66,8%	11 556	165	4 431	4 596
total	20 954 527	94,7%	1 172 729	5,3%	22 127 257	57 412	552 623	610 035

The exposure is understood as a sum of on-balance and off-balance sheet exposure.

Tab. Exposures and impairment provisions per economy sector – 31.12.2009 in PLN thou.

industry	exposure					impairment provisions		
	non impaired		impaired		total	non impaired	impaired	total
Agriculture	4 752 635	96,2%	189 226	3,8%	4 941 861	11 470	152 506	163 976
Manufacture of food products	1 975 902	87,6%	280 735	12,4%	2 256 638	4 360	85 091	89 451
Wholesale trade	1 403 599	91,8%	125 880	8,2%	1 529 479	31	103	134
Manuf. of chemical, rubber, metal or non-metallic prod.	1 279 374	96,4%	47 293	3,6%	1 326 667	18	4	21
Construction	554 446	90,0%	61 882	10,0%	616 328	70	36	105
Manufacture of machinery	511 789	85,7%	85 317	14,3%	597 105	1 244	26 388	27 632
Retail trade	551 003	97,1%	16 457	2,9%	567 460	2 648	31 178	33 826
Real estate, renting	545 688	98,7%	6 989	1,3%	552 677	1 607	16 055	17 662
Textile, leather and wood products or paper	483 173	91,2%	46 332	8,8%	529 505	80	0	80
Transport, storage and communication	375 926	92,3%	31 577	7,7%	407 503	29	351	380
Motor vehicles or fuel	264 540	96,0%	11 035	4,0%	275 575	1 213	9 738	10 951
Other business	206 075	99,9%	162	0,1%	206 237	775	4 143	4 918
Financial intermediation	150 672	91,7%	13 582	8,3%	164 254	4 731	45 182	49 913
Hotels and restaurants	116 804	89,2%	14 151	10,8%	130 956	1 325	11 816	13 141
Other service activities	104 732	99,6%	438	0,4%	105 170	420	1 931	2 351
Other industries	490 967	90,1%	54 019	9,9%	544 986	6 078	119 491	125 569
Private persons	7 187 202	97,5%	187 654	2,5%	7 374 856	21 312	48 612	69 924
total	20 954 527	94,7%	1 172 729	5,3%	22 127 257	57 412	552 623	610 035

The exposure is understood as a sum of on-balance and off-balance sheet exposure.

Tab. Exposures and impairment provisions per residual maturity class – 31.12.2009 in PLN thou.

residual maturity	exposures					impairment provisions for exposures		
	not impaired		impaired		total	not impaired	impaired	total
up to 1 year	4 912 259	89,4%	582 890	10,6%	5 495 149	12 633	339 635	352 268
from 1 to 3 years	2 674 177	94,1%	168 743	5,9%	2 842 921	7 232	45 627	52 860
from 3 to 5 years	2 272 268	94,6%	130 687	5,4%	2 402 955	9 224	56 314	65 539
from 5 to 10 years	3 196 353	94,5%	185 449	5,5%	3 381 803	8 260	66 467	74 726
over 10 years	7 895 635	98,8%	97 238	1,2%	7 992 873	19 898	40 149	60 047
unspecified	3 835	33,2%	7 721	66,8%	11 556	165	4 431	4 596
total	20 954 527	94,7%	1 172 729	5,3%	22 127 257	57 412	552 623	610 035

The exposure is understood as a sum of on-balance and off-balance sheet exposure.

Tab. Changes in impairment provisions in 2009 in PLN thou.

PLN thou.	current account loans	loans	purchased receivables	realized guarantees	other receivables	receivables from banks	off-balance sheet exposures	total
impairment provision at the beginning of the year	57 702	415 935	13 427	654	28 992	1 713	4 018	522 441
creation of provisions	91 970	514 505	28 897	21 678	96 554	11 650	25 185	790 439
release of provisions	(59 165)	(469 092)	(27 027)	(18 449)	(81 915)	(4 132)	(24 397)	(684 177)
write-offs	(950)	(20 040)	-	-	-	-	-	(20 990)
interest rate income adjustment related to IBNR	1 103	3 517	38	104	-	-	-	4 762
other changes	(5 475)	568	834	(63)	4 480	(848)	(1 936)	(2 440)
impairment provision at the end of the year	85 185	445 393	16 169	3 924	48 111	8 383	2 870	610 035

F. MARKET RISK

Bank's product policy, i.e. using of floating rates for credits, financed by short term fixed rate deposits results in a well matched interest rate exposure, concentrated in short tenors: as at end of 2009, 97/94% of positions – assets/liabilities incl. off-balance respectively – reprices or matures within 6 months, 90/79% within 3 months and 65/52% within 1 month. Derivatives were used to hedge interest rate risk of state treasury debt securities portfolio as well as a source of liquidity to finance foreign currency denominated portfolio of retail mortgage loans.

The table below presents key risk measures for banking book as end of 2007, 2008 and 2009.

Tab. Banking book risk profile in PLN thousand

risk measure	31.12.2008	31.12.2009	change	change [%]
Repricing gap (marginal)				
up to 1M	-2 212 889	4 892 758	7 105 648	-321%
1-3M	1 910 475	-76 204	-1 986 678	-104%
3-6M	1 041 986	-1 947 669	-2 989 654	-287%
6-24M	689 646	-1 084 062	-1 773 709	-257%
over 2Y	309 182	202 479	-106 703	-35%
Interest at Risk ¹⁾	22 815	18 766	-4 049	-18%
PLN impact	17 441	15 426	-2 016	-12%
EUR impact	2 334	472	-1 862	-80%
USD impact	1 146	1 211	65	6%
other currencies	1 894	1 658	-237	-12%
Equity at Risk ²⁾	48 193	8 573	-39 619	-82%
Value at Risk (99%, 1M holding period)	16 595	10 415	-6 179	-37%

1) Sensitivity of 12-month interest income to 50bps interest rate movement.

2) Sensitivity of net equity's fair value to 200 bps interest rate movement.

In 2009 Bank BGŻ continued its conservative policy with regard to market risk in trading book, concentrating its efforts on support of sale of treasury products as well as on investing of surplus liquidity. Foreign exchange position has been closed by the end of the day, Bank did not run option book (all client options were closed back-to-back) and did not engaged into credit derivatives and corporate debt.

The table below presents key risk measures for trading book as end of 2007, 2008 and 2009.

Tab. Trading book risk profile in PLN thousand

risk measure	31.12.2008	31.12.2009	change	change [%]
Market risk VaR (99%, 1D holding period)	1 480	414	-1 067	-72%
Foreign exchange risk	55	54	-1	-2%
Interest rate risk	1 479	400	-1 079	-73%
Diversification gain	-53	-40	13	-24%
Total open FX position	2 944	4 751	1 807	61%
Standard Stress Test (int. rates +100bp, FX +10%)	4 191	4 244	53	1%

G COUNTERPARTY CREDIT RISK

In addition to conservative credit risk policy, pertaining to establishment of safe size of transactional exposure limits towards the counterparties, Bank BGŻ puts emphasis also on the quality of legal framework, under which the transactions are being made.

Bank BGŻ aims to cooperate with all financial clients under ISDA agreements annexed with CSA (Credit Support Annex) that enables netting of undue exposures as well as is setting a maximum accepted exposure level (*threshold*), above which the side of the agreement for which the valuation of transactions is negative is obliged to provide additional collateral (*margin call*). As at end of 2009, Bank BGŻ had signed ISDA agreements with approx. half of its active counterparties, in that 1/3 has been annexed with CSA. Benefits resulting from application of netting clauses amount to 90%, i.e. total positive NPV exposure in the amount of PLN 96 million gets reduced to PLN 9 million after netting.

Cooperation with non-financial clients is based on standard, internally developed framework agreement, that specifies: rights and obligations of both sides, in particular the list of triggers indicating deterioration of client's financial situation, situations and instruments to be used by the client to provide additional collateral should the limit be breached or expired, or if other important clauses of the agreements are broken; mechanism of settlement compensation in case of early termination. Due to the fact that majority of client's exposures are one-sided, i.e. client is hedged against increase or decrease of foreign exchange rate or interest rate; the benefits from compensation are small and do not exceed PLN 0.2 million, i.e. 0.2% of exposure.

The table below presents structure of residual maturity of derivatives' portfolio, its positive, negative valuation and netting benefits as at end of 2009.

Tab. Exposure in derivatives (part 1) – 31.12.2009 in PLN thou.

type of instrument	notional							total
	up to 1M	1-3M	3-6M	6-12M	1-2Y	2-5Y	5Y+	
with banks	3 497 922	2 479 676	389 088	696 474	1 276 642	556 234	775 238	9 671 274
IRS / CIRS / OIS	25 000	500 000	325 000	584 731	1 276 642	556 234	775 238	4 042 845
FX Swap	3 430 465	1 916 821	0	49 298	0	0	0	5 396 584
FX Options, incl.:	42 456	62 855	64 088	62 445	0	0	0	231 844
- vanilla	27 474	18 487	9 860	12 325	0	0	0	68 145
- exotic	14 982	44 369	54 228	50 120	0	0	0	163 699
with non-banks	196 108	139 685	102 822	140 405	608 458	39 500	4 340	1 231 318
IRS / CIRS	0	0	0	0	585 575	39 500	4 340	629 415
FX Forward	70 662	14 238	7 799	38 784	0	0	0	131 482
FX Forward (NDF)	94 082	84 776	64 211	68 756	22 883	0	0	334 708
FX Options, incl.:	31 364	40 671	30 812	32 866	0	0	0	135 712
- vanilla	26 242	16 022	6 162	12 325	0	0	0	60 750
- exotic	5 123	24 649	24 649	20 541	0	0	0	74 962
total	3 694 030	2 619 361	491 910	836 879	1 885 100	595 734	779 578	10 902 592

Tab. Exposure in derivatives (part 2) – 31.12.2009 in PLN thou.

type of instrument	NPV			netting benefits	
	NPV +	NPV -	NPV net	NPV	%
with banks	95 754	-192 066	-96 312	9 292	90,30%
IRS / CIRS / OIS	41 604	-88 633	-47 029	2 053	95,07%
FX Swap	48 781	-84 470	-35 689	2 170	95,55%
FX Options, incl.:	5 368	-18 962	-13 594	5 069	5,58%
- vanilla	319	-641	-322	19	93,94%
- exotic	5 050	-18 321	-13 272	5 050	0,00%
with non-banks	104 864	-937	103 927	104 698	0,16%
IRS / CIRS	43 966	0	43 966	43 966	0,00%
FX Forward	16 422	-199	16 222	16 286	0,82%
FX Forward (NDF)	30 852	-706	30 145	30 852	0,00%
FX Options, incl.:	13 624	-31	13 594	13 594	0,23%
- vanilla	353	-31	322	322	8,75%
- exotic	13 272	0	13 272	13 272	0,00%
total	200 618	-193 002	7 615	113 990	43,18%

No credit provisions are being made on off-balance receivables, in particular resulting from derivative instruments, unless the transaction is terminated before its contractual maturity and is not settled – then it is converted into overdue receivable and standard provisioning procedures are then applied. In order to reflect in Bank's P&L account the risk of such event taking place, since December 2008 Bank BGZ applies monthly adjustment of fair value of non-financial counterpart's transactions. The model that is being used scales the regular fair value, treated in this process as an exposure at default (EAD), by the factor resulting from expected probability of default given by internal rating of the counterparty multiplied by expected level of loss assuming partial successful recovery (LGD). Such approach is applied to majority of counterparties; however using expert knowledge with regard to individual PD and LGD estimates is also possible. Above described adjustment takes into account cash collaterals provided by the clients as well as netting clauses in accordance with framework agreements.

As of 31.12.2009, the adjustment of fair value with credit risk component amounted to PLN 3.5 million, out of which 76% was connected with individually assessed exposures.

H. CAPITAL EXPOSURES NOT INCLUDED IN THE TRADING BOOK

Equity instruments outside the trading book comprise shares and investments of a strategic or infrastructural character. Valuation of these exposures is done by estimation of their fair value based on reliable information as of possible sale price to be obtained, or based on net assets. In case of lack of observable quotations on active markets and no possibility to reliably estimate fair value using alternative methods, such assets are carried at cost less any impairment.

Equity instruments are not quoted on regulated markets. As of the 31st of December 2009 carrying amount of the exposures amounted to PLN 1.4 million.

Due to lack of reliable fair value estimations assets have been valued at cost of their purchase.

As of 31 December 2009 there were no unrealized gains/ losses from revaluation.

I. INTERNAL CAPITAL REQUIREMENTS – ECONOMIC CAPITAL

Bank BGŻ defines internal capital as the value of capital that should be kept by the Bank to cover losses with such a value, that the probability of incurring it within 12 months is lower than 0.1%. The total value of internal capital consists of capital for the following risk types:

- credit risk,
- country and transfer risk,
- concentration risk,
- market risk (including market risk in the trading portfolio and the interest rate risk in the banking book);
- operational risk,
- business risk,
- risk connected with fixed assets, intangible assets.

Internal capital for risk, excluding internal capital for market risk, is calculated monthly basing on exposures at the end of the month. The capital for market risk is estimated on a daily basis and reported monthly. Bank BGŻ treats internal capital as one of the Bank's management tools allowing for defining risk limits and estimation of Bank's effectiveness. The Bank has implemented internal tools allowing for estimation of risk adjusted return on (internal) capital (i.e. RAROC). The table below presents the structure of internal (economic) capital at the end of 2009.

Tab. Structure of economic capital – 31.12.2009 in PLN thou.

risk type	PLN thou.	share
credit risk	1 306 182	72,88%
concentration risk	22 923	1,28%
country and counterparty risk	79 587	4,44%
operational risk	211 982	11,83%
market risk	45 845	2,56%
other asset related risks	50 966	2,84%
buisness risk	74 682	4,17%
total	1 792 168	100,00%

Brief information on internal capital model for credit risk, country and transfer risk as well as concentration risk

For the purpose of internal capital calculation for credit risk the Bank distinguishes models for non-financial as well as for financial obligors.

Internal capital calculation for non-financial obligors is performed in Bank BGŻ with the use of statistical methods allowing for modelling credit portfolios. For each recognized portfolio the Bank

calculates risk parameters which include: probability of default for different classes of overdue in repayment, recovery rate given default, as well as correlation coefficients expressing dependence between default moments of different obligors from the same credit portfolio. Moreover, the Bank analyses the interportfolio diversification effects which results in a reduction of internal capital due to the fact of non-perfect correlation of risks from different portfolios. The diversification effect is presented as a reduction in initial internal capital value and the value of the reduction is calculated with statistical methods. Inclusion of the diversification effect in the final internal capital calculation is possible using Monte Carlo simulations. The Bank estimates the value of economic capital for credit risk of non-financial obligors every month. The economic capital is precisely allocated to all credit exposures of the Bank. The total value of economic capital as well as its allocation forms a basis for decision making and effectiveness assessment as a part of RAROC calculation. The model of internal capital for non-financial obligors assumes perfect granulation within a portfolio and identical exposure to any of the existing obligors. As the Bank has comparatively high exposure to a limited number of obligors, an additional capital for concentration risk has to be created. The model for concentration risk is based on the Monte Carlo simulation and assumes creating additional capital for a hundred of obligors with the highest possible loss given their default. Estimation of the capital is performed on a monthly basis.

Internal capital calculation for banks and countries is performed with the use of a separate model. This group of obligors of the Bank is distinguished through external ratings. A rating adequately reflects the ability of an obligor to meet its obligations and can be thought of as an initial point for calculation of risk coefficient for the obligor as well as for the economic capital calculation. While estimating economic capital for those exposures the Bank bases on information on yearly default rates observed in history by the rating agency Moody's. As far as the loss given default (LGD) parameter is concerned, IRB Foundation assumptions from New Basel Capital Accord are used. Economic capital calculation for this kind of risk is performed with the use of Monte Carlo simulation and allows for covering concentration risk existing for this type of clients, too. Similarly as in the case of credit risk of non-financial obligors, a yearly risk-taking horizon and a confidence level of 99.9% are assumed. The capital is calculated on a monthly basis.

Brief description of the internal capital models for the market risk

In order to calculate the adequacy of internal economic capital for market risk, settlement risk and counterparty credit risk, the Bank uses:

- for foreign exchange risk: value at risk method (VaR), based on parametric delta-normal model (Bank does not allow for open positions in FX Options – all corporate transactions are immediately closed on a back-to-back principle) with an adjustment for kurtosis observed in empirical distribution of changes in risk factors and with exponentially weighting, according to the attachment No. 19 to the Resolution No. 380/2008 by the Financial Supervisory Commission;
- for commodity risk: simplified method, according to attachment No. 7 to the Resolution No. 380/2008 by the Financial Supervisory Commission;
- for price risk of equities: foundation method, according to attachment No. 8 to the Resolution No. 380/2008 by the Financial Supervisory Commission;

- for specific risk of debt instruments: foundation method, according to the attachment No. 9 to the Resolution No. 380/2008 by the Financial Supervisory Commission;
- for general interest rate risk: value at risk method (VaR), based on parametric delta-normal model adjusted for kurtosis observed in empirical distribution of interest rate changes, taking into account different types of yield curves for various types of assets; compliant with the requirements set out in attachment No. 19 to the Resolution No. 380/2008 by the Financial Supervisory Commission;
- for settlement risk: according to attachment No. 11 to the Resolution No. 380/2008 by the Financial Supervisory Commission;
- for counterparty credit risk: in case of interbank market counterparties the Bank uses value at risk method, based on Monte Carlo simulations; for the remaining counterparties market value method, according to attachment No 16 to the Resolution No. 380/2008 by the Financial Supervisory Commission.

Calculation of internal capital for market risk, including also interest rate risk in banking book, is performed on a daily basis and reported monthly.

Brief description of the internal capital model for the operational risk

For calculation of the internal capital for operational risk, the Bank applies the method commonly used in insurance and by other banks as a standard for operational risk assessment as well as for calculation of the regulatory capital requirements under the Advanced Measurement Approach (AMA). This method is based on a separate analysis of the probability distribution of the number of operational risk events, which occurred in the assumed time period, as well as on analysis of loss severity distribution for the individual event that happened. Both distributions are combined then, and it leads to obtaining a distribution of the probability of annual loss and to estimating the internal capital. When estimating the amount of this capital, the Bank's internal data is used as well as the results of scenario analysis performed by the Bank's operational risk management experts. As a target solution the Bank is also going to include in the analysis data from external databases provided by other institutions. Similar to other risks mentioned above, a one year horizon of losses and the confidence level of 99.9% are assumed.