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*The binding Polish original should be referred to in matters of interpretation.*

# MANAGEMENT BOARD'S REPORT ON THE ACTIVITIES OF BANK GOSPODARKI ŻYWNOŚCIOWEJ S.A. GROUP FOR THE FIRST HALF OF 2014

**Warsaw, 08 August 2014**

# CONTENTS

# 1. EXTERNAL CONDITIONS FOR THE FUNCTIONING OF BGŻ S.A. GROUP

## 1.1. MACROECONOMIC SITUATION

In the first half of 2014 the Polish economy continued its 2013 improvement. Gross Domestic Product grew in the 1st quarter by 3.4% y/y and according to BGŻ estimates by 3.3% in the 2nd quarter. Compared to 2013, growth structure changed significantly. Investments improved the most after several quarters of stagnation. As a result capital accumulation was the highest for the last two years. At the same time there was a further improvement of consumer spending. In the 1st quarter their GDP contribution was the highest since mid-2011, which resulted from a clear upturn in domestic labor market. In comparison to 2013 net export deteriorated heavily. In the beginning of 2014 export dynamics remained at fairly high level, whereas import dynamics grew significantly. In the beginning of 2014 it was caused by the increase of import contracts connected with i.e. domestic investments. In the 2nd quarter export was further affected by the crisis in Ukraine and Russia sanctions. It was however levelled by the increased demand from other economies, particularly in the euro zone.

**Chart 1. GDP Growth (y/y)**

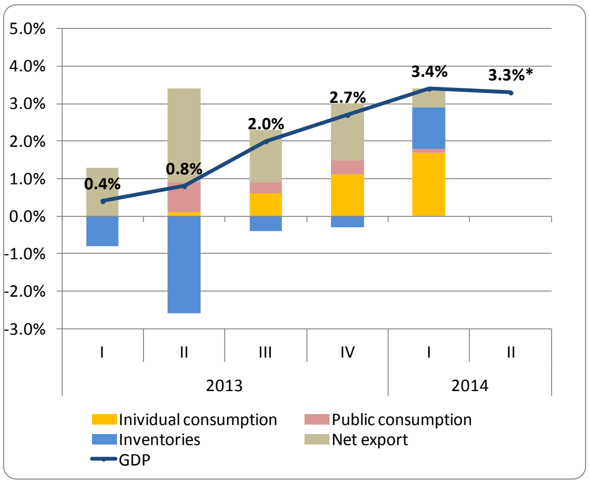
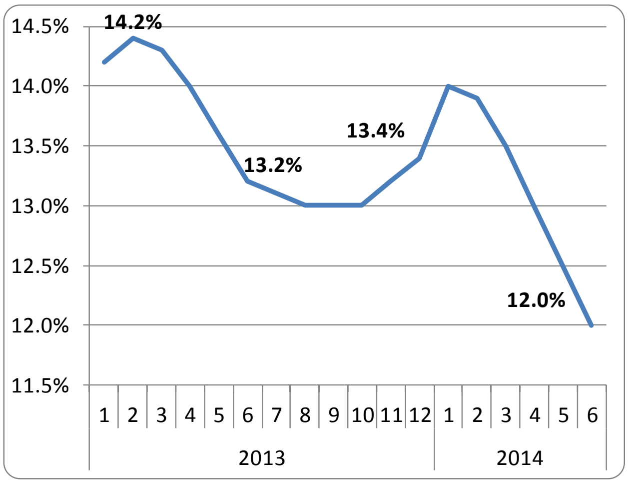



**Chart 2. Registered unemployment rate**




** Forecast of BGŻ S.A.*
*Source: GUS, own estimation*

In the first half of 2014, there was further employment increase in the national economy. In the 1st quarter there were 8.54 million employees i.e. increase by 0.7 y/y. The employment in the enterprise sector in the first quarter of 2014 increased by 0.2% y/y, and in the first half of the year by 0.5% y/y. At the same time, in the first half of 2014 there was a strong decline of unemployment rate. The average rate amounted to 13.2%, i.e. decrease by 0.8 p.p. y/y. The decrease was caused by non economic factors such as exceptionally mild winter (which allowed to early start of seasonal works) and changes in labor law. The upturn in labor market resulted in wage increase. In the 1st quarter of 2014, wages grew by 4.2% y/y (the highest increase since the first quarter of 2012), in real terms 3.9% y/y (the last time similar dynamic was recorded in 2008).

In the first half of 2014, slight deterioration in the financial situation of agricultural producers was noticed, due to lower agricultural commodities prices. Nonetheless purchase prices remained at historically high levels, especially in case of milk. A different situation occurred in pig market. Due to emergence of ASF in Poland, Custom Union and part of Asian countries an embargo on polish meat was imposed which resulted in decrease of domestic livestock prices.

Despite the improvement in domestic economy in the first half of 2014, clear reduction in inflationary pressure occurred. CPI of the period amounted to 0.5% y/y, compared to 0.9% in the previous year. Low price pressure resulted from the global disinflationary trends, visible particularly in agricultural commodity markets. Moreover, price pressure decline in the 2nd quarter was further increased by Russia sanctions, which led to an oversupply of some agricultural goods in the domestic market. Despite the strong decline in inflationary pressure and the threat of deflation, the Monetary Policy Council (MPC) kept interest rates unchanged, including the reference rate at 2.5%. The rediscount rate – which is the subject to preferential lending rates for agriculture remained at 2.75%.

In the first half of 2014 volatility in the foreign exchange market was fairly low. EUR/PLN fluctuated around 4.17; USD/PLN 3.05; and CHF/PLN 3.42. The domestic currency has proved to be very resistant to the turbulences on both international (especially the Ukraine Crisis) and domestic market (Pension Funds reform and fear of pre-term parliamentary elections). At the turn of May and June Polish zloty temporarily appreciated against major currencies, which was related to the assumption of ECB monetary policy change - in particular for its quantitative easing. Appreciation was stopped by the outflow of capital from emerging markets caused by inflamed conflict in Ukraine.

**Chart 3. Inflation and interest rates**

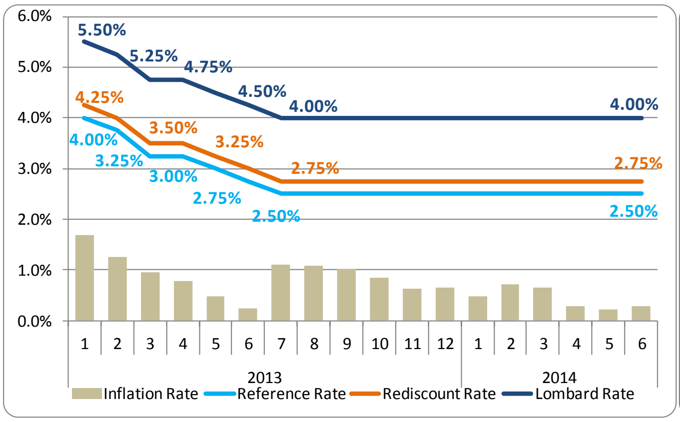
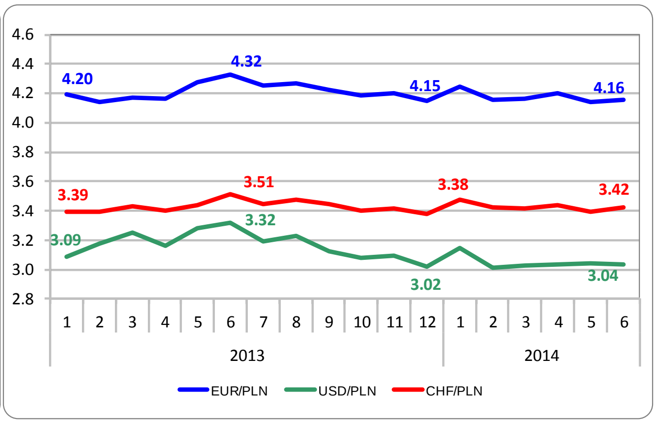



**Chart 4. PLN FX Rate**




*Source: GUS and NBP*

## 1.2. BANKING SECTOR RESULTS

According to the Polish Financial Supervision Authority preliminary data, in the first six months of 2014 the net financial result of the Polish banking sector increased by 6.3% y/y and reached the level of PLN 8.74 billion (compared to PLN 8.22 billion in 2013 corresponding period). The main growth factor of the net financial result of banking sector was an increase in result on banking activity (by 5.4% y/y). The improvement of the banking sector would be even more impressive unless high (in terms of volume) deterioration in net operating result (decrease by 37.9% y/y), which related to the high base effect caused by a single factor, which occurred in January 2013. Relatively smaller, but still negative impact on financial result had noticeable increase in impairments, other provisions (7.7% y/y) and in total costs (1.1% y/y). The latter applied for the depreciation, amortization and general administrative expenses (increase due to the new prudential fee for the stabilization fund within BFG).

The improvement in the net profit of the banking sector was settled by a high increase in net interest income (14.7% y/y). It was connected with the improvement on consumer and mortgage loans market, along with growth of lending activities for enterprises and increase of deposit margins on an annual basis. Positive, but relatively smaller impact on financial result had increase on dividend income (29.8%). Reduction of the positive financial result was generated primarily by deep decline in the other positions (-27.5% y/y), linked with i.e. decrease on T-bonds transactions.

**Table 1. Selected elements of banking sector's statement of profit or loss**

| *PLN million* | I-VI 2014 | I-VI 2013 | change | |
|---|---|---|---|---|
| | | | PLN million | % |
| Net interest income | 18 695 | 16 304 | 2 391 | 14.7% |
| Net fee and commission income | 6 944 | 6 956 | (12) | (0.2%) |
| Dividend income | 898 | 692 | 206 | 29.8% |
| Other elements of the net income from banking | 2 816 | 3 884 | (1 068) | (27.5%) |
| **Result on banking activity (total)** | **29 352** | **27 835** | **1 517** | **5.4%** |
| Other operating result | 538 | 866 | (328) | (37.9%) |
| Employment expenses | (7 550) | (7 562) | 12 | (0.2%) |
| Overhead costs | (6 200) | (6 071) | (129) | 2.1% |
| Amortization | (1 344) | (1 297) | (47) | 3.6% |
| **Expenses (total)** | **(15 094)** | **(14 930)** | **(164)** | **1.1%** |
| Net impairment losses on assets and other provisions | (3 986) | (3 702) | (284) | 7.7% |
| **Profit (loss) before income tax** | **10 799** | **10 088** | **711** | **7.0%** |
| Income tax and other mandatory expenses | (2 058) | (1 864) | (194) | 10.4% |
| **Net profit (loss) for the period** | **8 742** | **8 221** | **521** | **6.3%** |

*Source: PFSA*

The own funds of domestic banking sector (taken into account when calculating capital adequacy ratio) increased at the end of May 2014 by 1.0% to PLN 139.9 billion when compared to the end of 2013. However, the general capital requirement – with accelerating lending activity in some market segments, increased by 3.4% to PLN 73.2 billion, when compared to the end of 2013. As a result, the sector's capital adequacy ratio decreased by 0.4 p.p. reaching 15.3%, when compared to the end of 2013.

In the first half of 2014, lending activity of the banking sector, measured with the rate of growth in credit volumes for non-banking clients increased slightly. At the end of June the total loans increased by 4.5% y/y, whereas the nominal growth was noticeably reduced by the appreciation of polish zloty against core currencies (EUR, CHF and USD). The growth rate of deposits from non-banking clients remained also at the moderate level (increase by 7.5% y/y), as at the end of 2013.

Loans granted to private individuals increased at the end of June 2014 by 3.6% y/y. It was a result of a persisting improvement on mortgage market and further increase in consumer loans. Upturn in the mortgage market is connected with the lowest interest rates in the history and partial liberalization of supervisory regulations (including period extension for creditworthiness assessment to 30 years and earlier abolition of Debt-to-Income ratio). On the one hand this contributed to increase in formal and actual availability of housing loans in zloty and on the other hand it also stimulated the demand on housing loans. Maintaining high demand on housing loans was simultaneously supported by gradual improvement in the labor market, better situation on the real estate market (sales in the primary market are comparable to the boom period) and start of the new program "Mieszkanie dla Młodych".

Increase in housing loans on annual basis was noted in the first half of 2014 despite tightening of bank regulations regarding owner's contribution (Entry into force of S recommendation amendment) and slow increase in credit margins.

The currency structure of newly granted housing loans, according to The Polish Bank Association (ZBP), in 2014 was dominated by the housing loans in PLN. The sale of currency housing loans was marginal. The dynamics of private debt concerning them – due to repayment of loans already granted and appreciation of PLN - remained negative.

Additionally there was a further improvement of the consumer loan market due to an earlier liberalization of T Recommendation regarding granting low-value cash and installments loans by the Polish Financial Supervision Authority (PFSA). It was settled by persisting banks pressure on cash loans sales, reflected in high advertising activity and easing of lending policy in this segment. The latter was possible due to further improvement of consumer credit portfolio and prospects of advancement in economic and financial situation of households. Increased supply of consumer loans was be accompanied by gradually increased demand.

**Table 2. Loan volume of the banking sector**

| *PLN billion, as at the end of the period* | 30.06.2014 | 31.12.2013 | 30.06.2013 | change | |
|---|---|---|---|---|---|
| | | | | PLN billion | % |
| **Loans for individual clients** | **477.2** | **466.8** | **460.5** | **16.7** | **3.6%** |
| - housing loans | 342.4 | 334.2 | 332.2 | 10.2 | 3.1% |
| - PLN loans | 179.5 | 168.2 | 154.6 | 24.9 | 16.1% |
| - currency loans | 162.9 | 166.0 | 177.5 | (14.6) | (8.2%) |
| - consumer loans | 134.8 | 132.6 | 128.3 | 6.5 | 5.1% |
| **Loans for corporate clients** | **493.2** | **466.2** | **468.2** | **25.0** | **5.3%** |
| - non-banking financial sector | 44.0 | 39.9 | 40.9 | 3.1 | 7.6% |
| - loans for business entities | 371.3 | 348.0 | 349.2 | 22.1 | 6.3% |
| enterprises | 276.7 | 259.0 | 263.4 | 13.3 | 5,0% |
| individual entrepreneurs | 61.6 | 57.4 | 56.0 | 5.6 | 10% |
| individual farmers | 27.6 | 26.2 | 24.9 | 2.7 | 10.8% |
| non-profit institutions | 5.3 | 5.3 | 4.9 | 0.4 | 8.2% |
| - loans for government sector | 78.0 | 78.4 | 78.2 | (0.2) | (0.3%) |
| **Loans for non-banking clients** | **970.4** | **933.0** | **928.7** | **41.7** | **4.5%** |

*Source: NBP, data for monetary financial institutions, excluding Central Bank and SKOK, only residents*

In the first half of 2014 there was also an improvement in corporate lending. It was caused by the improvement of corporate clients activity and their investment tendencies. As a result, in the first half of 2014 volume of overdrafts and investments loans increased significantly. This growth was accelerated by an extension of de minimis guarantee program for SME with investment loans.

The savings of individual clients remained the main source of increase in banks' deposits. Their growth rate accelerated slightly in the first half of 2014 (partially due to improvement in the labor market situation and lack of clear trend on Warsaw Stock Exchange) but remained fairly stable. Increase in deposits from individual savings was caused by the increase in volume of term deposits (observed since the beginning of the fourth quarter of 2013). It was related to the appearance of attractive, special offers of classic term deposits and increasing popularity of high interest deposits linked with investment fund. Significant increase in volume of term deposits was accompanied by modest increase in volume of current deposits, the annual dynamics of which was gradually decreasing.

Despite continuing high dynamics of retail sales in the first half of 2014, corporate deposits decreased. On the one hand it had seasonal effect. On the other hand it may result from: increase of company investments, decline in export dynamics and appreciation of polish zloty in annual terms. The first half of 2014 brought also a significant increase in public sector deposits (mainly government), which was however temporary to a significant extent.

**Table 3. Deposit volume of the banking sector**

| *PLN billion, as at the end of the period* | 30.06.2014 | 31.12.2013 | 30.06.2013 | change | |
|---|---|---|---|---|---|
| | | | | PLN billion | % |
| **Deposits from individual clients** | **520.6** | **498.8** | **489.3** | **31.3** | **6.4%** |
| - current | 251.5 | 242.9 | 239.4 | 12.1 | 5.1% |
| - term | 269.1 | 255.9 | 249.9 | 19.2 | 7.7% |
| **Deposits from corporate clients** | **400.0** | **376.0** | **367.1** | **32.9** | **9.0%** |
| - non-banking financial institutions | 51.5 | 56.4 | 50.7 | 0.8 | 1.6% |
| - deposits of business entities | 254.3 | 263.0 | 240.7 | 13.6 | 5.7% |
| enterprises | 200.3 | 208.0 | 191.1 | 9.2 | 4.8% |
| individual entrepreneurs | 26.4 | 28.3 | 23.3 | 3.1 | 13.3% |
| individual farmers | 9.6 | 9.4 | 8.8 | 0.8 | 9.1% |
| non-profit institutions | 18.2 | 17.4 | 17.5 | 0.7 | 4.0% |
| - deposits from budget sector | 94.2 | 56.6 | 75.8 | 18.4 | 24.3% |
| **Deposits from non-banking clients** | **920.6** | **874.8** | **856.4** | **64.2** | **7.5%** |

*Source: NBP, data for monetary financial institutions, excluding Central Bank and SKOK, only residents.*

## 1.3. STOCK EXCHANGE TRENDS AND INVESTMENT TRENDS

The first half of 2014 did not bring any significant changes in stock market indices. During this period, difference in tendencies between stock quotations of the largest companies, and small and medium enterprises (SME) was recorded. On one hand, the WIG20, the index of the largest companies, increased during the period by 0.33% (due to the effect of subtracting dividends, but even without taking into account their payment the WIG20 would ended first half with one digit increase), while on the other hand SME (represented by WIG250 and WIG50 indices) decreased (WIG250 by 3.7% and WIG250 by 9.9%).

Impact on the image of WSE in the first half of 2014 had among others the following factors: an increase in tension in Ukraine which increased an expected risk premium with an investment in our region and still present risk of reduction in demand for shares from pension funds (OFE).

On the market of Polish treasury bonds the first half of the 2014 brought a return of the bull market that dominated the entire 2012 and the first half of 2013. As a result, the yields on Polish 10-year bonds dropped from the level of 4.4% at the end of 2013 to the level of 3.4% at the end of June 2014.

**Table 4. Value of main Stock Exchange indices**

| Index | 30.06.2014 | 31.12.2013 | 31.12.2012 | change in the 1st half of 2014 | change in 2013 |
|---|---|---|---|---|---|
| WIG | 51 935 | 51 284 | 47 461 | 1.3% | 8.1% |
| WIG20 | 2 409 | 2 401 | 2 583 | 0.3% | (7.0%) |
| WIG50 | 3 084 | 3 204 | 2 553 | (3.7%) | 25.5% |
| WIG250 | 1 243 | 1 380 | 1 000 | (9.9%) | 38.0% |

*Source: stooq.pl*

In the first half of 2014, 13 new companies joined the main floor of WSE, including 5 whose quotations were transferred from NewConnect. The number of WSE-listed companies increased from 450 at the end of December 2013 to 458 as at the end of June 2014. The organized NewConnect market had 11 new issuers in first half of 2014 (compared to 42 IPOs in 2013).

**Table 5. Number of companies, capitalization and turnover on the WSE**

| | 30.06.2014 | 31.12.2013 | 31.12.2012 | change in the 1st half of 2014 | change in 2013 |
|---|---|---|---|---|---|
| Number of companies | 458 | 450 | 438 | 1.8% | 2.7% |
| Capitalization of domestic companies (million PLN) | 607 218 | 593 464 | 523 390 | 2.3% | 13.4% |
| Shares turnover value (million PLN) | 117 688 | 256 147 | 202 880 | (54.1%) | 26.3% |
| Futures turnover volume (thousand pcs.) | 5 144 | 11 807 | 10 592 | (56.4%) | 11.5% |

*Source: WSE*

At the end of the first half of 2014, the Catalyst bond market quoted a total of 481 bond issues with the value of issues exceeding PLN 532 billion.

## 2. COMPOSITION OF BGŻ S.A. GROUP AND METHODS OF CONSOLIDATION

As at 30 June 2014, Bank Gospodarki Żywnościowej S.A. Group (hereinafter referred to as 'the Group' or 'BGŻ S.A. Group') consists of Bank Gospodarki Żywnościowej S.A., the parent company (hereinafter referred to as 'the Bank' or 'BGŻ S.A.') and:

- Bankowy Fundusz Nieruchomościowy Actus Sp. z o.o. - the subsidiary,
- BGŻ Leasing Sp. z o.o. - associated entity.

**Tabela 6. Scope of consolidation**

| Entity name | Nature of the business | Shareholding of BGŻ S.A. in company's equity | Method of the consolidation/ valuation |
|---|---|---|---|
| Bankowy Fundusz Nieruchomościowy ACTUS Sp. z o.o. | Purchase and sale of real estate | 100.0% | Full method |
| BGŻ Leasing Sp. z o.o. | Leasing services | 49.0% | Equity method |

## 3. IMPORTANT EVENTS IN BGŻ S.A. IN THE FIRST HALF OF 2014

| | |
|---|---|
| **30.05.2014** | The Ordinary General Meeting adopted a resolution regarding merger with Rabobank Polska S.A., increase of share capital of BGŻ Bank and amendments to the Statute of BGŻ Bank. |
| **18.06.2014** | On 18 June 2014 the District Court for the the Capital City Warsaw, XII Commercial Department of the National Court Register, in Warsaw registered the merger between Rabobank Polska S.A. (an acquiree) and BGŻ S.A. (an acquirer). It was executed in the way specified in art. 492 § 1 section 1 of the Commercial Companies Code through the transfer of the entire entity (all assets and liabilities) of Rabobank Polska S.A. to BGŻ through the issue of 5 002 000 shares of H series of BGŻ, which have been issued to the current shareholder of Rabobank Polska. |

# 4. AUTHORITIES OF THE PARENT COMPANY

## 4.1. CHANGES IN THE COMPOSITION OF THE SUPERVISORY BOARD

The composition of the Supervisory Board in the period from 1 January to 30 June 2014 was as follows:

- Jan Alexander Pruijs – President of the Supervisory Board,
- Dariusz Filar – Vice-President of the Supervisory Board,
- Tanja Cuppen – Member of the Supervisory Board,
- Evert Derks Drok – Member of the Supervisory Board,
- Jarosław Iwanicki – Member of the Supervisory Board,
- Mariusz Warych – Member of the Supervisory Board.

## 4.2. CHANGES IN THE COMPOSITION OF THE MANAGEMENT BOARD

The composition of the Bank's Management Board in the period between 1 January and 30 June 2014 was as follows:

- Józef Wancer – President of the Management Board,
- Gerardus Cornelis Embrechts – First Vice-President of the Management Board,
- Monika Nachyła – Vice-President of the Management Board,
- Magdalena Legęć – Vice-President of the Management Board,
- Johannes Gerardus Beuming – Vice-President of the Management Board (resignation on 30 June 2014),
- Dariusz Odzioba – Vice-President of the Management Board,
- Witold Okarma – Vice-President of the Management Board,
- Wojciech Sass – Vice-President of the Management Board ,
- Andrzej Sieradz –Vice-President of the Management Board.

# 5. EXTERNAL RATING OF THE PARENT COMPANY

## 5.1. RATINGS

The Bank was rated by the Moody's Investors Service rating agency. On 19 December 2013, Moody's Investors Service ("Moody's", "the Agency") decreased rating for the long-term and short-term deposits of the Bank respectively to Baa3 from Baa2 and to Prime-3 from Prime-2. The outlook for the ratings remains stable.

Simultaneously the Bank's Financial Strength Rating („BFSR") remained at the level „D" with a stable outlook.

In support of its assessment, Moody's notes that the reduction of long-term and short-term rating of the Bank's deposits is the result of the agreement between Rabobank Group and BNP Paribas on the sale of shares of BGŻ announced on 5 December 2013.

### 5.2. AWARDS AND DISTINCTIONS

In the first half of 2014, the Bank received the following awards and honors:

| | |
|---|---|
| **January 2014** | The President Józef Wancer received statuette "Wektor 2013" for outstanding long-term achievements in banking during the Polish transition. Award, since 2002, is given by the Organization of Employers in Poland. It is received by eminent Poles, whose activities bring on exceptional benefits to polish economy. |
| **February 2014** | The National Chamber of Commerce and the Polish-American Foundation of Small Enterprise awarded BGŻ Bank with Golden Statue and the title of Business Friendly Bank with 7 Golden Stars. The Bank received the title for their commitment in supporting the development of small and medium enterprises, for establishing a team with broad expertise and for creating product offer which support fast business development. |
| **February 2014** | Banking Newspaper („Gazeta Bankowa") in cooperation with ESG prepared ranking of the most socially responsible bank. BGŻ Bank took first place in both, overall and social ranking. |

## 6. SHAREHOLDERS' STRUCTURE OF THE BANK

Between 1 January and 30 June changes in shareholders structure occurred due to the merger of BGŻ Bank with Rabobank Polska on 18 June 2014.

**Table 7. Shareholders' structure of the Bank**

| Shareholder | 30.06.2014 | | 31.12.2013 | |
|---|---|---|---|---|
| | Number of shares | Share (%) | Number of shares | Share (%) |
| Rabobank International Holding B.V.* | 51 073 289 | 90.98 | 45 942 004 | 89.84 |
| Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A.* | 4 303 695 | 7.66 | 4 303 695 | 8.42 |
| Other shareholders | 761 780 | 1.36 | 891 065 | 1.74 |
| **Total** | **56 138 764** | **100.00** | **51 136 764** | **100.00** |

* Rabobank Group

## 7. FINANCIAL POSITION OF THE GROUP

On 18 June 2014 merger of BGŻ Bank with Rabobank Polska S.A. was executed through the transfer of the entire entity of Rabobank Polska S.A.. The value of assets of Rabobank Polska S.A. on the merger date amounted to PLN 3 328 619 thousand, which represents 9% of total assets of the combined Bank.

Further as at 18 June 2014 transferred loans in amount of PLN 2 097 157 thousand, and deposits in amount of PLN 339 034 thousand accounted to 7% and 1% of respectively loans and deposits of combined Bank.

Financial result of Rabobank Polska S.A. was recognized in the Semi-annual Consolidated Report of BGŻ S.A. Group for the 6-month period ending 30 June 2014 prospectively i.e. starting from 18 June 2014. Net profit of Rabobank Polska S.A. for the period from 1 January until the merger was recognized in equities of BGŻ Bank.

Comparative data of the Bank for prior periods has not been restated and in the following section an analysis is based on reported amounts.

### 7.1. INTERIM CONDENSED CONSOLIDATED STATEMENT OF PROFIT OR LOSS

In the first half of 2014, the Bank generated net profit of PLN 108 498 thousand i.e. PLN 25 966 thousand higher than in comparative period of 2013 (31.5%). Main factors impacting the net result were: improvement of net interest income and net fee and commission income, which levelled both, worse result on trading and investment activities and increase of net impairment losses on financial assets.

**Table 8. Consolidated statement of profit or loss**

| *PLN thousand* | 1st half of 2014 | 1st half of 2013 | change y/y | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| Net interest income | 546 825 | 478 711 | 68 114 | 14.2% |
| Net fee and commission income | 153 789 | 132 961 | 20 828 | 15.7% |
| Dividend income | 3 302 | 2 837 | 465 | 16.4% |
| Net trading income | 24 874 | 48 751 | (23 877) | (49.0%) |
| Result on investing activities | 5 476 | 20 613 | (15 137) | (73.4%) |
| Result on hedge accounting | (156) | (1 099) | 943 | (85.8%) |
| Other operating income | 16 390 | 14 920 | 1470 | 9.9% |
| Net impairment losses on financial assets and contingent liabilities | (111 153) | (91 323) | (19 830) | 21.7% |
| General administrative expenses | (444 867) | (443 892) | (975) | 0.2% |
| Depreciation and amortization | (49 835) | (49 257) | (578) | 1.2% |
| Other operating expenses | (10 822) | (7742) | (3080) | 39.8% |
| **Operating result** | **133 823** | **105 480** | **28 343** | **26.9%** |
| **Share in profit (loss) of associates** | 2 096 | (1 314) | 3 410 | (259.5%) |
| **Profit (loss) before income tax** | **135 919** | **104 166** | **31 753** | **30.5%** |
| Income tax expense | (27 421) | (21 634) | (5 787) | 26.7% |
| **Net profit (loss) for the period** | **108 498** | **82 532** | **25 966** | **31.5%** |

**Net interest income**

In the first half of 2014, the interest result which was the main source of income, increased by PLN 68 114 thousand i.e. 14.2%. This was achieved by reducing interest expenses by PLN 221 572 thousand i.e. 41.1%, what fully compensated decrease in interest income which amounted to PLN 153 458 thousand i.e. 15.1%. The dynamics of income and expenses was affected by both, external factors and the growth rate of commercial loans and deposits.

Among the external factors, NBP interest rate policy should be mentioned. In the first half of 2013 there have been 5 interest rate reductions by 1.5 p.p. in total. Another reduction by 0.25 p.p. effective from 4 July 2013, which was expected by the market, had an effect on market interest rates already in June 2013.

The most significant position of interest income is interest income on loans and advances to customers (66%) which decreased by PLN 82 335 thousand y/y (i.e. 12.6%) due to reduction of interest rates and the fact that major part of loan portfolio is based on a floating interest rate.

In the first half of 2014, growth rate of loan portfolio (gross) amounted to 11.7% y/y.

For the part of preferential loans with Agency for Restructuring and Modernization of Agriculture subsidies the NBP interest rates reduction effect on decrease of interest income was further impacted by a multiplier effect (the interest rate is determined as the product of NBP rediscount rate and a multiplier of 1.5 or 1.6). The effect was partly hedged until April 2014, covering 60% of preferential loans portfolio (the total value of the portfolio amounted to PLN 4.67 billion as at 30 June 2014)

Further decrease in income from debt securities by PLN 60 212 thousand (i.e. 35.1%) also impacted the interest result. The total portfolio of debt securities remained fairly the same however there was a transfer from NBP bills to T-bonds.

**Table 9. Net interest income**

| *PLN thousand* | 1st half of 2014 | 1st half of 2013 | change y/y | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| Loans and advances to banks | 14 132 | 19 054 | (4 922) | (25.8%) |
| Loans and advances to customers in current accounts | 134 124 | 142 429 | (8 305) | (5.8%) |
| Loans and advances to customers | 572 064 | 654 399 | (82 335) | (12.6%) |
| Hedging instruments | 9 024 | 8 622 | 402 | 4.7% |
| Reverse repo securities | 23 533 | 21 619 | 1 914 | 8.9% |
| Debt securities | 111 299 | 171 511 | (60 212) | (35.1%) |
| **Interest income** | **864 176** | **1 017 634** | **(153 458)** | **(15.1%)** |
| | | | | |
| Amounts due to banks | (29 679) | (41 178) | 11 499 | (27.9%) |
| Debt securities issued | (17 639) | (48 578) | 30 939 | (63.7%) |
| Amounts due to customers | (244 699) | (415 446) | 170 747 | (41.1%) |
| Repo securities | (25 334) | (33 721) | 8 387 | (24.9%) |
| **Interest expense** | **(317 351)** | **(538 923)** | **221 572** | **(41.1%)** |
| | | | | |
| **Net interest income** | **546 825** | **478 711** | **68 114** | **14.2%** |

The decrease in interest expenses was caused mainly by the reduction of amounts due to customers by PLN 170 747 thousand (i.e. 41.1% y/y) due to cuts in interest rates on deposits following NBP reductions. Prices adjustments of deposits to the low interest rates, which started in the second half of 2013, had positive impact on interest result for the first 6 months of 2014.

**Net fee and commission income**

Net fee and commission income for the first half of 2014 was higher by PLN 20 828 thousand, i.e. 15.7% in comparison to the first half of 2013. This was mainly due to the increase in fee and commission income by PLN 22 525 thousand (i.e.14.6% y/y) and simultaneous increase in commission expense by PLN 1 697 thousand (i.e. 8.0% y/y).

Increase in the net fee and commission income was a result of higher income on:

- account maintenance – thanks to the increase in the number of accounts and the effect of changes to the Fees and Commissions Table,
- loans and advances - primarily in small business and retail loans,

- payment cards – despite reduced interchange rates, fee and commission income on payment cards increased by PLN 4 841 thousand, i.e. 12.5%, mainly as a result of increased number of card transactions affecting higher income from card organizations due to bonuses for higher number of transactions,
- brokerage operation – due to focusing on retail services and selected institutional clients, constant increase of distributed investment funds and higher activity on primary market, the Group recorded good results of the Brokerage Office, which resulted in 68.1% increase of fees and commissions from brokerage operations.

**Table 10. Net fee and commission income**

| *PLN thousand* | 1st half of 2014 | 1st half of 2013 | change y/y | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| **Fee and commission income** | | | | |
| – loans and advances | 49 737 | 45 015 | 4 722 | 10.5% |
| – settlements | 8 274 | 8 557 | (283) | (3.3%) |
| – account maintenance | 51 999 | 41 626 | 10 373 | 24.9% |
| – guarantee commitments | 3 952 | 5 668 | (1 716) | (30.3%) |
| – brokerage operations | 9 508 | 5 656 | 3 852 | 68.1% |
| – payment cards | 43 619 | 38 778 | 4 841 | 12.5% |
| – insurance activity | 7 018 | 6 030 | 988 | 16.4% |
| – other | 2 481 | 2 733 | (252) | (9.2%) |
| **Fee and commission income** | **176 588** | **154 063** | **22 525** | **14.6%** |
| | | | | |
| **Fee and commission expense** | | | | |
| – loans and advances | (758) | (346) | (412) | 119.1% |
| – payment cards | (17 344) | (14 951) | (2 393) | 16.0% |
| – insurance activity | (128) | (913) | 785 | (86.0%) |
| – other | (4 569) | (4 892) | 323 | (6.6%) |
| **Fee and commission expense** | **(22 799)** | **(21 102)** | **(1 697)** | **8.0%** |
| | | | | |
| **Net fee and commission income** | **153 789** | **132 961** | **20 828** | **15.7%** |

The increase in expenses from fees and commissions was mainly caused by higher payment cards costs (by PLN 2 393 thousand, i.e. 16% y/y), paid to card operators due to a higher number of transactions executed by the Bank's customers.

### Dividend income

Dividend income in the first half of 2014 amounted to PLN 3 302 thousand and increased by PLN 465 thousand, i.e. 16.4%. Dividends originated from the Bank's minority interests in the National Clearing House S.A. (KIR), Credit Information Bureau S.A. (BIK).

### Net trading income and results from investment activities

Net trading income for the first 6 months of 2014, was nearly 50% lower than for the first half of 2013 (decrease by PLN 23 877 thousand, i.e. 49.0%). The level and volatility of this result is shaped mainly by the valuation of the Bank's position in the instruments of interest rate swaps (IRS) as a hedge against interest rate risk, and trading activity on debt securities whose profitability is dependent on the accuracy of predicted changes on the market.

Result on investment activity in the first half of 2014 fell by PLN 15 137 thousand, i.e. 73.4% compared with the same period of 2013. The main component of the result of investment activity remained realized gains on portfolio of securities available for sale, while in the same period of 2013, twice the volume of instruments was sold. Decisions to sell these securities prior to the maturity date shall be made, taking into account the needs arising from interest rate risk management and the use of favorable market conditions.

**Other operating income**

Other operating income in the first half 2014 increased by PLN 1 470 thousand, i.e. 9.9% compared with the same period of 2013, mainly due to income from the repayment of debts written off from the Bank's statement of financial position.

**Table 11. Other operating income**

| *PLN thousand* | 1st half of 2014 | 1st half of 2013 | change y/y | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| Gain on sale of goods and services | 3 975 | 4 208 | (233) | (5.5%) |
| Release of provisions for litigation and claims as well as other liabilities | 749 | 918 | (169) | (18.4%) |
| Recovery of debt collection costs | 1 383 | 999 | 384 | 38.4% |
| Recovery of overdue, amortized and uncollectable debts, and repayment of debts excluded from statement of financial position | 3 114 | 2 904 | 210 | 7.2% |
| Other | 7 169 | 5 891 | 1 278 | 21.7% |
| **Total other operating income** | **16 390** | **14 920** | **1 470** | **9.9%** |

**Net impairment losses on financial assets and contingent liabilities**

The result of impairment losses on financial assets and provisions for contingent liabilities for the first half of 2014 worsened by PLN 19 830 thousand, i.e. 21.7% compared to the first half of 2013. The largest impairment increase y/y recorded housing portfolio, what resulted however from adjustments made in the same period of 2013, changes made in collective impairment methodology. Other factors impacting net impairment losses were cash loans and loans granted to micro companies, what is however related to increased lending granted to those clients.

Corporate clients in the first half of 2014 recorded decrease in impairment created in comparison to the first half of 2013, when individual significant impairment provisions were booked.

**General administrative expenses, staff costs and depreciation/amortization**

General administrative expenses, personnel expenses and depreciation/amortization in the first half of 2014 increased by PLN 1 553 thousand, i.e. 0.3%, compared to the first half of 2013, primarily due to increase in personnel expenses, BGF fee and other non-personnel costs.

**Table 12. General administrative expenses, staff costs and depreciation/amortization**

| *PLN thousand* | 1st half of 2014 | 1st half of 2013 | change y/y | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| Personnel expenses, in this: | (252 735) | (245 855) | (6 880) | 2.8% |
| Wages and salaries | (204 167) | (191 945) | (12 222) | 6.4% |
| Social benefits and other fringe benefits | (48 568) | (53 910) | 5 342 | (9.9%) |
| Marketing | (21 523) | (28 517) | 6 994 | (24.5%) |
| IT | (38 792) | (42 872) | 4 080 | (9.5%) |
| Rental expenses | (45 908) | (46 076) | 168 | (0.4%) |
| Other non-personnel expenses | (22 625) | (20 186) | (2 439) | 12.1% |
| External services | (41 034) | (42 784) | 1 750 | (4.1%) |
| Bank Guarantee Fund fee | (18 424) | (13 498) | (4 926) | 36.5% |
| Polish Financial Supervision Authority fee | (3 826) | (4 104) | 278 | (6.8%) |
| **Total general administrative expenses** | **(444 867)** | **(443 892)** | **(975)** | **0.2%** |
| **Depreciation and amortization** | (49 835) | (49 257) | (578) | 1.2% |
| **Total expenses[1]** | **(494 702)** | **(493 149)** | **(1 553)** | **0.3%** |

[1] - for calculation of ratio cost/ income

The increase in personnel expenses by PLN 6 880 thousand, i.e., 2.8%, was mainly due to:

- increase in wages and salaries by PLN 12 122 thousand (including PLN 10 449 thousand related to the release of bonuses provisions for the previous year in June 2013). Higher salaries for the best employees starting from 1st July 2013 and better realization of goals than in the first half of 2013, resulted in increase of bonuses and awards in accordance with the Bank's rules of the bonus scheme,
- decrease in social benefits and other fringe benefits by PLN 5 342 thousand due to lower provisions charged (liabilities for unused vacation and retirement benefits). Additionally in the first half of 2013, this position included additional provision created in the amount of PLN 2 370 thousand for employee severance payment expenses due to restructuring process, started in 2012 and continued in 2013.

The increase in fees for the Bank Guarantee Fund of PLN 4 926 thousand was caused by new prudential charge introduced in November 2013. As at June 2014, the Bank has booked provision for the fee in amount of PLN 5 026 thousand.

Marketing costs decrease by PLN 6 994 thousand, i.e. 24.5% due to limited number of advertising campaign - especially on retail, compared to the first half of 2013.

Decrease in IT costs by PLN 4 080 thousand (i.e. 9.5%) comprised:

- lowered maintenance costs of servers by PLN 1.8 million (under warranty scheme) and banking cards system by 1.4 million (due to terminating in the 3rd quarter of Base 24 system connected with outsourcing of banking cards authorization and ATM sale),
- reduction of mobile phone fees by PLN 0.3 million as a result of the renegotiation of contracts,
- lowered outsourcing costs by PLN 0.3 million.

Other material costs increased by PLN 2 439 thousand, i.e. 12.1%. Increase comprised: (i) costs related to outsourcing of banking cards authorization by PLN 2.2 million, (ii) credit database queries costs by PLN 0.7 million, while in the same period the costs of cash processing and transport of cash decreased by PLN 0.7 million.

**Depreciation** for 2013 increased by PLN 578 thousand, i.e. 1.2%, compared with the first half of 2013. It was due to the increase in amortization of intangible assets by PLN 888 thousand (as a result of investment in IT systems) and decrease in depreciation of property, plant and equipment by PLN 310 thousand. The latter resulted from the opening of the last wave of (11) new branches in the second half of 2012 and the first quarter of 2013.

### Other operating expenses

In the first half of 2014, other operating expenses increased by PLN 3 080 thousand (i.e. 39.8%) in comparison to the first half of 2013, primarily due to higher debt collection costs by PLN 2 053 thousand (i.e. 56.6%) being a result of increased engagement of external law firms in servicing debt collection process.

**Table 13. Other operating expenses**

| *PLN thousand* | 1st half of 2014 | 1st half of 2013 | change | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| Loss on sale or liquidation of property, plant and equipment, intangible assets | (739) | (184) | (555) | 301.6% |
| Impairment charges on other receivables | (1 112) | (600) | (512) | 85.3% |
| Provisions for litigation and claims, and other liabilities | (474) | (699) | 225 | (32.2%) |
| Debt collection | (5 683) | (3 630) | (2 053) | 56.6% |
| Donations made | (1 287) | (1 375) | 88 | (6.4%) |
| Other | (1 527) | (1 254) | (273) | 21.8% |
| **Total other operating expenses** | **(10 822)** | **(7 742)** | **(3 080)** | **39.8%** |

## 7.2. INTERIM CONDENSED CONSOLIDATED STATEMENT OF OTHER COMPREHENSIVE INCOME

In the first half of 2014, total comprehensive income of the Group increased by PLN 206 770 thousand, compared to the first half of 2013. It was mainly due to positive valuation of financial assets available for sale (i.e. portfolio of long-term treasury bonds) while in the first half of 2013 those securities had negative valuation. The negative valuation of the available for sale financial assets in the first half of 2013 was a result of the change of market expectations referring to long-term interest rates (an increase of interest rates for long term securities).

In the analyzed period, also negative effects of valuation of derivatives instruments securing future cash flows were demonstrated, what occurred in connection to applied hedge accounting. In particular, the Bank entered into IRS float-to-fix transaction for the period until April 2014, in order to hedge interest rate risk regarding future interest cash-flows from preferential loans granted with interest rates based on NBP's rediscount rate (with multiplier of 1.5 and 1.6).

**Table 14. Statement of other comprehensive income**

| *PLN thousand* | 1st half of 2014 | 1st half of 2013 | change | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| **Net profit (loss) for the period** | **108 498** | **82 532** | **25 966** | **31.5%** |
| **Other comprehensive income** | | | | |
| ***Items that will be subsequently reclassified to profit or loss under certain conditions*** | ***88 268*** | ***(94 657)*** | ***182 925*** | ***(193.3%)*** |
| Net change in valuation of financial assets available for sale | 117 373 | (118 668) | 236 041 | (198.9%) |
| Net change in valuation of cash flow hedges | (8 400) | 1 808 | (10 208) | (564.6%) |
| Income tax expense on other comprehensive income | (20 705) | 22 203 | (42 908) | (193.3%) |
| ***Items that will not be reclassified to profit or loss*** | ***(2 121)*** | ***-*** | ***(2 121)*** | ***-*** |
| Actuarial valuation of employee benefits | (2 619) | - | (2 619) | - |
| Deferred tax | 498 | - | 498 | - |
| **Other comprehensive income (net of tax)** | **86 147** | **(94 657)** | **180 804** | **(191.0%)** |
| **Total comprehensive income for the Period** | **194 645** | **(12 125)** | **206 770** | **(1 705.3%)** |

## 7.3. INTERIM CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION

### Assets

As at the end of the first half of 2014 the total value of the Bank's assets amounted to PLN 38 774 537 thousand and was by PLN 2 997 396 thousand, i.e. by 8.4% higher than at the end of 2013.

Asset structure was dominated by loans and advances to customers which share increased by 1.1 p.p. compared to 31 December 2013. In terms of volume it increased by PLN 2 620 781 thousand, i.e. 10% and was the main factor of assets increase. Loans advances to customers of Rabobank Polska amounted to PLN 1.9 billion.

Additionally financial assets available for sale increased by PLN 1 711 686 thousand, i.e. 35.5% due to increase of NBP bills. Nevertheless debt securities held for trading decreased by PLN 717 883 thousand.

Cash remained at similar level, but decline of balances with Central Bank fluctuated and was followed by the current needs of the Bank to settle the obligatory reserve requirements.

**Table 15. Assets**

| *PLN thousand* | 30.06.2014 | 31.12.2013 | change | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| Cash and balances with the Central Bank | 1 416 197 | 1 617 713 | (201 516) | (12.5%) |
| Loans and advances to banks | 291 876 | 269 757 | 22 119 | 8.2% |
| Reverse repo transactions | 61 351 | 309 255 | (247 904) | (80.2%) |
| Debt securities held for trading | 300 818 | 1 018 701 | (717 883) | (70.5%) |
| Derivative financial instruments | 247 465 | 363 260 | (115 795) | (31.9%) |
| Hedging instruments | - | 57 387 | (57 387) | (100.0%) |
| Loans and advances to customers | 28 918 697 | 26 297 916 | 2 620 781 | 10.0% |
| Available for sale financial assets | 6 537 759 | 4 826 073 | 1 711 686 | 35.5% |
| Investment properties | 62 524 | 62 524 | - | - |
| Investments in associates | 37 101 | 35 052 | 2 049 | 5.8% |
| Intangible assets | 153 405 | 158 589 | (5 184) | (3.3%) |
| Property, plant and equipment | 427 054 | 449 139 | (22 085) | (4.9%) |
| Deferred tax assets | 159 639 | 142 792 | 16 847 | 11.8% |
| Current tax assets | - | 12 519 | (12 519) | (100.0%) |
| Other assets | 160 651 | 156 464 | 4 187 | 2.7% |
| **OTHER ASSETS** | **38 774 537** | **35 777 141** | **2 997 396** | **8.4%** |

### Liabilities and equity

At the end of the first half of 2014, the total value of the Group's liabilities equalled to PLN 34 725 530 thousand, and was higher by PLN 2 457 579 thousand, i.e. 7.6% in comparison to the end of 2013. The main factors of growth were amounts due to other banks and customers.

The amounts due to other banks increased by PLN 1 011 221 thousand i.e. 30.9% as a result of financing (partly utilized) granted in the loan agreement with Rabobank in a total amount of EUR 700 million. The loan is used for financing from liquidity and interest risk perspective both current and new lending activities of Rabobank Polska S.A. The agreement has been signed on the date's of Bank's merger with Rabobank Polska.

The amounts due to customers increased by PLN 1 759 923 thousand, i.e. 6.6% mainly as result of higher funding obtained from term deposits of retail customers.

Liabilities from debt securities issuance has been reduced by PLN 383 575 thousand, i.e. 32.2%, as a result of non-renewal of expiring portion of securities in a situation of reduced Bank's demand for funding.

By the end of the first half of 2014, the Bank's equity amounted to PLN 4 049 007 thousand and was by PLN 539 817 thousand higher than at the end of 2013. The change in equity during this period was the result of changes of financial assets available for sale valuation and merger with Rabobank Polska:

- increase of other supplementary capital by PLN 345 726 thousand, i.e. 11.2%,
- increase of other reserve capital by PLN 243 005 thousand, i.e. 117.7%.

**Table 16. Total Liabilities and Equity**

| *PLN thousand* | **30.06.2014** | **31.12.2013** | **change** | |
|---|---|---|---|---|
| | | | **PLN thousand** | **%** |
| Amounts due to other banks | 4 282 635 | 3 271 414 | 1 011 221 | 30.9% |
| Repo transactions | 159 148 | - | 159 148 | - |
| Financial liabilities held for trading | 53 083 | 271 288 | (218 205) | (80.4%) |
| Derivative financial instruments | 293 503 | 336 950 | (43 447) | (12.9%) |
| Amounts due to customers | 28 252 639 | 26 492 716 | 1 759 923 | 6.6% |
| Debt securities issued | 807 583 | 1 191 158 | (383 575) | (32.2%) |
| Subordinated liabilities | 308 674 | 304 817 | 3 857 | 1.3% |
| Other liabilities | 494 559 | 326 041 | 168 518 | 51.7% |
| Provision for deferred tax | 9 552 | 9 552 | - | - |
| Deferred tax liabilities | 1 265 | - | 1 265 | - |
| Provisions | 62 889 | 64 015 | (1 126) | (1.8%) |
| **TOTAL LIABILITIES** | **34 725 530** | **32 267 951** | **2 457 579** | **7.6%** |
| | | | | |
| Share capital | 56 139 | 51 137 | 5 002 | 9.8% |
| Other supplementary capital | 3 430 785 | 3 085 059 | 345 726 | 11.2% |
| Other reserve capital | 449 468 | 206 463 | 243 005 | 117.7% |
| Retained earnings | 112 615 | 166 531 | (53 916) | (32.4%) |
| - net profit for the period | 4 117 | 6 387 | (2 270) | (35.5%) |
| - net profit from previous periods | 108 498 | 160 144 | (51 646) | (32.2%) |
| **TOTAL EQUITY** | **4 049 007** | **3 509 190** | **539 817** | **15.4%** |
| | | | | |
| **TOTAL LIABILITIES AND EQUITY** | **38 774 537** | **35 777 141** | **2 997 396** | **8.4%** |

## 7.4. LOAN PORTFOLIO QUALITY

As at 30 June 2014 the share of impaired loans, in the portfolio of loans and advances granted to customers amounted to 7.0% in comparison to 8.0% as at the end of 2013.

Comments regarding loan portfolio quality are presented in section *Structure and quality of credit portfolio* (Chapter 10.1 Credit risk).

**Table 17. Credit portfolio quality ratios**

| *PLN thousand* | 30.06.2014 | 31.12.2013 | change | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| **Loans and advances to customers (gross)** | 30 280 945 | 27 513 885 | 2 767 060 | 10.1% |
| Impairment allowances (negative value) | (1 362 248) | (1 215 969) | (146 279) | 12.0% |
| **Loans and advances to customers (net)** | **28 918 697** | **26 297 916** | **2 620 781** | **10.0%** |
| **Losses incurred but not reported (IBNR)** | | | | |
| Gross exposure | 28 161 262 | 25 313 766 | 2 847 496 | 11.2% |
| Impairment allowances on receivables assessed collectively with no impairment identified (IBNR provision) | (117 573) | (100 217) | (17 356) | 17.3% |
| **Net exposure** | **28 043 689** | **25 213 549** | **2 830 140** | **11.2%** |
| **Impaired exposures** | | | | |
| Gross exposure | 2 119 683 | 2 200 119 | (80 436) | (3.7%) |
| Impairment allowances on receivables assessed collectively and individually | (1 244 675) | (1 115 752) | (128 923) | 11.6% |
| **Net exposure** | **875 008** | **1 084 367** | **(209 359)** | **(19.3%)** |
| **Ratios:** | | | | |
| **Share of impaired exposures in loan portfolio, gross** | **7,0%** | **8,0%** | **-** | **(1.0 p.p)** |
| **Impairment coverage** | **(58.7%)** | **(50.7%)** | **-** | **(8.0 p.p.)** |

## 7.5. CAPITAL ADEQUACY RATIO

The capital adequacy ratio increased from 13.27% at the end of 2013 to 14.03% at the end of the first half of 2014.

The equity increased in the analyzed period by PLN 335 280 thousand, i.e. 32.4%, primarily as a result of a merger with Rabobank Polska:

- increase of share capital by PLN 5 002 thousand – issuance of H series shares,
- increase of other supplementary capital, in which: (i) retained earnings for 2013 in amount of PLN 162 403 thousand, (ii) equity resulting from the merger – PLN 183 323 thousand,
- increase of other reserve capital and general risk fund resulting from the merger by PLN 156 858 thousand.

**Table 18. Own funds and capital adequacy ratio**

| *PLN thousand* | 30.06.2014 | 31.12.2013 | change | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| | | | | |
| **Supplementary funds** | **3 880 398** | **3 545 118** | **335 280** | **9.5%** |
| | | | | |
| **Total capital requirements** | **2 213 200** | **2 137 568** | **75 632** | **3.5%** |
| | | | | |
| **Combined capital adequacy ratio (%)** | **14.03%** | **13.27%** | **-** | **0.76 p.p.** |

Starting from 1 January 2014, regulations regarding own funds and capital adequacy are applicable as set in The Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 (CRR).

As of 30 June 2014, the capital adequacy ratio (formerly the solvency ratio) was calculated in accordance with the guidelines of CRR standards. The ratio as at the end of 2013 was presented in accordance with the Resolution No. 76/2010 of the Polish Financial Supervision Authority of 10 March 2010 on the scope and detailed procedures for determining capital requirements for particular risks.

## 7.6. FINANCIAL RATIOS

In the to the first half of 2013, which resulted from the net effect of the improvement in net profit and simultaneous equity and assets increase.

Net interest margin increased in the first half of 2014, the Group recorded moderate improvement of return on equity and return on assets ratios compared slightly compared to the first half of 2013 when it was affected by the reduction of NBP interest rates and delayed possibility of prices adjustments to some deposit products according to the Act on Payment Services.

The ratio of cost effectiveness (Costs/Income) improved due to slower increase of costs than income.

The increase in credit risk costs ratio corresponded with higher net impairment losses on loans and advances when compared to the same period of 2013.

The financial ratios as loans to deposits and loans to total sources of funding increased compared to the end of the first half of 2013, which reflects the decline of excess liquidity on the balance sheet of the Group as a result of adjustments made in funding sources for lending activity.

**Table 19. Financial ratios**

| | 1st half of 2014 | 1st half of 2013 | change |
|---|---|---|---|
| Return on Equity (1) | 5.9% | 4.8% | 1.1 p.p. |
| Return on Assets (2) | 0.6% | 0.4% | 0.2 p.p. |
| Net interest margin (3) | 3.0% | 2.5% | 0.5 p.p. |
| Costs / Income (4) | 66.9% | 71.5% | (4.6) p.p. |
| Credit Risk Costs (5) | (0.8%) | (0.7%) | (0.1) p.p. |
| Loans / Deposits (6) | 107.2% | 101.6% | 5.6 p.p. |
| Loans / Total sources of funding (7) | 90.9% | 84.7% | 6.2 p.p. |

*(1) Relation of the net profit to average shareholders' capital based on the balances at the end of the quarters (annualized).*

*(2) Relation of the net profit to average assets based on the balances at the end of the quarters (annualized).*

*(3) Relation of the net interest income to average assets based on the balances at the end of the quarters (annualized).*

*(4) Relation of the total of general administrative expenses, and depreciation and amortization to the total result on banking activities and other operating income and costs.*

*(5) Relation of net impairment losses on loans and advances to the average balance of loans and advances to customers based on the balances at the end of the quarters (annualized).*

*(6) Relation of gross loans and advances to customers to amounts due to customers based on the balances at the end of the period.*

*(7) Relation of gross loans and advances to customers to the total amounts due to customers, debt securities issued and loans from other banks. Balances at the end of the period.*

# 8. PARENT COMPANY'S OPERATIONS IN THE FIRST HALF OF 2014

## 8.1. DISTRIBUTION CHANNELS

### 8.1.1. TRADITIONAL CHANNELS

**Branches**

As at 30 June 2014, the Bank had 390 branches of retail and business banking, of which 115 were operating branches and 275 subordinated branches (compared to 116 operating branches and 281 subordinated branches as at 31 December 2013). The network of branches was supplemented by 13 external cash desks, which service cash transactions and 10 Centers of Investment Products Service (COPI), which provide full service of investment products offered by The Brokerage Office of BGŻ.

In the first half of 2014, due to financial results and local market potential analysis, the decision was made to liquidate 7 subordinated branches and to transform 2 operating branches into subordinated and 1 subordinated branch into an operating one.

Tasks from the scope of the sale of products and banking facilities offered to corporate customers are performed by 44 Business Centers of Small and Medium Enterprises, 6 Business Centers of Large Enterprises (LE) and 1 International Desk Warsaw Business Centre.

In March 2014 the Bank launched Corporate Services Center – the new unit to support corporate customers in the area of current IT operating services. The Corporate Services Center is the first centralized unit in the Bank which performs operating tasks, which were so far in the scope of operating branches and advisers.

**ATM network**

On 19 December 2013 the Bank signed an agreement on sale of ATMs located at Bank's branches to IT Card company, the owner of ATM chain PlanetCash. After transferring ATMs to the buyer they will have both BGŻ and Planet cash4you logo. The transfer of devices is in progress. When finished, IT Card will be the owner of all ATMs located at Bank's branches. The Bank will not own its ATM chain.

As at 30 June 2014 there were 413 ATMs at the Bank's branches.

As a result of above measures, an offer of free debit cards to personal accounts was changed. Depending on the type of personal account owned, there were all or only 4 free transactions in a month. Additionally the customers with personal account *Plan Aktywny, Plan 3* and *Konto bardzo osobiste* were allowed to free of charge withdrawals from all ATMs in Poland and abroad.

The institutional customers (Micro segment) had the possibility to freely use ATMs located at Bank's branches and selected ATMs of Planet Cash4 You (74 pieces). Moreover the customers with *Plan Agro Lider, Agro Lider Prestiz* and *Plan Agro* were allowed to freely use ATMs of Group of BPS S.A and SGB-Bank S.A.

The customers with *Standardowy e-Biznes Lider Prestiż* will be allowed to freely use ATMs located at the Bank's branches, selected Planet Cash4You (74 pieces) and also Euronet ATMs (4 538 pieces). The customers with *Agro Lider Prestiż* will be allowed to freely use all ATMs in Poland.

### 8.1.2. ON LINE AND OTHER DISTRIBUTION CHANNELS

**Internet banking**

In the first half of 2014, the Bank recorded a growth in the number of customers using internet service eBGŻ (retail clients) and eBGŻ Firma (institutional clients). The number of operations executed using the internet channel increased systematically.

**Table 20. Data related to eBGŻ and eBGŻ Firma**

| | | 30.06.2014 | 30.06.2013 | change y/y | |
|---|---|---|---|---|---|
| Number of clients with access | eBGŻ | 438 107 | 385 099 | 53 008 | 13.8% |
| | eBGŻ Firma | 89 496 | 78 967 | 10 529 | 13.3% |
| Number of clients actively logging in | eBGŻ | 278 300 | 251 688 | 26 612 | 10.6% |
| | eBGŻ Firma | 53 466 | 47 977 | 5 489 | 11.4% |
| Average number of transactions | eBGŻ | 1 171 875 | 1 106 593 | 65 282 | 5.9% |
| | eBGŻ Firma | 1 121 302 | 974 017 | 147 285 | 15.1% |

***eBGŻ***

In May 2014 the Bank launched the mobile banking for retail customers – eBGŻ Lite service. It allows, among others, the current control over the amount of money in account, transfer of money to all parties and between customer's own accounts, recharge of mobile phone, presentation of currency exchange rate, restriction of a card, presentation of currency exchange or location of the nearest branch.

In addition, along with changing the Bank's offer, the functionality of internet banking service eBGŻ was supplemented and adjusted to the current offer.

**Phone-banking**

In the first half of 2014, a further increase by 69 436 i.e. 13% in the number of Tele-banking retail and institutional users was recorded in comparison to the half-year of 2013.

**Table 20. Data related to TeleBGŻ**

| | | 30.06.2014 | 30.06.2013 | change y/y | |
|---|---|---|---|---|---|
| Number of customers with access to TeleBGŻ | Retail Customers | 473 674 | 423 103 | 50 571 | 12.0% |
| | Institutional Customers | 141 225 | 122 360 | 18 865 | 15.4% |

In the first half of 2014 the process of quality improvement of services offered to customers using phone-banking was continued. The modification of automatic IVR service was made, the standards of customer's services were changed and the IT and quality monitoring tools were implemented. Additionally in the course of courier process for personal accounts the time to deliver files with the card to customers was shortened.

For clients using the TeleBGŻ service the range of services available via phone-channel was expanded with:

- bank transfer and setting a standing order at credit card,
- activation of dual currency card between PLN and EUR accounts,
- transfer of card's limit to personal account,
- activation of VISA card,
- issuance of new token.

The further development in the area of activating and retention process was made.

As a part of sell processes via alternative distribution channels a remote sale of the revolving loan with personal account via courier was launched as well as the process of receiving applications for the credit card by phone.

The consultants of Call Centre took actively part in the after-sale process services and offered help and support to users of internet banking.

**Banking cards**

As far as issuance and cards servicing is concerned, the Bank cooperates with MasterCard and Visa. The portfolio of payment cards includes debit cards, credit cards and cards with deferred payment. As at 30 June 2014, the number of debit card issued to clients amounted to 618.4 thousand and was nearly by 4.5 thousand, i.e. 0.7%, lower than in the previous year. In this period, increase concerned only credit cards granted to retail clients (an increase of 2.5 thousand, i.e. by 0.5%).

**Table 21. Number of banking cards issued by BGŻ S.A.**

| *Cards in thousand* | 30.06.2014 | 30.06.2013 | change y/y | |
|---|---|---|---|---|
| Debit cards retail | 502.4 | 499.9 | 2.5 | 0.5% |
| Credit cards retail | 54.6 | 58.4 | (3.8) | (6.5%) |
| Debit cards business | 60.1 | 63.1 | (3.0) | (4.8%) |
| Business cards with deferred payment | 1.3 | 1.5 | (0.2) | (13.3%) |
| **Total number of cards issued** | **618.4** | **622.9** | **(4.5)** | **(0.7%)** |

In the first half of 2014 contactless payment functionality (MasterCard PayPass) was introduced to all types of cards enabling transactions below PLN 50 without typing the PIN or signature. However the Bank allows its customers to decide if they want this type of card or they prefer to use the card without contactless functionality.

As part of enhancing the cashless payments with debit cards the following offer was introduced: „*Płać kartą i odbierz voucher*" promoting contactless payments and „*Płać kartą i wypłacaj*" supporting Cash-back service, i.e. the possibility to withdraw cash along with paying with card for purchase.

In January 2014 the Bank widened the credit card offer with Visa Gold, designed for wealthy customers. The card is equipped with contactless functionality (activated on request), the attractive insurance package for unauthorized transactions and travel insurance, and also discounts prepared by Visa. The card is unique because of its attractive interest rate, lower by 2 percentage points than rates offered with other cards.

As part of the retail credit card offer the Bank continues the offer payback of the part of expenses made by the customer.

**Cooperation with intermediaries**

At the end of June 2014, the Bank actively cooperated with 22 network intermediaries, such as Open Finance, Notus and Expander and also with 39 local agents. The cooperation was based on the active sale of banking products. Direct supervision over all cooperation agreements (both with network-based and local intermediaries) is performed by the Bank's Head Office.

In the first half of 2014 the Bank introduced the changes in the area of cooperation with financial intermediaries:

- resignation from offering by financial intermediaries housing loan for retail customers,
- decrease of remuneration for the biggest chain intermediaries.

In 2014, there was carried on a policy of central monitoring was continued on how the intermediaries meet their agreement obligations. The evaluation concerned sale effects, as well as a quality of the credit portfolio provided by intermediaries. These actions resulted, among others, in the termination of 31 intermediary contracts during this period.

## 8.2. RETAIL BANKING

### 8.2.1. PRODUCT OFFER DEVELOPMENT

In the first half of 2014 the interest rates of NBP stabilized at low level and rates on the interbank market were decreasing, influencing the prices of deposit offer for retail customers. In these circumstances the main target of the Banks' deposit activity was stabilization of retail customer's savings portfolio, along with non-interest income optimization.

In the same period the Bank implemented changes in offer and pricelist of personal accounts. On 28 March 2014 the Bank terminated the *Program Premia+,* which allowed the owners of personal accounts with Konto Plus to be granted cash bonus, when certain conditions from the regulations of *Program* are met. The program was introduced in 2010.

On 28 March another change was made to the offer of personal account – the rules of "Framework Agreement of bank accounts, payment cards and phone- and internet banking" were changed. New acquisition account with tariff plan *Konto Nr 1* was introduced. Moreover in the offer remained *Plan Aktywny* and *Konto bardzo osobiste* (dedicated to VIP clients), and other tariff plans were transferred to service, i.e. they will not be available in new sales offer, but will be maintained for clients.

The changes in the offer refer also to debit cards issued to personal accounts. For the entire portfolio the cards with contactless payment functionality (MasterCard PayPass) were introduced. In the same time the rules referring to charges for cash withdrawal were changed. It was a result of the Banks' care for stable financial results after sale of own ATMs and changes in legislation in the area of interchange rates. For personal accounts which remained in the Bank's offer, due to big acquisition strength, all ATMs in the country are free of charge. For accounts which are not in the offer but are still maintained by the Bank there are now granted 4 free withdrawals per period and then the fixed fee, which compensates the Bank's cost for the next withdrawals.

A promotion was introduced which supports non-cash payments with cards with the following accounts:

1) „*Płać kartą i odbierz voucher*", allowing to collect, in return for contactless payments, a voucher for PLN 100 or PLN 200 valid in "Empik" or "Smyk" stores (the offer was available until 16/05/2014) and
2) „*Płać kartą i wypłacaj*", promoting cash-back, i.e. the possibility to withdraw cash while paying with the card (the promotion available in the period of 1/03/2014 – 31/08/2014).

Since April 2014 the Bank, to meet customer's expectations, has widen the insurance offer with new product - *Terminowe Ubezpieczenie na Życie*, which is an individual insurance with very wide scope. This insurance is dedicated to personal banking customers.

### 8.2.2. BGŻOPTIMA

The BGŻOptima serves as a supplement to the Bank's offer with regards to saving and investment products, and is dedicated to clients who wish to use Internet-based services. The BGŻOptima offer comprises term deposits, saving accounts and distribution of open-end investment funds participation units.

In the first half of 2014, the Bank's offer has been consistently expanded in the area of deposit and investment products – the offer was extended to include new Investment Fund Managing Companies (TFI) and investment deposits (structured). As at 30 June 2014, the number of clients serviced by BGŻOptima amounted to 138.4 thousand, which means that from the beginning of 2014, 26.3 thousand new clients were acquired. In the first half of 2014, the Bank concentrated on increase of the volume along with improving the average margin.

### 8.2.3. DEPOSIT ACTIVITIES

In the first half of 2014 the Bank was offering products allowing customers to reach higher profits than on standard deposit products, and offers rewarding new funds.

The scope of products was widen by 5 new subscriptions of investment deposit and 2 special offers for the new saving account "Konto z Zyskiem".

Moreover, the Bank was actively developing the cooperation with the customers of VIP Segment, offering competitive price conditions for the given tenors of *Lokata bardzo osobista* (9 editions) and introducing *Lokata Urodzinowa*, dedicated to the customers involved in other Bank's products.

As at 30 June 2014 the number of retail deposits amounted to PLN 17 501 035 thousand, which was an increase of 1 151 381 thousand y/y (7.0%). The main growth factor was the increase of term deposits volume (both standard and negotiable) at Bank's branches. The investment deposits also increased significantly, both offered by branches (the increase from PLN 178.4 million as at the end of June 2013, to PLN 434.7 million as at the end of June 2014), and via BGŻOptima internet channel (respectively from PLN 2.2 million to PLN 34.7 million).

**Table 22. Volume and structure of retail deposits**

| *PLN thousand* | **30.06.2014** | **31.12.2013** | **30.06.2013** | **change y/y** | |
|---|---|---|---|---|---|
| | | | | **PLN thousand** | **%** |
| Current and savings accounts | 10 277 273 | 10 100 652 | 10 869 480 | (592 207) | (5.4%) |
| Term deposits | 7 165 722 | 6 208 272 | 5 469 447 | 1 696 275 | 31.0% |
| Other liabilities | 58 040 | 68 250 | 10 727 | 47 313 | 441.1% |
| **Total amounts owed to retail customers** | **17 501 035** | **16 377 174** | **16 349 654** | **1 151 381** | **7.0%** |
| **including: BGŻOptima** | **4 863 211** | **4 181 477** | **4 021 314** | **841 897** | **20.9%** |

The number of deposit accounts increases systematically: as at the end of June 2014 there were 1 238.6 thousand of accounts, which is an increase by 100.9 thousand accounts y/y (8.9%).

**Table 24. Number of retail deposits accounts**

| *Number of items (in thousands)* | **30.06.2014** | **30.06.2013** | **change y/y** | |
|---|---|---|---|---|
| | | | **PLN thousand** | **%** |
| **Number of deposits* accounts in branches, including** | **1 238.6** | **1 137.7** | **100.9** | **8.9%** |
| Personal accounts | 659.5 | 625.9 | 33.6 | 5.4% |
| Saving accounts | 333.5 | 284.2 | 49.3 | 17.3% |
| **Number of savings accounts in BGŻOptima** | **158.0** | **115.1** | **42.9** | **37.3%** |

** excluding technical deposits*

### 8.2.4. LENDING ACTIVITIES

In the first half of 2014, lending activities of the Bank in the area of retail loans were focused on building Bank's share in the retail lending market along with maintaining the profitability of credit products.

As at the end of the first half of 2014, the volume of the retail gross loan portfolio amounted to PLN 9 869 441 thousand and was by PLN 532 662 thousand, i.e. 5.7% higher than as at the end of June 2013. The main growth factors included: sale of cash loans and housing loans in PLN.

In 2014 the Bank continued dynamic growth of cash loans. The total sale of this product amounted to PLN 1 216 261 million and was by 36.1% higher than in the prior year. It was caused by the nationwide marketing campaigns organized by the Bank (in TV, on the Internet and radio), as well as the implementation of new product functionality.

In this period there was a number of promoting activities performed, which were dedicated to the wide range of customers among others the owners of mortgage loans and people who are the leaders of their communities. According to the Bank's motto „Bank BGŻ - Dobrze służy ludziom" (Bank BGŻ – serves people well) and in order to increase the economic awareness of customers in the area of the positive credit history, the Bank is involved in cooperation with Credit Information Bureau S.A. (BIK). Thanks to this cooperation, customers with very good history in BIK and a BIK Pass certificate were offered a cash loan. The most popular among customers was the offer "Kredyt za darmo", which does not implicate any costs for the customers in relation to the granted loan. The offer allowed the Bank to acquire new portfolio of customers (over 11 thousand of new customers), which were then offered following loans as a part of preapproved action. The new functionality of flexible choice of the payment date at the stage of applying for cash loan increased attractiveness of the product.

The basic loan parameters were also changed i.e. the extension of credit maturity period to 96 months and the increase of cash loan to PLN 150 000 without extra collaterals. The customers could also decide if they are interested in payment insurance or not. The implemented changes allowed the sale of bigger volumes of cash loan for longer periods, while customer's burden remains low.

In the February 2014 the Bank began to accept credit applications with financial subsidy of state budget as part of "Mieszkanie dla Młodych" program (MdM). The Bank decided to join the program in order to widen the housing product's offer and to meet expectations of customers, who treat MdM loan as very attractive way to buy the first real estate. Additionally the activities were intensified to increase interest and non-interest income, especially by change of Schedule of Fees and Charges, resignation from some discounts offered while granting housing or construction loan, and also increase of the margin for consolidation or housing loan.

**Table 25. Volume and structure of retail loans**

| *PLN thousand* | **30.06.2014** | **31.12.2013** | **30.06.2013** | **change y/y** | |
|---|---|---|---|---|---|
| | | | | **PLN thousand** | **%** |
| Current account loans | 105 591 | 103 674 | 96 231 | 9 360 | 9.7% |
| Housing loans | 8 166 188 | 8 038 380 | 7 892 242 | 273 946 | 3.5% |
| – in PLN | 5 220 066 | 5 035 855 | 4 680 710 | 539 356 | 11.5% |
| – in foreign currencies | 2 946 122 | 3 002 525 | 3 211 532 | (265 410) | (8.3%) |
| Cash loans | 1 216 261 | 1 018 435 | 893 610 | 322 651 | 36.1% |
| Credit card limits | 84 484 | 82 295 | 74 836 | 9 648 | 12.9% |
| Other loans to retail clients | 296 917 | 326 411 | 379 900 | (82 983) | (21.8%) |
| **Total loans to retail clients** | **9 869 441** | **9 569 195** | **9 336 819** | **532 622** | **5.7%** |

Unfortunately the slowdown on the housing loan market which has continued for a few years now, caused not only by decreasing propensity to long-term indebtedness of individuals, but also by financing of mortgage purchase from their own savings, affected the level of sales of mortgage loans in PLN in the first half of 2014, which amounted PLN 388.9 million and was by 18 % lower than in the first half of 2013. That tendency affects most of banks and even joining the MdM program did not change the situation on the market.

The portfolio of foreign currency mortgage loans (withdrawn from Bank's offer in 2009) is systematically decreasing.

**Table 26. Number of retail credit accounts**

| *Number of items (in thousands)* | 30.06.2014 | 31.12.2013 | 30.06.2013 | change y/y | |
|---|---|---|---|---|---|
| Housing construction and consolidation loans | 56.8 | 56.1 | 54.9 | 1.9 | 3.5% |
| Cash loans | 124.3 | 104.1 | 97.0 | 27.3 | 28.1% |

## 8.3. BROKERAGE SERVICES AND DISTRIBUTION OF PARTICIPATION UNITS IN INVESTMENT FUND MANAGING COMPANIES (TFI)

The Brokerage Office of the Bank („BM BGŻ" or the "Brokerage Office") focuses on retail client services. The offer of rendered services supplements the Bank's offer in the area of investment products. The Brokerage Office also provides services to selected institutional clients such as open-end pension funds (OFE), investment fund managing companies (TFI) and other entities managing entrusted assets.

Brokerage fee income in the first half of 2014 amounted to PLN 2 463 thousand, and was by 28% higher compared to the first half of 2013. In analyzed period the fees from TFI units sold in Centers of Investment Products Service (COPI) and the Bank's branches dynamically increased. In the first half of 2014 the above mentioned fees amounted to PLN 7 045 thousand and were by 89% higher than in the prior year.

The offer of investment funds distribution is widening. As at the end of June 2014, BM BGŻ was offering 118 funds managed by 9 TFIs. As at 30.06.2014 the value of TFI assets sold by BGŻ amounted to PLN 1 205.04 million and was by 66% higher than in the prior year.

In the first half of 2014 BM BGŻ took part in 8 Initial Public Offerings. In 4 cases BM BGŻ was acting as an offering, taking part in every stage, both in preparing and conducting an offer as its organizer.

**Table 27. Fee and commission income of the Brokerage Office of Bank BGŻ**

| *Thousand PLN* | 30.06.2014 | 30.06.2013 | change y/y | |
|---|---|---|---|---|
| | | | thousand PLN | % |
| Brokerage fees and commissions | 2 463 | 1 928 | 535 | 27.7% |
| Commissions from the sale of units in investment funds | 7 045 | 3 727 | 3 318 | 89.0% |
| **Fee and commission income from brokerage operations** | **9 508** | **5 655** | **3 853** | **68.1%** |

**Table 28. Share of the Brokerage Office of Bank BGŻ in trading on the WSE**

| | | 30.06.2014 | | 30.06.2013 | |
|---|---|---|---|---|---|
| | | Market share | Volume | Market share | Volume |
| Stock | PLN million | 0.29% | 630.46 | 0.16% | 368.89 |
| Bonds | PLN million | 3.56% | 33.49 | 0.24% | 5.02 |
| Futures | Number of contracts | 0.46% | 44 864 | 0.62% | 73 941 |
| Investment certificates | PLN million | 1.93% | 1.22 | 3.00% | 1.36 |
| Options | Number of contracts | 0.37% | 1 543 | 0.26% | 2 031 |

The improvement of results of BM BGŻ is an effect of consequently realized Growth Strategy emphasizing the quality of human resources and also the development of products offer.

In order to meet customers' expectations and to simplify investment decision making, BM BGŻ introduced investment advice and the investment fund branded BGŻ.

The investment advice is currently in a pilot stage and is offered only in COPI. However there have been already actions taken toward launching the sale in Bank's branches. The BM BGŻ offers three types of the service; investment fund's portfolio, stock exchange portfolio and mixed portfolio. There are also 4 investment strategies available: conservative, stable, balanced and dynamic.

In May 2014 BM BGŻ jointly with Ipopema TFI created BGŻ Specjalistyczny Fundusz Inwestycyjny Otwarty (BGŻ SFIO). There are 4 subfunds available for customers included in BGŻ SFIO offer and diversified in terms of investment risk and expected rate of return: conservative, stable, balanced and dynamic. The offer is available both in Bank's branches and via internet-based service BGŻOptima.

## 8.4. INSTITUTIONAL BANKING

### 8.4.1. CLIENT SEGMENTATION

In 2013 new rules of Client segmentation were introduced. The criteria of Institutional client classification for LE, SME and Micro segments have changed. According to the new Client segmentation:

- **Large Enterprises (LE)** – the entrepreneurs who conduct the full financial reporting according to Polish Accounting Act (this condition doesn't have to be met in case of farmers), with annual net revenues for the previous financial year of PLN 60 million or more, or with credit exposure to the Bank of PLN 25 million or more.
- **Small and Medium-Sized Enterprises (SME)** – the entrepreneurs who conduct the full financial reporting according to Polish Accounting Act (this condition doesn't have to be met in case of farmers), with annual net revenues for the previous financial year ranging from PLN 10 million to PLN 60 million, or with credit exposure to the Bank ranging from PLN 2 million to PLN 25 million (in case of farmers ranging from PLN 1 million to PLN 25 million).
- **Microenterprises (Micro)** – the entrepreneurs who do not conduct the full financial reporting according to Polish Accounting Act and the entrepreneurs who conduct the full financial reporting according to Polish Accounting Act with annual net revenues for the previous financial year of less than PLN 10 million or with credit exposure to the Bank of less than PLN 2 million.

As part of those segments, there are separated sub-segments for agro and non-agro clients, including farmers, non-profit organizations and financial institutions.

### 8.4.2. PRODUCT OFFER DEVELOPMENT

**Product packages and transaction products**

*Micro segment*

In the first half of 2014 not a single new deposit or transaction products were launched for customers from Micro segment and no change was made in the rules on products already offered by the Bank.

*SME and LE segments*

In 2013 the Bank launched the new process of opening a bank account along with the comprehensive agreement on transaction banking products for corporate clients (SME and LE). The purpose of the implementation of the new process is to reduce the time to prepare the agreement and simplify the agreement documents. The comprehensive agreement provides the client within one framework agreement, access to basic transaction banking products, such as settlement accounts, deposits, access to electronic banking, the ability to conduct foreign exchange transactions, access to payer identification services (IDEN), and the ability to use debit cards. Additional products are launched after the customer files the relevant application, without the need to sign an annex. At the same time, along with the comprehensive agreement, the Schedule of Fees and Charges for corporate clients was introduced. The schedule apart from simplified content includes only an offer for corporate segment. The new Schedule introduces 3 new tariff plans:

- *Standard* – plan dedicated to SME and LE segments, it enables, among others, the individual pricing decisions;

- *e-Biznes Lider Prestiż* – plan dedicated to SME segment as Internet package i.e. cheap operations conducted via electronic channel, and more expensive operations conducted in branches;
- *Agro Lider Prestiż* – plan dedicated to farmers, offering among others the cheap operations in branches.

Initiated in the last year process of customer migration to the above mentioned comprehensive agreements is almost completed; as at the end of the first half of 2014 there were almost 90% of corporate customers' agreements migrated (excluding customers from a group of local government units whose contracts cannot be exchanged). The strategic objective of these activities is to increase fee income and to maintain interest income on the current level.

**Credits**

*Micro segment*

Since 17 March 2014 subjective scope of uncollateralized loan was extended with customers from Micro segment who conduct the full financial reporting and their business is other than farming.

The offer for customers from Micro segment who conduct the simplified financial reporting did not change significantly.

**Agribusiness financing**

*Guarantee line "de minimis"*

The Agreement of the de minimis guarantee line of the portfolio was signed with Bank Gospodarstwa Krajowego (BGK) on 6 June 2013. The de minimis guarantee offers the collateral of repayment of a loan dedicated to current business financing, and is offered on preferential terms. Clients of the Bank will be allowed to apply for a de minimis guarantee while they apply for an overdraft facility, credit facilities and revolving loan. The guarantee could also include renewed credit agreements concerning credit facilities. In case of growing value of non-revolving credit, the guarantee could include the value, which increases that credit. Creditworthy clients from SME sector could also be granted the "de minimis" guarantee.

The "de minimis" guarantee of BGK does apply to entities in the field of primary production, processing and placing on the market agricultural products, fishery, aquaculture and coal sector. The main benefits for the customer are: (i) the minimum of formalities while obtaining BGK warranty; (ii) the opportunity to be granted the higher loan value than in the standard offer; (iii) the lack of fees for the first year of BGK guarantee; (iv) the opportunity to be granted the loan even if there are no material collaterals or existing ones are not sufficient.

On 13 November 2013, the Bank signed an annex to the agreement of "de minimis" guarantee line of the portfolio with BGK. Amendment allows BGK for the settlement of guarantees "de minimis" also for investment loans. The products to which the "de minimis" guarantee will also apply are commercial investment loans; investment loans from the EIB line; investment loans for financing renewable energy - Green Energy Loan. The maximum guarantee period for an investment loan is 99 months. Guarantees for investment loans are granted within the limits provided by the BGK PLD agreement dated 6 June 2013.

On 28 May 2014 the Bank signed an annex which increased granted de minimis guarantee line of the portfolio. The next annex signed on 27 June 2014 refers to the change of rules on granting de minimis guarantee and prolongation of the period of program availability until the end of 2015.

*Polseff Program*

In April 2014 the Bank signed the last credit agreement as part of program of Sustainable Energy Financing in Poland (Polseff) realized together with European Bank for Reconstruction and Development and fully used the EUR 50 million limit dedicated to micro, small and medium-sized enterprises which are customers of the Bank.

*Agro Progres*

In September 2013 new product was introduced - investment loan *Agro Progres*, which is intended to finance farms. The loan is an alternative to preferential loans, giving the possibility of a much wider and more flexible range of funding at a comparable cost. It is dedicated to persons engaged in agricultural activities, who want to enlarge and modernize their farm, especially by the purchase of land.

The loan may be granted up to 30 years, and the Bank BGŻ on request issues a promissory note of credit, valid for 12 months. Thanks to this a borrower can fulfill all of their investment plans during the year. Possibility of choice of fixed interest rate makes payments equal, and the change in interest rates does not affect the household budget. In the case of a temporary deterioration of the situation on the farm, it is possible to suspend the repayment of capital by using so-called "credit vacation".

Unlike preferential loans, loan Agro Progres gives the freedom to establish the scope and scale of planned investment and a flexible repayment schedule, tailored to the specifics of the business. In individual cases it is possible to determine the annual repayments of capital. The Bank does not require a high own contribution, and the procedure for granting the loan is friendly and has been kept to a minimum. The customer does not need to present a business plan - assessment of creditworthiness can be carried out on the basis of the currently pursued production.

In the first quarter of 2014 the minimal value of Agro Progres loan which could be granted for more than 15 years, decreased from PLN 200 thousand to PLN 100 thousand. Moreover the regulation from BGŻ S.A. referring to compliance with Recommendation S enters into force starting from 1 July 2014.

The events that have an impact on the market of preferential loans in the first half of 2014:

- introduction of significant limits and changes to financing purchase of agricultural lands,
- modification of rules regarding granting "disaster" revolving loan,
- restore of financing of processing of agricultural products for all entities,
- maintenance of rules regarding granting a part of investment credit lines from prior years.

*The purchase of agricultural lands*

- Since 1 January 2014 to 8 May 2014 the possibility to purchase an agricultural land on preferential rules was excluded. On 31 December 2013 the decision 2010/10/WE of 20 November 2009 was overruled. The decision refers to possibility granted to the authorities of Republic of Poland to subsidize the purchase of agricultural real estate in the period between 01.01.2010 to 31.12.2013, which allowed them to subsidize purchases of agricultural lands.
- Since 9 May 2014 as a result of amendment of domestic legislation (Decree of Council of Ministers and Decree of President of ARiMR) the new possibilities to purchase agricultural land with preferential loan was reintroduced:
    - the new form of help as part of nKZ and nGR lines with subsidies to interests as de minimis (subsidies up to EUR 15 thousand for the entire crediting period);
    - as part of nIP, nMR, nBR15 and CSK up to 10 % of eligible investment costs, for example purchase of agricultural lands for construction or modernization of outhouses.

*The modification of rules of granting "disaster" loans*

As a result of amendment to European Committee regulation and domestic legislation since 9 May 2014 rules regarding calculation of the amount of de minimis subsidy in the form of subsidy to "disaster" loans were changed. This kind of help is granted in cases when losses incurred due to natural disasters in given farm do not exceed 30%. The amount of the subsidy to interest was increased from EUR 7.5 thousand to EUR 15 thousand. The amount of the subsidy is calculated once for entire crediting period and is not recalculated during the period of repayment of the loan.

*The financing of processing of agricultural products for all entities*

Since 9 May 2014 the possibility to finance investments was restored for all entities regardless of the form of the business and the size of the entity. In case of large enterprises (according to WE classification),which are allowed to use national aid only in the form of de minimis, the amount remained at the level of EUR 200 thousand. The amount is calculated once for entire crediting period without any further recalculation.

**Insurance for farmers**

With the cooperation of Concordia Polska TUW, the Bank offers insurance products for farmers (voluntary and compulsory insurance). In the first half of 2014 there were no new products introduced into the offer, and no significant changes were made to rules regarding already offered products.

### 8.4.3. LENDING ACTIVITIES

In the first half of 2014 the Bank recorded an increase in lending to institutional clients. As at 30 June 2014 value of gross loan portfolio amounted to PLN 20 411 504 thousand and increased by PLN 2 466 814 thousand, i.e. 13.7% compared to 31 December 2013. On y/y basis the credit portfolio recorded an increase of 14.8%.

**Table 29. Loans and advances to institutional customers**

| *PLN thousand* | **30.06.2014** | **31.12.2013** | **30.06.2013** | **change y/y** | |
|---|---|---|---|---|---|
| | | | | **PLN thousand** | **%** |
| **Overdraft facilities, including:** | **4 999 669** | **4 168 862** | **4 071 259** | **928 410** | **22.8%** |
| – businesses | 2 255 378 | 1 907 354 | 2 031 975 | 223 403 | 11.0% |
| – individual entrepreneurs | 365 712 | 313 552 | 326 648 | 39 064 | 12.0% |
| – farmers | 2 271 848 | 1 926 116 | 1 673 206 | 598 642 | 35.8% |
| **Loans and advances to Customers:** | **15 411 835** | **13 775 828** | **13 707 801** | **1 704 034** | **12.4%** |
| – businesses, including: | 8 156 047 | 6 892 196 | 7 238 932 | 917 115 | 12.7% |
| - investment loans | 5 059 803 | 4 238 097 | 4 535 650 | 524 153 | 11.6% |
| - operating loans | 1 994 047 | 1 752 067 | 1 675 785 | 318 262 | 19.0% |
| – individual entrepreneurs | 1 312 720 | 1 259 146 | 1 220 963 | 91 757 | 7.5% |
| – farmers | 5 589 851 | 5 217 481 | 4 908 308 | 681 543 | 13.9% |
| – public sector institutions | 238 432 | 251 572 | 272 937 | (34 505) | (12.6%) |
| – other entities | 114 785 | 155 433 | 66 661 | 48 124 | 72.2% |
| **Total** | **20 411 504** | **17 944 690** | **17 779 060** | **2 632 444** | **14.8%** |
| *of which:* | | | | | |
| *preferential loans* | *4 669 701* | *4 657 474* | *4 504 036* | *165 665* | *3.7%* |

The following factors influenced the increase of volume of loans in 2014:

- the growing credit activity towards microenterprises,
- acquisition of the portfolio of Rabobank Polska with value of PLN 1.9 billion,
- Bank's industry policy – identifying high-risk industries and determining tightening of credit conditions for entities operating in these industries.

### 8.4.4. DEPOSIT ACTIVITIES

In the first half of 2014 the Bank pursued a conservative pricing policy in case of deposits for institutional clients that aimed at obtaining better interest margins and securing the required liquidity levels.

Deposits of corporate clients showed an upward trend. The growing volume of current accounts by PLN 321 536 thousand y/y (i.e. 7.2%) was compensated by decrease in term deposits by PLN 97 839 thousand and other liabilities by PLN 5 215 thousand. The detailed analysis indicates that as far as farmers are concerned, the volume of term deposits grew significantly by PLN 109 033 thousand (i.e. by 69.4%) along with similar decrease of amounts on current accounts. The adverse tendency was recorded in LE segment (decrease of term deposits by PLN 206 872 thousand along with increase of current accounts by PLN 423 880 thousand) and among public sector.

In the deposit volume as at the end of June 2014 the deposits transferred from Rabobank Polska amounted to PLN 0.3 billion.

At the same time the Bank increased financing received from non-banking financial entities, especially in the area of term deposits (increase y/y by 286 405 thousand i.e. 27.2%).

**Table 30. Amounts due to institutional customers**

| *PLN thousand* | 30.06.2014 | 31.12.2013 | 30.06.2013 | change y/y | |
|---|---|---|---|---|---|
| | | | | PLN thousand | % |
| **Other financial Institutions** | **1 345 843** | **1 046 953** | **1 064 957** | **280 886** | **26.4%** |
| Current accounts | 6 578 | 9 894 | 12 097 | (5 519) | (45.6%) |
| Term deposits | 1 339 254 | 1 037 048 | 1 052 849 | 286 405 | 27.2% |
| Other liabilities | 11 | 11 | 11 | - | - |
| **Corporate customers** | **8 716 731** | **8 466 523** | **8 498 249** | **218 482** | **2.6%** |
| Current accounts | 4 798 291 | 4 891 038 | 4 476 755 | 321 536 | 7.2% |
| Term deposits | 3 850 004 | 3 510 860 | 3 947 843 | (97 839) | (2.5%) |
| Other liabilities | 68 436 | 64 625 | 73 651 | (5 215) | (7.1%) |
| **of which farmers** | **1 240 411** | **1 200 404** | **1 235 686** | **4 725** | **0.4%** |
| Current accounts | 968 530 | 1 040 784 | 1 070 874 | (102 344) | (9.6%) |
| Term deposits | 266 221 | 152 923 | 157 188 | 109 033 | 69.4% |
| Other liabilities | 5 660 | 6 697 | 7 624 | (1 964) | (25.8%) |
| **Public sector customers** | **689 030** | **602 066** | **765 025** | **(75 995)** | **(9.9%)** |
| Current accounts | 484 383 | 458 346 | 473 172 | 11 211 | 2.4% |
| Term deposits | 204 518 | 143 593 | 291 727 | (87 209) | (29.9%) |
| Other liabilities | 129 | 127 | 126 | 3 | 2.4% |
| **Total** | **10 751 604** | **10 115 542** | **10 328 231** | **423 373** | **4.1%** |

### 8.4.5. TRADING BUSINESS FINANCING

The product offer dedicated to finance foreign trade operations comprises of: export and import letters of credit, export and import documentary collection, letter of credit discount, Nostro and Loro guarantees, avals and guarantees, factoring, payment orders and foreign exchange payment orders.

**Factoring**

As part of providing factoring services, in the first half of 2014 the Bank acquired 65 899 invoices with a total value of PLN 1 165 628 thousand compared to 73 756 invoices acquired in the first half of 2013 with a value of PLN 1 525 410 thousand.

In June 2014, the Bank changed the internal regulations regarding factoring in order to meet the requirements arising from the internal audit of factoring process and VAT of factoring services.

The Bank's added „vendor financing" product consisting of repayment by the Bank of trade receivables owed to suppliers of goods/services from customers to the accounts of suppliers of goods/services – customers of the Bank.

Through Internet banking system eBGŻFirma, customers gained access to the factoring account statement. The new solution based on automatic generation of requests for payment and confirmations of balances was implemented – to improve the timeliness and quality of payment by factoring counterparties.

**Bank guarantees**

As at the end of June 2014 the total value of guarantees granted to clients amounted to PLN 365 941 thousand. The Bank's portfolio included 1 560 granted guarantees.

The decrease in the value of guarantees compared to the end of June 2013 is mainly a result of a more prudential approach in relation to the Bank's customers in the construction industry, including road construction contractors that most often makes use of bank guarantees as collateral of commercial contracts.

**Letters of credit**

In the first half of 2014 the Bank issued 126 import letters of credit with a total value of PLN 32 million (compared to 122 import letters of credit with a total value of PLN 30.8 million in the first half of 2013) and processed 55 export letters of credit with a total value of PLN 34.3 million (compared to 41 export letters of credit with a total value of PLN 14.5 million in the first half of 2013).

**Transaction statistics**

In the first half of 2014, the upward trend was maintained in respect of foreign trade transfers. The share of SEPA Credit Transfer in the total import and export transfers in the first half of 2014 increased compared to the first half of 2013 and amounted respectively to 75.7% and 67.0%. The share of SEPA transfers in total import transfers in the first half of 2014 remained at the same level as in the corresponding period in 2013 and amounted to 69.8%.

**Table 31. Statistics of operations handled by BGŻ S.A.**

| Transaction type | Quantity/value | 30.06.2014 | 30.06.2013 | change r/r |
|---|---|---|---|---|
| Transactions using the nostro accounts (commercial banks and NBP) | Number of transactions | 411 542 | 371 723 | 10.7% |
| | Value in PLN billion | 1 484 | 1 794 | (17.3%) |
| Transactions using the loro accounts | Number of transactions | 33 998 | 51 140 | (33.5%) |
| | Value in PLN billion | 508 | 421 | 20.7% |
| Export transfers | Number of transfers | 243 202 | 226 812 | 7.2% |
| | Value in PLN million | 9 919 | 10 208 | (2.8%) |
| *including: SEPA Credit Transfer* | *Number of transfers* | *184 049* | *152 042* | *21.1%* |
| | *Value in PLN million* | *4 343* | *3 851* | *12.8%* |
| Import transfers | Number of transfers | 111 266 | 94 255 | 18.0% |
| | Value in PLN million | 5 232 | 5 705 | (8.3%) |
| *including: SEPA Credit Transfer* | *Number of transfers* | *77 701* | *65 210* | *19.2%* |
| | *Value in PLN million* | *2 882* | *2 781* | *3.6%* |
| Own letters of credit and own documentary collection (newly opened) | Number | 154 | 142 | 8.5% |
| | Value in PLN million | 59 | 48 | 22.9% |
| Guarantees and own promissory notes granted | Number | 579 | 636 | (9.0%) |
| | Value in PLN million | 88 | 156 | (43.6%) |
| Third party letters of credit and third party guarantees | Number | 293 | 281 | 4.3% |
| | Value in PLN million | 112 | 92 | 21.7% |

## 8.5. ACTIVITIES IN DEBT SECURITIES MARKETS

In the first half of 2014, the Bank serviced two non-public debt securities issuance programs, including one program of municipal bonds issue. The Bank acted with the corporate bonds issues as an issuing agent, paying agent, calculation agent, dealer and custodian.

## 8.6. ACTIVITIES IN MONEY AND FOREIGN EXCHANGE MARKETS

In the first half of 2014, the activities of the Bank in money and foreign exchange markets were influenced by the following factors:

- continuation of reduction of the quantitative easing by the Federal Reserve started in December 2013,
- maintaining a low rate of economic growth in the Euro zone combined with a further decline in CPI inflation,
- introduction of the new monetary policy tools by the European Central Bank that are aimed at increase of lending in the Euro zone combined with the reduction in interest rates,
- increase in economic growth in Poland associated with decreasing CPI inflation to levels close to zero on an annual basis,
- stabilization of the NBP interest rates (the reference rate at 2.5%), along with market expectations of interest rate cuts in the second half of the year,
- stabilization of PLN against primary foreign currencies, leading to a decline in the volatility of the EUR/PLN to historical lows,
- systematic decline in yields of domestic T-bonds observed throughout the first half of the year, accompanied by a decrease in liquidity on treasury securities market as a result of the reform of open-end pension funds,
- stabilization at a low level of the cost of obtaining funds by the Bank.

In the first half of 2014, the Bank introduced in the area of Financial Markets changes resulting from the Regulation of the European Parliament and of the Council (EU) No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR) in the field of transaction reporting to a trade repository and decided about the clearing model for OTC transactions covered by the obligation of the central settlement.

The Bank was approved by the ACI Poland – the Polish Financial Markets Association and authorized to be a fixing participant for WIBID and WIBOR starting from 14 July 2014.

**Activities on own account**

***FX market***

In the first half of 2014, activities of BGŻ S.A. in the interbank market focused on PLN and currencies of the G7 countries. The turnover achieved by the Bank in the interbank FX market decreased compared to the same period last year. The decrease was the result of the very low volatility of foreign exchange rates in relation to the PLN, which limited the hedging of the Bank's customers and decreased volume of transactions conducted on their own account. The highest volume of FX transactions was achieved by EUR/PLN, followed by USD/PLN and GBP/PLN. Due to the small customers' interest in currency options, the activity of the Bank in the interbank market in this segment remained at a low level.

***Interest rate market***

The Bank's trading activities on interest rate market concentrated on PLN yield curve, mainly on the Polish T-bonds. These instruments were the most popular among clients and had also dominant position in the trading portfolio of the Bank. Among other instruments the most popular were those denominated in Euro that resulted from a higher interest of the Bank's customers in hedging interest rate risk in that currency. Just as in previous years, the Bank did not conduct commercial activity on the market of non-treasury debt securities.

**Short-term liquidity management**

The purpose of the Bank's activity on the uncollateralized interbank deposit market was to manage immediate and short-term liquidity. The main instrument for placing short-term liquidity surpluses were NBP bills. The Bank did not use neither the interbank market nor resources from non-bank financial institutions as sources of financing for its credit activities. Market risk relating to short-term liquidity management and to customers' transactions on the money market, was actively managed by such transaction as: OIS, FRA, IRS and FX Swap. The Bank is an active member of interbank market in terms of short term interest rate derivatives.

**Assets and liabilities management**

Asset and liability management is shaping the Bank's balance sheet in a way that minimizes the negative impact of variability of external factors - such as interest rates, exchange rates and the cost of financing - on the Bank's financial stability. At the same time it shall enable - within the assigned risk limits - generating additional income from the Bank's risk position adjustment to long-term market trends.

***Financing Bank activities***

In the first half of 2014, the Bank's credit loan assets development is characterized by two opposing trends: a very dynamic and steady growth of loan portfolio in retail and micro segments (respectively by over PLN 300 million and by PLN 715 million compared to the end of 2013) and a reduction in loans granted to corporate customers, where exposure has decreased by more than PLN 160 million, mainly in the SME segment. The merger of BGŻ and Rabobank Polska resulted also in an increase of loan commitments by PLN 1.9 billion. In total, during the first 6 months of 2014, the Bank's loan portfolio increased by PLN 2.77 billion.

The Bank has continued the policy of creating a stable deposit base that financed the growth of assets in a diversified manner – almost half of the new deposits, i.e. PLN 1.13 billion, was collected from retail customers, including PLN 0.67 billion from the BGŻOptima Internet channel, despite the constantly conservative pricing policy, i.e. the possibility of a reduction of margins due to the low level of interest rates and low inflation. This strategy was less effective among entrepreneurs and enterprises in the BGŻ portfolio, where the balance of liabilities remained almost unchanged (an increase by PLN 0.05 billion). The Bank decided not to reissue maturing Certificates of Deposits due to dynamic situation regarding the ownership of the Bank and contradictory signal from the market. Deposits value decreased in the first half of 2014 by PLN 0.38 billion to PLN 0.8 billion. As a result of the merger of BGŻ and Rabobank Polska, the Bank acquired the financing of Rabobank Polska, in particular, deposits and loans of Rabobank – as at 30 June 2014 – PLN 1.25 billion, matched to the amount, currency, date, and interest rates type for Rabobank Polska[1] loans; and PLN 0.3 billion of term deposits in current accounts and core deposits of clients of Rabobank Polska, mainly large enterprises.

As a result, an increase in the Bank's assets resulting from BGŻ's lending activities, as well as the acquisition of assets of Rabobank Polska, was almost entirely covered with new financing sources, in particular customers deposits and credit lines with Rabobank.

Due to the record-low interest rates the Bank aggressively lowered interest rates on short term deposits, current accounts (basic interest rate of 1%) and reduced the benefits of current accounts. Clients thus decided to short seasonal offers, progressive and structured deposits where the Bank paid an additional premium for an extended term from 12 up to 24 months, while the balance of on-demand accounts remained almost unchanged. The increase of deposits with maturity exceeding 12 months is also a result of acquisition of long-term financing received from Rabobank after the merger of BGŻ and Rabobank Polska.

At the end of June 2014, 20% of the Bank's assets were loans in foreign currencies, mainly CHF, EUR and USD. In order to make the liquidity situation and financial result independent of currency exchange rates, the Bank seeks to balance the assets and liabilities in the same currency: in 2014 loans in EUR and USD were financed by funds collected from customers on current accounts and term deposits, and (in the case of EUR) of EBRD credit line. The remaining in-use portfolio of mortgage loans in CHF is financed by the CHF credit line with Rabobank. The remaining open currency position is managed on an ongoing basis using short-term FX swaps, where the Bank exchanges deposit surpluses in PLN and USD into CHF and EUR.

### *Interest rate risk, investment portfolio and hedging transactions*

Structural Bank's exposure to interest rate risk – i.e. the sensitivity of net interest income, on the scope and direction of interest rates changes – was adapted to the changing market situation: stable interest rates and distant perspective of change, allowed partially to reduce the mismatch in portfolio hedge revaluation of assets and liabilities in the direction of its natural profile, i.e. "shorter" assets and "longer" liabilities, which is beneficial in case of interest rates increase. This strategy was stopped in May/June, under the influence of a potential return of the MPC to tighten monetary policy, due to potential deflation.

As a result, the Bank's net interest income sensitivity to changes in interest rates during the period of one year – the so-called *Interest at Risk* for scenarios +/- 200bps – increased by approx. 28%, while the sensitivity of the fair value of the equity to changes in interest rates – remained almost unchanged (the so-called *Earnings at Risk*).

[1] The difference compared to PLN 1.9 billion value of loans as at the end of second quarter of 2014, is a result of matching the currency structure of financing of revolving loan – just before the end of June the Bank repaid the loan of USD 200 million, and at the beginning of July the Bank incurred loans in EUR and PLN in the similar amount.

Investment portfolio of debt securities plays a key role in shaping the exposure to interest rate risk – in particular *EaR* – and stabilization of the Bank's result. Its value during the 6 months of 2014 increased from PLN 3.23 billion to PLN 3.45 billion, wherein in this period the ALM sold PLN 0.2 billion of securities maturing in 2015, realizing an additional revenue of PLN 5.1 million; and purchased PLN 0.5 billion of securities, mainly medium-term floating rate securities, due to low yields of fixed coupon bonds and their higher risk of negative valuation. Monthly interest income remained at a level of about PLN 13-14 million, and amounted to total PLN 80 million for 6 months.

As at the end of June 2014, the fair value of the portfolio, taking into account accrued interest amounted to PLN 3.8 billion, including: PLN 214 million recognized in the revaluation reserve – it represents the discounted difference between the interest income generated in the future by the portfolio, and the revenue from a theoretical portfolio of the same structure acquired at the valuation date at market prices.

***Funds' transfer price***

The historically low interest rates in Poland and around the world, stable situation on the financial market regarding risk in Poland, prolonged global slowdown and the reluctant withdrawal of central banks' from quantitative easing resulted in further reduction of financing costs. Due to that fact, the ALM performed successively reduction of liquidity margins, particularly in the long end of the yield curve – over 6 months, respectively: -8bps (6M), 19bps (1 year), 33bps (5 years) and 37 bps (10 years), which on the one hand supports the Bank's competitive position in the credit market (pressure on margins), while maintaining the integrity of the system, i.e. differentiating the charge depending on the tenor of loan/deposit.

At the same time starting from the beginning of 2014 there was introduced an adjustment of liquidity margins for deposits, based on stability of funding sources that helps form the Bank's pricing policy in accordance with the expectations of supervisory authorities (Resolution no. 386/2008 of PFSA, CRD4), and differentiate interest rates adequately to the contribution of a type of financing to the stability of the Bank's deposit base.

**Sale of treasury products to clients**

In the first half of 2014, the dynamics of sale of treasury products in all segments of institutional clients portfolio were comparable to the results in the first half of 2013.

The leading treasury products having impact on the income level were still mainly spot and forward foreign currency transactions, available also via the eBGŻ Treasury Internet platform.

In the first half of 2014, the sale of hedging instruments remained at similar diversification level, as in the first half of 2013.

## 8.7. COOPERATION WITH FINANCIAL INSTITUTIONS

As at 30 June 2014, the Bank maintained correspondent contacts with approximately 860 banks keeping 25 Nostro accounts in foreign banks and 1 in domestic bank in 16 main currencies.

As at 30 June 2014, the Bank maintained 28 Loro accounts in 6 currencies for 19 foreign banks, 1 domestic bank and 1 foreign non-banking financial institution. The Loro accounts maintained in books of the BGŻ S.A. represent an external source of free working capital funds at no cost, which serve to satisfy the operating needs of the Bank. Using these accounts, the Bank executes primarily client transfers and bank-to-bank transfers.

The Bank serviced cooperative banking sector, both in transactional banking and treasury.

In 2014, BGŻ S.A. collaborated with one foreign non-banking financial institution offering cheap and fast electronic money transfer services – MoneyGram (USA). The subject of collaboration was both cash transfers as well as transfers to bank accounts. Transactions were executed in both directions.

The Bank also continued collaboration with other domestic and foreign financial institutions, mainly with investment funds, insurer, pension funds, brokers and banks. This collaboration enabled the Bank to offer a wide range of treasury and deposit transactions. Moreover, the Bank has entered into many agreements with new partners from those segments, which enable the Bank to settle transactions for old and new products.

## 8.8. BANK ORGANIZATION AND HUMAN RESOURCES

### 8.8.1. ORGANIZATIONAL STRUCTURE

The most significant change in the Bank's organizational structure made in the first half of 2014 was the merger of BGŻ S.A. and Rabobank Polska S.A. into one universal bank with a wide range of products and services to customers, including specialized products, targeted to customers segments of strategic importance for the Bank.

Organizational units responsible for maintaining and developing stable business relationships with existing clients of Rabobank Polska S.A. acquired after the merger and new customers with similar profile. The so called global corporate customers were grouped into the Head Office structure of BGŻ S.A. under the new Global Corporate Clients and Products.

According to the accepted model of merge of the two banks, the activities of this area are supported by the existing organization units performing the various functions of the Bank, including: sales support and after-sales service, control of market and operational risk, collection and recovery, controlling, IT support, audit, compliance, HR, legal services. Moreover, to optimize the management of the business area of global corporate clients, several new units in the Headquarters dedicated exclusively to support this area were created. They are responsible for the sale of financial products for global corporate customers, analyzing and assessing the credit risk of these customers, operational support, financial reporting.

In addition to changes associated with the merger of BGŻ S.A. with Rabobank Polska S.A. in the first half of 2014 a number of organizational changes were introduced aiming at automating customer service, improving the loan process and the safety of the Bank, as well as improving the Agro competence. New organizational structure of Agribusiness Division created the conditions for the wider and coherent approach for product innovation and supported external financing, and increased focus and better use of expert knowledge of Agro products, insurance, marketing and credit processes and the strengthening of cooperation with the business divisions.

### 8.8.2. HUMAN RESOURCES

**Employment levels**

As at the end of June 2014, BGŻ S.A. had 5 384 employees (5 326.5 FTEs), i.e. by 3.3% less than in the previous year. The decrease of employment in the Bank was a result of optimization, mainly in branches.

The Head Office employment increased by 12%. The main reasons for the increase are the centralization of certain functions that has contributed to the organizational changes of employees allocation from the Network to Head Office (+128 FTEs) and the acquisition of Rabobank Polska employees as a result of the merger (+51 FTEs).

**Table 32. Bank's employment in employees and FTEs**

| Employees | 30.06.2014 | 31.12.2013 | 30.06.2013 | change y/y | |
|---|---|---|---|---|---|
| Branch network | 3 749 | 4 061 | 4 103 | (354) | (8.6%) |
| Head Office | 1 499 | 1 382 | 1 334 | 165 | 12.4% |
| Brokerage Office | 56 | 58 | 56 | - | 0.0% |
| BGŻOptima | 49 | 52 | 44 | 5.0 | 11.4% |
| Holiday resorts | 28 | 30 | 30 | (2.0) | (-6.7%) |
| Trade unions | 3 | 3 | 3 | - | 0.0% |
| **Total (employees)** | **5 384** | **5 586** | **5 570** | **(186)** | **(3.3%)** |

| FTEs | 30.06.2014 | 31.12.2013 | 30.06.2013 | change y/y | |
|---|---|---|---|---|---|
| Network | 3 720.9 | 4 030.2 | 4 074.2 | (353.3) | (8.7%) |
| Head Office | 1 477.5 | 1 362.6 | 1 319.9 | 157.6 | 11.9% |
| Brokerage Office | 56.0 | 58.0 | 55.5 | 0.5 | 0.9% |
| BGŻOptima | 41.5 | 43.6 | 37.4 | 4.1 | 11.09% |
| Holiday resorts | 27.5 | 29.5 | 29.5 | (2.0) | (6.8%) |
| Trade unions | 3.0 | 3.0 | 3.0 | - | 0.0% |
| **Total (FTEs)** | **5 326.5** | **5 526.9** | **5 519.5** | **(193.0)** | **(3.5%)** |

The level of the cost of salaries in the Bank in the first half of 2014 was influenced by the salary increases for the best employees, started from 1 July 2013 and redeployment of staff as well as implemented process of employment optimization.

Variable remuneration in the Bank is related to the Bank's net profit. Due to the higher level of objectives achieved in the first half of 2014 compared to the level achieved in the first half of 2013, the provision charged for variable components of remuneration in the first half of 2014 was higher compared to the first half of 2013.

Provision for future liabilities for personnel costs includes: in 2013 – mainly release of provision for previous years bonuses; in 2014 – reversals: (i) restructuring reserve (PLN 1 490 thousand), (ii) provision related to the prize fund of the President, and (iii) provision for overtime hours.

**Table 33. Personnel expenses**

| *PLN thousand* | 1st half of 2014 | 1st half of 2013 | change y/y | |
|---|---|---|---|---|
| | | | PLN thousand | % |
| **Wages and salaries including:** | **(204 082)** | **(191 860)** | **(12 222)** | **6.4%** |
| - base remuneration | (170 828) | (168 133) | (2 695) | 1.6% |
| - other components of salaries and wages* | (2 655) | (6 312) | 3 657 | (57.9%) |
| - awards and bonuses | (31 949) | (29 246) | (2 703) | 9.2% |
| - non-employment contracts | (1 487) | (1 455) | (32) | 2.2% |
| - provisions for future liabilities** | 2 837 | 13 286 | (10 449) | (78.6%) |
| **Social benefits and other fringe benefits** | **(48 558)** | **(53 902)** | **5 344** | **(9.9%)** |
| - salary overheads | (38 506) | (37 816) | (690) | 1.8% |
| - employee benefits | (1 928) | (2 331) | 403 | (17.3%) |
| - employment restructuring provision | - | (2 370) | 2 370 | (100.0%) |
| - contributions to the Social Fund | (3 056) | (2 752) | (304) | 11.0% |
| - provisions for future liabilities** | (5 068) | (8 633) | 3 565 | (41.3%) |
| **Total personnel expenses** | **(252 640)** | **(245 762)** | **(6 878)** | **2.8%** |
| ***Awards and bonuses as % of base remuneration*** | ***18.70%*** | ***17.39%*** | | ***1.31 p.p.*** |

** Contingent liabilities payments due to changes in the Management Board of the Bank – refers to 2013 year*

*** Refers to provisions for unused holiday, retirement, disability and health benefits for the current year and previous years and provision for bonuses and awards.*

Information about the amount of the Bank's shares directly owned by the members of the Management Board and Supervisory Board is presented in BGŻ Group's financial statements in Note 41 Shareholders of the Bank.

**Remuneration policy**

The Bank has pursued a reasonable and balanced remuneration policy which reflects its client-oriented approach, accounts for the long-term Bank's interests and supports reasonable and effective risk management.

The remuneration policy supports the implementation of the Bank's business strategy. The principles set out in the remuneration policy are in line with the standards and values of the Bank and the relevant laws and regulations.

The Bank participates in salary market research and thus has regularly monitored competitiveness of its remuneration package (of fixed and variable part) against the market.

The Bank's remuneration policy also includes detailed rewarding regulations for these employees at managerial posts who have a considerable impact on the Bank's risk profile (as per the PFSA Resolution No. 258/2011).

**Incentive schemes**

In the Bank there are incentive schemes that combine three elements: goals relating to priorities set in the Bank's strategy and financial plans, results which are the work output of the Bank's employees, and the amount of bonus.

The incentive schemes, adjusted to the specific character of tasks performed in the area of sales, sales support and risk and support, are based primarily on the Management by Objects (MbO) formula, which means that an individual bonus is related to the level and quality of the objectives achievement.

The system (MbO) focuses on defining tasks or goals that set the development direction of the entire organisation which are then divided into the objectives of individual organisational units and individual employees. The combination of individual and collective objectives illustrates the employee expected results taking into consideration the risk profile of the Bank and attention for actions consistent with the client's interests.

There is also a separate bonus system in the Bank for variable remuneration, including bonuses for employees holding managerial positions who have a significant impact on the Bank's risk profile. The adopted solution is also a result of implementation of the PFSA Resolution No. 258/2011 dated 4 October 2011.

**Training and career development**

Similar as in the last year, in the first half of 2014, training program supported the implementation of the Bank's business objectives by closely cooperation with business in developing the skills and competencies of employees. Total number of participants in classroom training and e-learning amounted to 40 034, including: 33 754 participants of e-learning training programs.

The main areas of trainings conducted in the first half of 2014 were as follows:

- Training to support the development of sales skills and building partnership with customers and enhancing customer service quality standards among the employees of the sales network.
- Training programs to support the development of knowledge and competence in the field of F&A, in relation to the implemented business strategy of the organization.
- Training to improve the level of product knowledge for sales network Staff, including in the area of investment funds and insurance sales.

- Training to support the design of the Bank's risk culture and pro-active attitude and behavior of employees, particularly in the areas of credit and operational risk, compliance and crisis management.
- Awareness training of employees in the area of financial security and clients' assessment referring to money laundering.
- Promoting knowledge of the sustainable business development standards and principles of ethical business code of conduct.

Completed development programs:

- Potential Development Program „The Prestige" – launched the third edition of the Program that aims to identify and develop employees with the highest potential in the fields of management and expertise.
- Sales Talent Development program – the continuation and completion of the program dedicated to the best advisors of retail banking and business customers. The program implemented in three development paths, consistent with the needs of employees: managerial, sales and expert as well as competence of an individual.

**Internship programs**

Bank offers internship programs to students and graduates.

As in previous years, the Bank continues the implementation of the summer internship program targeted at a group of approx. 120 students and graduates. With focus on young talented people from rural areas, for the second time, an internship program was launched for graduates „Klasy BGŻ" in cooperation with business area and BGŻ Foundation.

**The construction of the image of the institution as a desirable employer (employer branding)**

In the first half of 2014, the Bank carry out activities related to the construction of the image as employer and the cooperation with external labor market, i.e. through collaboration with job portals and participation in job fairs. The main goal was to create a consistent and distinctive set of Bank's image features – based on the keynote: „Deal with what's important, as you like."

**Social welfare and medical care**

The social fund is intended for the implementation of benefit payments (awarded on the basis of social criteria) for employees (approximately 5 500 persons) and pensioners of the Bank (approximately 4 500 persons).

In the first half of 2014 there were granted 1 178 social benefits.

The largest share has:

- subsidies for holiday for employees and their children (680 subsidies),
- financial assistance (366 benefits),
- housing loans (132 loans).

Also funds from Employee Benefit Fund are intended for financing: sports and recreation events, tourist trips, sport tickets – Multisport, purchase of tickets/vouchers to the theatres/cinemas, events for children of employees.

The Bank's employees have the option of profiting from private medical care. Around 75% of employees are covered by such medical care. The employees have a choice of two package of care (including one package with a surcharge paid by the employee). There is also the opportunity to take medical care of family members fully paid by the employee.

## 8.9. IT

In the first half of 2014, the IT Department spent PLN 21.42 million on its investment projects. During this period, 6 projects were completed and 18 projects are in progress.

The most significant IT initiatives undertaken are as follows:

- Integration with Rabobank Polska systems in the areas of treasury, back office, risk management, payments and reporting.
- Implementation of changes in IT systems to enable the introduction of a dedicated offer for Personal Banking with support for cross-currency cards.
- Implementation of access to online banking through mobile devices.
- Implementation of mechanisms that mitigate operational risk in the Bank's main transactional system.
- Implementation of the system to support enforcement activities and queries of enforcement authorities.
- Implementation of preapproved campaign service in an electronic distribution channel – personalized product offers for the existing customers.
- Implementation of mechanisms for data quality in the Bank's main transactional system and the online banking system.
- Implementation of customer retention process based on the CRM system.
- Implementation of a new channel for the data exchange with Credit Information Bureau (BIK).
- Sale of ATMs to IT Card and switching them to the purchasing system, in progress.
- Implementation of the requirements arising from the regulation of EMIR (European Market Infrastructure Regulation) regarding regulation of derivates trading.
- Implementation of data archiving in the main Bank's transactional system.
- Implementation of centralized management process for user identification and their authorization in IT system.
- Implementation of the requirements of FATCA regulations (Foreign Account Tax Compliance Act) issued by the U.S. IRS (Internal Revenue Service, the equivalent of polish tax office in the U.S.) relating to disclosure of financial information about foreign accounts for the taxation purposes. The project in BGŻ S.A. is part of a global project of Rabobank International.
- Implementation of the requirements of Recommendation D of FSA and recommendations of the Dutch central bank DNB (De Nederlandsche Bank) in terms of raising the level of maturity of IT processes supporting the delivery of IT services to the business departments. The project also includes the implementation of IT service management processes.
- Implementation of a new reporting platform to replace existing management information system.
- Establishing a central repository of documents in the Bank.
- Establishing the Bank's Data Corporate Model, that is the first stage of the project of establishing the Bank's Data Architecture – basis of data quality management process. The project meets the requirements of Recommendation D of FSA in terms of architecture and data quality.
- Change in customers' identification and authorization method via TeleBGŻ electronic banking platform that facilitate customers an access to account and services offered by the Bank.
- Implementation of IT system to support the electronic archive of loan applications and monitoring of loan agreements.
- Establishing of a central repository to archive and manage information about Bank's collaterals. The central repository will support credit, restructuring and collection processes.
- Implementation of the processes automation for retail clients monitoring and retail and institutional clients debt collection.

- Implementation of an IT tool type Fraud Detection System, which aims to strengthen anti-fraud control in lending process and monitoring of suspicious transactions in the existing portfolio of retail and institutional loans.
- Implementation of investment advisory services to retail customers of the Bank.
- Implementation of Pay-By-Link payment service that will enable electronic banking customers to perform fast, safe and convenient transfers for Internet shopping.
- Implementation of a system to automate event campaigns, i.e. offer presentation to the client tailored to the context and characteristics of the client at the optimal time and communication channel in response to the specific events relating to this client.
- Implementation of the new user application and adaptation of Bank's systems with the requirements of KIR, related to interbank clearing operations.
- Implementation of electronic banking system adaptation for corporate customers, so that it was possible to service customers with Home Banking system.
- Implementation of a system at the Bank's Head Office to protect against access to resources from unauthorized computers.
- Implementation of new technologies in the IT infrastructure – to give dynamic addresses to the computers, access to the 10 Gb/s network.

# 9. OPERATIONS OF SUBSIDIARIES AND ASSOCIATE ENTITIES OF BGŻ S.A. GROUP

## 9.1. BANKOWY FUNDUSZ NIERUCHOŚCIOWY ACTUS SP. Z O.O.

The company was founded in 1999 and its main activities include:

- acquisition and disposal of real estate and limited property rights related to real estate,
- management of own and third-party construction projects,
- real estate trading intermediary services and lease of premises,
- lease of real estate and rental of premises,
- services relating to real estate valuation, management and advisory (real estate management agency activities).

As at 30 June 2014, the company's investment portfolio comprised open land real estate in Wrocław – Marszowice with square footage of 46.8468 ha. In accordance with binding Local Spatial Management Plan, the real estate is destined for residential development.

In the first half of 2014, supervisory activities undertaken towards the Company concentrated on creating conditions for sale of real estate situated in Wrocław – Marszowice.

**Table 23. Basic financial data of BFN Actus Sp. z o.o.**

| *PLN thousand* | 30.06.2014 | 30.06.2013 |
|---|---|---|
| Total assets | 64 263.8 | 62 467.3 |
| Long-term investments | 62 524.0 | 62 301.0 |
| Equity | 17 492.1 | 17 937.5 |
| in this: net result | 192.2 | (1 166.9) |

## 9.2. BGŻ LEASING SP. Z O.O.

The company was founded in April 2007 as an associate entity of De Lage Landen International B.V. (Rabobank Group). The main activity of the company is to offer lease products, especially lease of machines, vehicles and other fixed assets as well as loans.

Main distribution channel are branches network and client advisors of BGŻ Bank. In the first half of 2014, as many as 685 deals were made totaling PLN 173.95 million, compared to 824 deals totaling PLN 190.70 million in the first half of 2013.

In the first half of 2014, the company recorded extremely good financial result, due to release of impairment provision for receivables followed by improvement of the quality of leasing portfolio.

**Table 24. Basic financial data of BGŻ Leasing Sp. z o.o.**

| *PLN thousand* | 30.06.2014 | 30.06.2013 |
|---|---|---|
| Total assets | 956 875 | 1 050 826 |
| Net receivables from leases and loans | 850 200 | 941 423 |
| Equity | 75 715 | 91 462 |
| in this: net result | 4 277 | (2 682) |

## 10. RISK MANAGEMENT

### 10.1. CREDIT RISK

**Credit risk management**

Credit risk is defined as the risk of default of financial liabilities by debtor in specified term, being – in particular – the risk of non - payment of loan as well as the risk of worsening of the financial situation of debtor, which both affect valuation and quality of the Bank's assets.

Credit risk is included in the basic and essential financial activities of the Bank, including both lending activity, as well as the financing of capital market products. As a result, credit risk is identified as having the greatest risk of potential impact on current as well as future, profits and equity of the Bank. The significance of credit risk confirms its 70% share in the total amount of economic capital estimated by the Bank to cover the significant risks involved in the activities of the Bank, as well as 90% of the total amount of regulatory capital.

The primary objective of credit risk management is the implementation of the Bank's strategy through steady growth of the loan portfolio while maintaining an acceptable level of credit risk appetite.

The main activities in respect to credit risk realized by the Bank are as follows:

- each credit transaction requires a comprehensive assessment of credit risk, which is reflected by internal rating or scoring,
- thorough and careful financial analysis provides a basis for recognition of customer financial data and information about the value of the collateral as reliable; careful analysis of the Bank always includes the necessary safety margin,
- basis for financing of the client is - as a rule - its ability to generate cash flows to ensure repayment of financial obligations to the Bank,
- credit risk assessment is additionally verified by independent of the business units, credit risk assessment units,
- price terms of credit transactions must cover the risks of the transaction,
- credit risk is diversified in terms of geographical areas, sectors, products and customers,
- credit decisions can be made only by authorized persons,
- the Bank enters into credit transactions only with known customers, and the basis for cooperation with clients are long-term relationships,
- client and transactions are monitored in a manner transparent to the client and strengthening customer relationships.

**Collaterals**

Established by the Bank means of legal protection of loan transactions are monitored by assessing the value of any collateral on the basis of documents submitted by borrowers. In addition, during the evaluation of collateral, the Bank uses internal databases that contain historical information about statistics of realization of rights from collateral.

The Bank recognizes that the primary protection of the Bank's interest is good financial standing of a customer, while the acceptance of the material or personal collateral is an additional aspect of mitigating risk in the event of insolvency of the customer.

The key principles of hedging the Bank's credit exposure, including special rules for mortgages, are described by credit handbook of institutional clients and management policy for retail credit exposures of BGŻ S.A., adopted by the Management Board.

As a rule, the Bank requires that the collateral was established prior to release of funds relating to loan transaction, and the form, nature and value of the security was adequate for the identified risk of hedged transaction. When choosing the form and the collateral the Bank takes into account particularly:

- nature, amount and duration of the credit transaction,
- requirements for establishing a specific form of collateral for specific product,
- economic and financial situation of the debtor in respect of a collateral in case of personal security and the value of the collateral for material security,
- liquidity of the collateral, understood as a real opportunity to meet the Bank's claims on security in the shortest possible time, and without a significant decrease in the value of the collateral due to the price fluctuation of the collateral,
- costs incurred by the customer associated with the establishment of collateral,
- availability and the ability to control the collateral and time needed for monitoring by the Bank,
- place in ranking for claiming collateral.

Bank's internal regulations specify the procedures for the establishment, measurement and monitoring of collateral, including requirements for assessment of the financial standing of the personal security issuer, and with respect to the collateral - the principles of valuation of assets that the Bank accepts as a collateral. With respect to the mortgage collateral, the Bank determines the value of the property based on valuations prepared by professional appraisers, and for selected types of real estate Bank accepts internal valuations based on statistical data and transaction prices. In the case of other physical collateral (pledge registration, transfer of ownership) the Bank calculates the value of the collateral, in particular, on the basis of actual transaction prices.

Update of the value of collateral, the evaluation of the technical condition of the collateral and the control of LtV ratio for transactions secured by mortgages, are elements of monitoring customer credit risk, including transactions. In the process of mortgage valuation, Bank use internal indicators, and rely on valuations made by professional appraisers.

Reducing the risk of changes in the collateral value is carried out, inter alia, through including relevant provisions in the loan agreements, including contractual clauses regarding inability to satisfy from fixed asset collateral pledged as security - without consent or notification to the Bank - or a lack of possibility of disposal fixed assets - without consent or notification to the Bank.

Implementing the provisions of the rules and supervisory recommendations, the Bank introduced internal rules complying with the regulations of the Polish Financial Supervision Authority, in particular with Recommendation S concerning the mortgage collateral. Bank collects data on properties which are a collateral in mortgage transaction, in Central Collateral Database.

**Structure and quality of credit portfolio**

The Bank's credit portfolio is characterized by a high share, with increasing tendency, of loans with relatively safer risk profile i.e. housing loans and loans granted to farmers. Their share in the structure of loan portfolio exceeds 40%.The share of cash loans with higher risk of default is relatively low, however systematically increases. In the first half of 2014, share of loans granted to big enterprises (increase by 2.4% p.p.) increased significantly, mainly due to Rabobank Polska loans.

**Table 25. Structure of credit portfolio**

| *PLN thousand* | 30.06.2014 | | 31.12.2013 | | 30.06.2013 | |
|---|---|---|---|---|---|---|
| | *PLN thousand* | *share %* | *PLN thousand* | *share in %* | *PLN thousand* | *share %* |
| **Loans and advances, gross** | **30 280 945** | **100.0%** | **27 513 885** | **100.0%** | **27 115 879** | **100.0%** |
| Mortgage loans | 8 166 188 | 27.0% | 8 038 380 | 29.2% | 7 892 242 | 29.1% |
| – in PLN | 5 220 066 | 17.2% | 5 035 855 | 18.3% | 4 680 710 | 17.3% |
| – in foreign currencies | 2 946 122 | 9.7% | 3 002 525 | 10.9% | 3 211 532 | 11.8% |
| Cash loans | 1 216 261 | 4.0% | 1 018 435 | 3.7% | 893 610 | 3.3% |
| Other loans to retail clients | 486 992 | 1.6% | 512 380 | 1.9% | 550 967 | 2.0% |
| Individual entrepreneurs | 1 678 432 | 5.5% | 1 572 698 | 5.7% | 1 547 611 | 5.7% |
| Farmers | 7 861 699 | 26.0% | 7 143 597 | 26.0% | 6 581 514 | 24.3% |
| Corporates | 10 411 425 | 34.4% | 8 799 550 | 32.0% | 9 270 907 | 34.2% |
| Public sector | 248 227 | 0.8% | 252 979 | 0.9% | 286 585 | 1.1% |
| Other receivables | 211 721 | 0.7% | 175 866 | 0.6% | 92 443 | 0.3% |

As at 30 June 2014, the share of loans that are impaired in the gross portfolio of loans and advances to customers decreased from 8% at the end of 2013 to 7%. Ratio decrease for total portfolio was a result of smaller share of receivables that have lost value in the portfolio of corporate loans from 8.8% on 31.12.2013 to 7.2% on the period and while excluding farmers exposure, respectively from 12.3% to 9.8%

The quality of cash loans to retail customers has improved (decrease of ratio respectively from 13.2% to 12.3%), what was driven by the dynamic growth of the portfolio – 19% volume growth in the first half of 2014.

**Table 37. Quality of the loan portfolio**

| *PLN thousand* | 30.06.2014 | | | 31.12.2013 | | |
|---|---|---|---|---|---|---|
| | Gross total | including: impaired | share % | Gross total | including: impaired | share % |
| **Loans and advances, gross** | **30 280 945** | **2 119 683** | **7.0%** | **27 513 885** | **2 200 119** | **8.0%** |
| Housing loans | 8 166 188 | 356 338 | 4.4% | 8 038 380 | 357 636 | 4.4% |
| – in PLN | 5 220 066 | 189 852 | 3.6% | 5 035 855 | 192 848 | 3.8% |
| – in foreign currencies | 2 946 122 | 166 486 | 5.7% | 3 002 525 | 164 788 | 5.5% |
| Cash loans | 1 216 261 | 150 012 | 12.3% | 1 018 435 | 134 397 | 13.2% |
| Other loans to retail clients | 486 992 | 140 950 | 28.9% | 512 380 | 127 800 | 24.9% |
| Farmers | 7 861 699 | 247 605 | 3.1% | 7 143 597 | 248 724 | 3.5% |
| Corporate clients excluding farmers | 12 549 805 | 1 224 778 | 9.8% | 10 801 093 | 1 331 562 | 12.3% |

### Restructuring and recovery of high risk debt

The policy of restructuring and debt recovery, conducted in the first half of 2014, was a continuation of activities conducted in the area of:

- identification, negotiation and implementation of activities aimed at maximizing repayments by debtors or – where possible – implementation and monitoring of debtor corporate recovery proceedings leading to improvement of debtor financial and economic position, with the overall view to return debtors for servicing by their original sales units,
- providing a support for business units in handling loans at risk,
- business units support in recovery of overdue debts,
- active monitoring of execution and bankruptcy proceedings,
- disposal of part of non – performing loans,

- tax optimization of executed strategies,
- identification of early warning signals and taking appropriate actions (where possible, in collaboration with sales units) limiting the risk of potential losses,
- appropriate training for business units personnel and credit area personnel in order to increase efficiency in identifying warning signals, helping with proper granting of loans (particularly in the collateral establishment, which apart from the repayments are the main source of recovery),
- improvement of the Bank's organizational structure, procedures and tools to enhance the efficiency of the tasks carried out,
- implementation of IT tools to streamline activities regarding restructuring and debt recovery.

Debts recovered in the first half of 2014 in the amount of PLN 148.7 million (principal) were the result of the conducted court executive procedures, bankruptcy proceedings in progress, civil-legal agreements with debtors and composition proceedings in process.

The number of enforceable titles issued by the Bank in the first half of 2013 amounted to 375 for corporate loans and 1 133 for retail loans.

The value of collaterals in the portfolio, which is recovered or restructured, is as follows (in the context of the LTV ratio for mortgage loans and loans secured by mortgages):

- institutional in PLN – 58.9% and in foreign currency 88.5%,
- retail in PLN – 80.0% and in foreign currency 112.7%.

The above information reflects a relatively adequate level of collateralization with the concurrent limitation of risk of debt non-recovery. A high LTV ratio for retail loans results mainly from currency appreciation (CHF).

## 10.2. FINANCIAL RISK

### 10.2.1. MARKET RISK

The Bank's operations are recorded in the trading and banking books. Fluctuations in market interest rates, currency exchange rates, prices of securities or in the implied volatility of option instruments cause changes in present values of these books. The risk of unfavorable fluctuations in value due to the above risk factors is recognized by the Bank as market risk, and due to the different nature of these books, this risk is monitored and managed separately for each book. In addition, the Bank resigned from conducting activities on the stock market by the Brokerage Office.

**Market risk in the banking book**

The banking book of the Bank consists of two elements – ALM, which aims to manage the interest rate risk and long-term liquidity of the Bank. The second part is Money Market Portfolio, which functions as a short term liquidity management centre.

ALM consists of deposits and loans, strategic positions (long-term investments and debt securities issue), financial market transactions hedging the banking book (derivatives) and non-interest items (i.e. equity, tangible assets, intangible assets, taxes and provisions, result for the period). Management over all these elements is transferred to Bank's Headquarters through Funds' Transfer Pricing (TCF) system.

Money Market encompasses liquid assets and the closed-up differences on client's derivatives transactions (mostly regarding currency forward/futures contracts). This portfolio consists of derivatives instruments, whose goal is to stabilize the cost of financing, to meet the needs of ALM portfolio through market operations, to secure cash flows from client's transactions and to adjust the level of portfolio risk to the acceptable level.

The Bank's policy with respect to the banking book is to earn additional income above the product margin, while avoiding the risk of instability of deposits placed by clients, equity or financial result. The Bank achieves this goal by keeping or adjusting the natural risk exposure resulting from deposit and lending activities within current risk limits or middle- and long-term financial market trends.

The main measures of the market risk applied by the Bank in the ALM portfolio are:

- interest rate revaluation gap,
- the weighted average duration of assets/liabilities and equity known as 'duration',
- sensitivity measures – defining sensitivity of the financial item – valuation, interest income, net economic value of equity – to changes in risk factors,
- IaR (Interest-at-Risk – sensitivity of interest result),
- EaR (Equity-at-Risk – sensitivity of the current value of net capital).

In the Money Market portfolio, according to its nature and purpose, equivalent measures to those used for the trading book are applied:

- VaR – Value-at-Risk – showing maximum acceptable level of loss on the given item in normal market conditions in a defined time period that can be exceeded with a defined probability; The Bank applies the parametric model with modified variance – covariance matrix and exponential weighting of historical observations; the accepted confidence level is 99%, and the period of position holding for the banking book is 1 month,
- scenario analysis and stress tests – supplement VaR to include statistically unpredictable market events: historical economic and political crises, theoretical scenarios,
- BpV (basis point value) – price sensitivity to a parallel shift of the yield curve.

The Bank manages the banking book risk by limiting risk measures and monitoring the risk on an ongoing basis.

**Situation in the first half of 2014**

As at the end of June 2014, the value of the „duration" measure, i.e. the average weighted period to repricing of interest rate for assets remained at the level of 3.6 months (at the end of December 2013 – 3.8 months), whereas for liabilities – equaled to 2.7 months (at the end of December 2013 - 3.3 months). The duration of net principal decreased from 11.9 months at the end of 2013 to 10.1 months at the end of June 2014. The repricing period for almost 91% of assets and liabilities was lower than 6 months (at the end of 2013 - 90%), however almost 51% of assets and liabilities are to be re-valued within one month (at the end of 2013 - 53%).

In the first half of 2014, the interest rate risk (measured IaR) has slightly decreased, reaching the average level of PLN 36.5 million in a scenario of 200 bps increase in interest rates and PLN -38.8 million in a scenario of 200 bps decrease in interest rates, in comparison to PLN 37.4 million and PLN -39.3 million respectively in the second half of 2013. Decrease in interest income in both the second half of 2013 and first half of 2014 would occur in case of decrease of interest rates scenario.

The merger of Bank BGŻ with Rabobank Polska, on 18 June 2014, had marginal effect on the Bank interest rate risk profile, due to effective structure of repricing assets and liabilities of Rabobank Polska.

The sensitivity of net interest income (IaR) was as follows as at the end of first half of 2014 (in brackets: values as at the end of 2013):

- an immediate increase in interest rates by 50 bps would result in increase in net interest income during one year by PLN 22.4 million (+ PLN 14.1 million),
- an immediate decrease in interest rates by 50 bps would result in decrease in net interest income during one year by PLN 22.6 million (- PLN 15.6 million),
- a gradual increase in interest rates by 200 bps during one year would result in increase in net interest income by PLN 48.6 million (+ PLN 35.8 million),
- a gradual decrease in interest rates by 200 bps during one year would result in decrease in net interest income by PLN 48.6 million (- PLN 38.7 million).

The exposure of Money Market portfolio was dominated by positions in NBP bills and Interest Rate Swaps transactions (OIS and IRS – exposure adjusting, hedging the price risk) and FX Swap (the financing of the Group in foreign currencies). In the first half of 2014 the average utilization of VaR limits reached the level of 25% compared to 45% in the second half of 2013. In March and April the exposure increased significantly (by about 50% of VaR limit) however at the end of the first half of 2014 it returned to very low level. In terms of the currency structure, the biggest share had exposures in PLN and USD, EUR, CHF.

In the first half of 2014 there were no excess of interest rate risk limits in ALM portfolio and no excess of market risk limits in Money Market portfolio.

**Market risk in the trading book**

Trading activities of the Bank are supplementary in nature and are conducted to support sales of financial products to corporate clients, financial non-banking clients (directly) and retail clients. By opening own positions for these purposes, the Bank generates revenues from short-term fluctuations in price parameters (foreign currency exchange rates, interest rates, debt securities prices etc.) whilst keeping the exposure within defined risk limit. The Bank does not have open position in currency and commodity options and for this reason market risk in the options portfolio does not exist.

The key measures for market risk used by the Bank in the trading book are:

- Value-at-Risk (VaR) – showing maximum acceptable level of loss on the given item in normal market conditions in a defined time period that can be exceeded with a defined probability; BGŻ S.A. applies the parametric model with modified variance – covariance matrix and exponential weighting of historical observations; the accepted confidence level is 99%, and the period of position holding for the trading book is 1 day,
- Scenario analyses and Stress Test – supplement VaR to include statistically unpredictable market events: historical economic and political crises, theoretical scenarios, expected shortfall analyses (expected loss of value above confidence level) and max-loss (the highest possible loss based on a known history of fluctuations in market-based factors),
- BpV (basis point value) – price sensitivity to a parallel shift of the yield curve,
- Nominal measures – among others, value of currency position during a day and at day end, securities nominal value,
- Non-monetary limitations – among others, allowed types of instruments, currencies and pairs of currencies, maximum maturity dates, minimal credit rating for acquired debt securities,
- Maximum level of acceptable losses – stop-loss limits – for different time frames (day, month, year) at the portfolio and sub portfolio level.

In order to limit the exposure to market risk, based on the decisions of the Committee for Risk and Balance Sheet Management, limits are established for IaR, VaR and FX VaR, stress tests, BpV sensitivity and other measures. Utilization of all limits is monitored and controlled on a daily basis.

***Situation in the first half of 2014***

In the first half the VaR limit in trading portfolio was utilized at low level (27% compared to 66% in the second half of 2013) and risk profile was determined mainly by interest rate risk exposures (IR_TRADING portfolio with average utilization of VaR limit at the level of 27% compared to 68% in the second half of 2013). The increased fluctuation of risk factors in the first quarter (intensified outflow of capital from emerging markets and escalation of conflict in the Ukraine) had influenced value at risk in trading portfolio in limited extent, because of low positions of treasury bonds (only Polish treasury bonds). The trading portfolio was the most exposed to the scenario of 'LTCM Collapse 1998' and clockwise shift of the curve. The currency risk remained at the low level (VaR limit of FX_TRADING portfolio was utilized in average at 24% in the first half of 2014, compared to 21% in the second half of 2013), the activity was focused on EUR and, in lower extent, on USD. Mainly as a result of customers' activity, the currency exposure of the Group during most of the quarter was significantly limited at the end of the day.

In the first half of 2014 there were no market risk limit excess.

The changes in market risk profile, following the merger of Bank BGŻ with Rabobank Polska, were insignificant and mainly the result of increase of debt securities volume in trading portfolio.

**Liquidity risk and assessment of finance sources stability**

In the first half of 2014 the Bank was selectively accumulating resources in order to finance current credit activity. It is worth to mention that the most significant growth referred to the most stable resources i.e. segment of retail customers and internet business line BGŻOptima. The most dynamic growth in credit activity was reported for segments of: retail customers and Microenterprises. The stable growth of funding along with growth of credit activity, provided the liquidity safety and remaining the liquidity risk indicators at safe level below limits.

The merger with Rabobank Polska, which was finalized in the second half of 2014, resulted in significant growth of the credit portfolio which was properly compensated by high-stable financing resources. As a result the impact on Bank liquidity was neutral.

The growth of high-stable resources to finance Global Corporate Clients, combined with growth of CDs stability, and remaining high stability of retail resources and BGŻOptima (at level of 93.5%) resulted in increasing stability of funding up to the level of 89.6% at the end of June 2014 (from 89.4% at the end of 2013).

Possessed financial resources allowed for timely payment of all liabilities of the Bank. The portfolio of the most liquid securities was maintained at a level fully securing potential outflow of the largest depositors. The surplus of liquid assets over the minimum required limit at the end of December 2013 amounted to PLN 572 million, despite the increase of the minimum by 0.5 billion after the merger.

As at the end of the first half 2014 the surplus funding sources outside the interbank market over the balance of loans amounted to PLN 2.64 billion, and shortage of stable deposits over the loan portfolio amounted to PLN 507 million, and was caused by maturity day for some highly stable deposits, which were reestablished in early July 2014.

## 10.3. OPERATING RISK

In accordance with the regulations in force, the Bank defines operating risk as a risk of loss or unjustified costs resulted from inadequacy or failure of internal processes, people, systems or external factors. The Bank includes also the risk of non-compliance, including legal risk.

The purpose of operating risk management is to limit losses and costs arising from the risk, ensure rendering services of the highest quality as well as the security and compliance of Bank's activities with binding laws and regulations.

In the first half of 2014, bank continued its activities focused on strengthening operating risk infrastructure in both Head Office and branches. Moreover Bank undertook actions in area of internal control focused on improving reaction process responsible for identifying inefficiency of control environment.

Bank actively identified operating risk and took action to mitigate this risk, through including Subcommittee of Operational Risk, Compliance and Fraud Prevention.

## 10.4. LEGAL RISK

The litigation situation in the first half of 2014 within compensation and employment claims was stable and did not generate material legal risk for the Bank.

There were no court or administrative proceedings held by public administration bodies in relation to liabilities or receivables of the Bank, with the claim amount for at least 10% of the Bank's equity as at 30 June 2014.

## 11. DEVELOPMENT PROSPECTS OF THE GROUP

According to the strategy, the Bank is focused on the continued development of its activities as an universal bank for clients from small-medium towns and rural areas, specializing in rendering services for the agricultural and food sector.

For the clients BGŻ wants to be perceived as an open Bank which communicates in comprehensible way, shares both experience and know-how as well as treats them as a business partner.

From the perspective of the client, the Bank strives to develop long-term relations and be perceived as a responsible business partner.

Within the scope of universal banking, the strategy assumes further strengthening of the Bank's position by expanding the product offer and adjusting servicing model to customers' needs including alternative distribution channels.

In the area of banking services for agricultural and food sector, the Bank intends to strengthen its leadership based on the product range and a service model tailored to the needs of that sector. The Bank plans also to concentrate on further growth of the business relating to providing services for small, medium and micro – businesses in local markets.

At the same time the Bank pursues to build comprehensive product offer for Global Corporate Clients by taking advantage of own experience, as well as know-how of Rabobank Polska

BGŻ Bank plans to be a major bank, whose scale and market shares provides effective activity and allows achieving positive financial results

## 12. SUBSEQUENT EVENTS

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| **14.07.2014** | Bank was approved by ACI Poland – the Financial Markets Association and authorized to be a fixing participant for WIBID and WIBOR. |

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| *Józef Wancer* | *Gerardus Cornelis Embrechts* | |
| *President* | *First Vice-President* | |
| ................................. | ................................. | ................................. |
| *Monika Nachyła* | *Magdalena Legęć* | *Dariusz Odzioba* |
| *Vice-President* | *Vice-President* | *Vice-President* |
| ................................. | ................................. | ................................. |
| *Witold Okarma* | *Wojciech Sass* | *Andrzej Sieradz* |
| *Vice-President* | *Vice-President* | *Vice-President* |

Warsaw, 8 August 2014