60. DERIVATIVE INSTRUMENTS RISK MANAGEMENT

The risk of derivative instruments is a risk resulting from the Bank's taking up a position in financial instruments, which meet all of the following conditions:

1) the value of an instrument changes with the change of the underlying instrument,
2) it does not require any initial net investment or requires only a small initial net investment compared with other types of contracts which similarly respond to changes in market terms,
3) it is to be settled at a future date.

The derivative risk management process is integrated with the management of the following types of risk: interest rate, currency, liquidity and credit risk management. However, due to the specific nature of derivatives it is subject to special control specified in the internal regulations of the Bank.

6.1. Measurement of the derivative instruments risk

The Bank measures the derivative instrument risk using, among others, the Value at Risk (VaR) model described in the section on interest rate risk or currency risk, depending on the risk factor which affects the value of the instrument.

In the measurement of other Group members' derivative-related risk, information on the companies' positions in specific instruments is used, as indicated by the Bank.

6.2. Forecasting and monitoring of the derivative instruments risk

Monitoring the risk of derivative instruments takes place as part of monitoring of other types of financial and credit risk. The Bank pays particular emphasis to monitor financial risk related to the maintenance of currency options portfolio and customer credit risk resulting from amounts due to the Bank in respect of derivative instruments.

6.3. Reporting of the derivative instruments risk

The Bank prepares daily, weekly, monthly, and quarterly reports addressing the risk of derivative instruments. The quarterly reports are also applicable to the Group. Reports present the information on the derivative risk exposure and updates on available limits regarding the risk.

6.4. Management decisions concerning risk of derivative instruments

The main tools used in derivative risk management are as follows:

- written procedures for derivative risk management,
- limits and thresholds set for the risk related to derivative instruments,
- master agreements specifying, i.a. settlement mechanisms.

Risk management is carried out by imposing limits on the derivative instruments, monitoring limits and reporting risk level.

Master agreements concluded by the Bank with the major business partners based on the standards developed by the Polish Banks Association (domestic banks) and ISDA (foreign banks and credit institutions), which allow offsetting mutual liabilities, both due (mitigation of settlement risk) and not yet due (mitigation of pre-settlement risk), are particularly important for mitigating the risk associated with derivative instruments. Additional collateral for exposures, resulting from derivative instruments are collateral deposits escrowed by counterparties as a part of CSA agreement (Credit Support Annex).

Methods of derivative risk management in the Group subsidiaries are defined by internal regulations implemented by these entities which take up a position in derivative instruments or plan to take positions in such instruments. These regulations are developed after consultation with the Bank and take into account the recommendations issued by the Bank for the Group entities.

Positions taken by the other Group entities in particular derivative instruments are determined using similar methods to those used for positions taken by the Bank in such derivative instruments, taking into account the specific nature of the business conducted by the Group entities.