Fair Value

The best reflection of fair value of financial instruments is their market value which can be obtained for the sale of assets or paid for the transfer of liability in case of mutually beneficial market transactions (an exit price). For many products and transactions for which market value to be taken directly from the quotations in an active market (marking-to-market) is not available, the fair value must be estimated using internal models based on discounted cash flows (marking-to-model). Financial flows for the various instruments are determined according to their individual characteristics, and discounting factors include changes in time both in market interest rates and margins.

Accordingly IFRS 13 "Fair value measurement" in order to determinate fair value the Group applies models that are appropriate under existing circumstances and for which sufficient input data is available, based to the maximum extent on observable input whereas minimizing use of unobservable input, namely:

1. valuation based on the data fully observable (active market quotations);
2. valuation models using the information not constituting the data from level 1, but observable, either directly or indirectly;
3. valuation models using unobservable data (not derived from an active market).

Valuation techniques used to determine fair value are applied consistently. Change in valuation techniques resulting in a transfer between these methods occurs when:

- transfer from method 1 to 2 takes place when for the financial instruments measured according to method 1 quoted market prices from an active market are not available at the balance sheet day (previously used to be);
- transfer from method 2 to 3 takes place when for the financial instruments measured according to the method 2 value of parameters not derived from the market has become significant at the balance sheet day (and previously used to be irrelevant).

Financial instruments not recognized at fair value in the balance sheet

All estimation models are arbitrary to some extent and this is why they reflect only the value of those instruments for which they were built. In these circumstances the presented differences between fair values and balance-sheet values cannot be understood to mean adjustments of the economic value of the Group. Fair value of these instruments is determined solely in order to meet the requirements of the presentation defined by IFRS 13.

The main assumptions and methods applied in estimating fair value of assets and liabilities of the Group are as follows:

Receivables and liabilities with respect to banks (structured contract)

This is a transaction, which comprises the simultaneous purchase of a long-term zero-coupon bond and the taking-out of a long-term fixed-rate loan from the issuer of the bond.

The fair value of both sides of the transaction is estimated by discounting the related cash flows on maturity/due date with use of the current zero-coupon rate and the margin, which was rescaled to adjust it to the current level of market rates.

Other receivables and liabilities with respect to banks

The fair value of these instruments was determined by discounting the future principal and interest flows with current rates, assuming that the flows arise on contractual dates.

Loans and advances granted to customers

The fair value of such instruments without specified repayment schedule, given their short-term nature and the time-stable policy of the Group with respect to this portfolio, is close to balance-sheet value.

With respect to floating rate leasing products fair value was assessed by adjusting balance-sheet value with discounted cash flows resulting from difference of spreads.

The fair value of instruments with defined maturity is estimated by discounting related cash flows on contractual dates and under contractual conditions with the use of current zero-coupon rates and credit risk margins.

In case of mortgage loans due to their long-term nature estimation of the future cash flows also includes: the effect of early repayment and liquidity risk in foreign currencies.

Liabilities to customers

The fair value of such instruments without maturity or with maturity under 3 months is considered by the Group to be close to balance-sheet value.

Fair value of instruments due and payable in 3 or more months is determined by discounting future cash flows from principal and interest (including the current average margins by major currencies and time periods) using current interest (including the original average margins by major currencies and time periods) in contractual terms.

Liabilities from the issuance of structured debt securities

Liabilities from the issuance of structured debt securities - bank's securities (BPW) are stated/priced at fair value in accordance with Bank's model. In this model, zero coupon bond price is calculated, which afterwards is increased by the option price, which was basis for a strategy built in a given structured bond.

The fair value of other liabilities arising from debt securities issued by the Bank (bonds (BKMO)) was estimated based on the expected cash flows using current interest rates taking into account the margin for credit risk. The current level of margins was appointed on the basis of recent transactions of similar credit risk.

Subordinated liabilities and medium term loans

The fair value of these financial instruments is estimated on the basis of a model used for determining the market value of floating-rate bonds with the current level of market rates and credit risk margin based on current level of market rates and historical margin for credit risk. Similar as in loan portfolio the Bank includes the level of the original margin as a part of mid-term cost of financing obtained in the past in relation to the current margin level for the comparable instruments, as long as reliable assessment is possible. Due to lack of the mid-term loans liquid market as a reference to estimate current level of margins, the Bank used the original margin.

The table below presents results of the above-described analyses as at 31.12.2014 (data in PLN thousand):

Assets

	Note	Balance sheet value	Fair value
Loans and advances to banks	15	2.384.744	2.412.196
Loans and advances to customers *	18	44.142.699	42.412.993

* The negative impact of fair value valuation of the loans portfolio is largely attributable to growth of loan spreads due to the refinancing cost increase of those positions. The methodology, which the Bank uses for valuation of the loans portfolio, assumes that current spreads best reflect existing market conditions and economic situation. A corresponding rule is widely applied for valuation of debt securities, which are not quoted on active markets. In result, paradoxically whenever the Bank raises spreads, fair value of the "old" loans portfolio falls.

Liabilities

	Note	Balance sheet value	Fair value
Amounts due to banks	26	2.037.269	2.067.403
Amounts due to customers	28	47.591.244	47.599.483
Debt securities	30	1.739.461	1.752.825
Subordinated debt	34	639.739	633.950

Models used for determination of the fair value of financial instruments presented in the above table and not recognized at fair value in Group's balance sheet, use techniques based on parameters not derived from the market. Therefore, they are considered as the third level of valuation.

The table below presents data as at 31 December 2013 (data in PLN thousand):

Assets

	Note	Balance sheet value	Fair value
Loans and advances to banks	15	1.519.614	1.562.373
Loans and advances to customers	18	41.765.680	39.991.327

Liabilities

	Note	Balance sheet value	Fair value
Amounts due to banks	26	2.348.562	2.393.988
Amounts due to customers	28	45.305.121	45.308.196
Debt securities	30	701.352	705.382

Subordinated debt	34	622.585	615.720

Financial instruments recognized at fair value in the balance sheet

The table below presents balance-sheet values of instruments measured at fair value, by applied fair value measurement technique:

	note	Quoted market prices	Valuation techniques - observable inputs	Valuation techniques - significant unobservable inputs
ASSETS				
Financial assets valued at fair value through profit and loss (held for trading)	16			
- derivatives			381.159	74.785
- debt securities		933.482		
- shares and interests		753		
Hedging derivatives	17		18.999	
Financial assets available for sale	19			
- debt securities		6.749.204	2.400.000	93.371
- shares and interests		320		6.642
LIABILITIES				
Financial liabilities valued at fair value through profit and loss (held for trading)	27			
- derivatives and short sale of securities		162.254	373.510	73.979
Hedging derivatives	17		1.390.225	

	note	Quoted market prices	Valuation techniques - observable inputs	Valuation techniques - significant unobservable inputs
ASSETS				
Financial assets valued at fair value through profit and loss (held for trading)	16			
- derivatives			331.090	75.273
- debt securities		432.822		
- shares and interests		227		

Hedging derivatives	17		211.395	
Financial assets available for sale	19			
- debt securities		5.134.748	2.999.792	105.878
- shares and interests		291		808
LIABILITIES				
Financial liabilities valued at fair value through profit and loss (held for trading)	27			
- derivatives and short sale of securities		173.641	326.616	74.932
Hedging derivatives	17		930.345	

Using the criterion of valuation techniques Group classified into the third category following financial instruments:

- index options, option transactions are measured at fair value with use of option measurement models, the model measurement is supplemented with impact on fair value of the estimated credit risk parameter;
- municipal bonds, the fair value is calculated based on discounted cash flows with consideration of the impact of credit risk parameter;
- shares not quoted on an active market, the fair value is assumed to be the cost value less any accumulated impairment losses.

In the reporting period, the Group did not make transfers of financial instruments between the techniques of fair value measurement.

Changes of fair values of instruments measured on the basis of valuation techniques with use of significant parameters not derived from the market in 2014 are presented in the table below:

	Indexes options	Options embedded in securities issued and deposits	FX options	Municipal bonds	Shares and interests
Balance on 1 January 2014	60.778	-60.437	0	105.878	808
Settlement/sell/purchase	-213	522	0	-12.791	5.832
Change of valuation recognized in P&L account (including interests)	8.180	-8.024	0	284	2
Balance on 31 December 2014	68.745	-67.939	0	93.371	6.642

For options on indexes concluded on an inactive market, the Group concludes back-to-back transactions on the interbank market, in result estimated credit risk component has no impact on the financial result.

Accordingly Bank's estimation impact of adjustments for counterparty credit risk was not significant from the point of view of individual derivative transactions concluded by the Bank. Consequently, the Bank does not consider the impact of unobservable inputs used in the valuation of derivative transactions for significant and in accordance with the provisions of IFRS 13.73 does not classify such transactions for level 3 fair value measurements.

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