Kereskedelmi és Hitelbank Zrt.

CONSOLIDATED SEMI-ANNUAL REPORT

30 June 2016

Budapest, 30 August 2016

CONTENT

Statement of the Issuer

K&H Bank Zrt., as the Issuer (represented by Hendrik Scheerlinck, CEO and Attila Gombás, CFO) hereby declare that K&H Bank Zrt.'s consolidated 2016 Semi-annual Report has been prepared in compliance with the applicable accounting laws and regulations, to the best of the Issuer's knowledge, and that the financial details contained therein reflect a true and reliable status of the assets, liabilities, financial position and profit of K&H Bank Zrt. and of the companies involved in the consolidation, and that the consolidated management report shows a true and fair picture of the position, development and performance of K&H Bank Zrt. and the companies involved in the consolidation, also including the major risks and uncertainties pertaining to the remaining six months of the financial year.

Furthermore, the Issuer hereby declares that the Semi-annual Report has not been verified by an independent auditor, thus the financial details contained therein are not audited figures.

Budapest, 30 August 2016

Hendrik Scheerlinck	*Attila Gombás*
Chief Executive Officer	*Chief Financial Officer*

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Not audited 30 June 2016	Audited 31 December 2015
	MHUF	MHUF
ASSETS		
Cash and cash balances with central banks	76 738	68 715
Financial assets	2 457 458	2 431 286
Held for trading	132 226	81 735
Available for sale	207 358	163 245
Loans and receivables	1 708 942	1 746 912
Held to maturity	392 848	428 371
Hedging derivatives	16 084	11 023
Tax assets	14 577	13 703
Current tax assets	11 688	7 803
Deferred tax assets	2 889	5 900
Investments in associated companies	542	542
Investment property	692	740
Property and equipment	37 045	37 457
Intangible assets	11 768	11 723
Other assets	11 749	18 790
Total assets	2 610 569	2 582 956
LIABILITIES AND EQUITY		
Financial liabilities	2 329 264	2 286 854
Held for trading	37 160	35 859
Designated at fair value through profit or loss	244 072	216 315
Measured at amortised cost	2 045 738	2 034 669
Hedging derivatives	2 294	11
FV changes of hedged item under portfolio hedge of interest rate risk	5 762	3 164
Tax liabilities	113	15
Current tax liabilities	113	15
Deferred tax liabilities	0	0
Provisions for risks and charges	2 983	7 765
Other liabilities	34 689	63 771
Total liabilities	2 372 811	2 361 569
Share capital	140 978	140 978
Share premium	48 775	48 775
Statutory risk reserve	8 749	8 749
Available for sale reserve	8 133	12 211
Cash flow hedge reserve	5 833	4 266
Retained earnings	25 290	6 408
Total equity	237 758	221 387
Total liabilities and equity	2 610 569	2 582 956

Budapest, 30 August 2016

Hendrik Scheerlinck
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Share capital MHUF	Share premium MHUF	Statutory risk reserve MHUF	Available for sale reserve MHUF	Cash flow hedge reserve MHUF	Retained earnings MHUF	Total equity MHUF
Balance as at 1 January 2015	140 978	48 775	5 541	8 662	4 007	(28 247)	179 716
Net profit for the year	-	-	-	-	-	37 863	37 863
Other comprehensive income for the period	-	-	-	3 549	259	-	3 808
Total comprehensive income	-	-	-	3 549	259	37 863	41 671
Dividend	-	-	-	-	-	0	0
Transfer from retained earnings to statutory risk reserve	-	-	3 208	-	-	(3 208)	-
Total change	-	-	3 208	3 549	259	34 655	41 671
Balance as at 31 December 2015	140 978	48 775	8 749	12 211	4 266	6 408	221 387
of which							
revaluation reserve for shares	-	-	-	3 452	-	-	3 452
revaluation reserve for bonds	-	-	-	8 759	-	-	8 759
Balance as at 1 January 2015	140 978	48 775	8 749	12 211	4 266	6 408	221 387
Net profit for the year	-	-	-	-	-	18 882	18 882
Other comprehensive income for the period	-	-	-	(4 078)	1 567	-	(2 511)
Total comprehensive income	-	-	-	(4 078)	1 567	18 882	16 371
Total change	-	-	-	(4 078)	1 567	18 882	16 371
Balance as at 30 June 2016	140 978	48 775	8 749	8 133	5 833	25 290	237 758
of which							
revaluation reserve for shares	-	-	-	(11)	-	-	(11)
Revaluation reserve for bonds	-	-	-	8 144	-	-	8 144

Budapest, 30 August 2016

Hendrik Scheerlinck
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED INCOME STATEMENT

	Not audited 1st half of year 2016 MHUF	Not audited 1st half of year 2015 MHUF
Interest income	47 178	51 105
Interest expense	(12 319)	(14 238)
Net interest income	34 859	36 867
Fee and commission income	33 912	33 605
Fee and commission expense	(8 160)	(8 465)
Net fee and commission income	25 752	25 140
Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange	10 476	9 821
Net realised gains / (losses) from available-for-sale assets	5 288	665
Dividend income	0	0
Other net income	330	2 694
Total income	76 705	75 187
Operating expenses	(52 657)	(57 925)
Staff expenses	(16 853)	(14 598)
General administrative expenses	(24 578)	(24 340)
Depreciation and amortisation of tangible and intangible assets	(3 672)	(3 289)
Bank tax	(7 554)	(15 698)
Impairment:	595	(3 575)
Loans and receivables	850	(3 533)
Other	(255)	(42)
Share in results of associated companies	0	0
Profit before tax	24 643	13 687
Income tax expense	(5 761)	(4 700)
Profit after tax	18 882	8 987

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Not audited 1st half of year 2016 MHUF	Not audited 1st half of year 2015 MHUF
Profit after tax	18 882	8 987
Other comprehensive income		
Available-for-sale equity instruments		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	202	-
Deferred tax impact on fair value changes	(42)	-
Transfer from available for sale reserve to net profit		
(Losses)/ gains on disposal	(4 565)	-
Deferred income tax	941	-
Available for sale debt instruments		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	(31)	(2 401)
Deferred tax impact on fair value changes	6	495
Transfer from available for sale reserve to net profit		
(Losses)/ gains on disposal	(723)	(665)
Amortisation of reclassified assets	(19)	(47)
Deferred income tax	153	147
Cash flow hedge		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	1 883	(656)
Deferred tax impact on fair value changes	(388)	135
Transfer from cash flow hedge reserve to net profit		
Ineffective part	141	-
Gross amount	(50)	(382)
Deferred income tax	(19)	79
Total other comprehensive income	(2 511)	(3 295)
Total comprehensive income	16 371	5 692

Budapest, 30 August 2016

Hendrik Scheerlinck
Chief Executive Officer

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Chief Financial Officer

CONSOLIDATED STATEMENT OF CASH FLOWS

	Not audited 1st half of year 2016	Restated Not audited 1st half of year 2015
	MHUF	MHUF
OPERATING ACTIVITIES		
Profit before tax	24 643	13 687
Adjustments for:		
Net transfer from available for sale reserve	(5 307)	(712)
Net transfer from cash flow hedge reserve	91	(382)
Depreciation and impairment of property, plant and equipment, intangible assets, available-for-sale financial assets and other assets	3 870	3 339
(Profit)/Loss on the disposal of property and equipment	(92)	(149)
(Profit)/Loss on the disposal of investment property	(6)	(20)
(Profit)/Loss on disposal of investment	-	-
Change in impairment on loans and advances*	4 580	3 533
Change in other provisions	(834)	52
Unrealised valuation differences	(4 116)	1 849
Income from associated companies	-	-
Cash flows from operating profit before tax and before changes in operating assets and liabilities	22 829	21 197
Changes in financial assets held for trading	(46 335)	(37 917)
Changes in financial assets designated at fair value through profit or loss	0	(147)
Changes in financial assets available for sale	(48 494)	(29 325)
Changes in loans and receivables	76 218	56 195
Changes in financial assets held to maturity	3 848	3 394
Changes in other assets	3 037	164
Changes in operating assets	(11 726)	(7 636)
Changes in financial liabilities held for trading	945	7 366
Changes in financial liabilities designated at fair value through profit or loss	27 184	16 269
Changes in financial liabilities measured at amortised cost	38 061	58 276
Changes in other liabilities	(30 123)	(4 441)
Changes in operating liabilities	36 067	77 471
Income taxes paid	(2 097)	(2 237)
Net cash from/(used in) operating activities	45 072	88 795

* Including impairments on loans and receivables and loan commitments.

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2016 MHUF	Restated Not audited 1st half of year 2015 MHUF
INVESTING ACTIVITIES		
Purchase of held-to-maturity securities	(42 856)	(25 810)
Proceeds from the repayment of held-to-maturity securities at maturity	74 467	27 472
Proceeds from the disposal of a subsidiary or a business unit	4 565	-
Dividends received from associated companies	-	-
Purchase of intangible fixed assets	(1 458)	(1 202)
Purchase of property, plant and equipment	(2 039)	(1 919)
Proceeds from the sale of property, plant and equipment	257	552
Net cash from/(used in) investing activities	32 936	(907)
FINANCING ACTIVITIES		
Net cash from/(used in) financing activities	-	-
CHANGE IN CASH AND CASH EQUIVALENTS		
Net increase/(decrease) in cash and cash equivalents	78 008	87 889
Net foreign exchange difference	(6)	5 009
Cash and cash equivalents at beginning of the period	202 213	299 541
Cash and cash equivalents at end of the period	280 215	392 439

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2016 MHUF	Restated Not audited 1st half of year 2015 MHUF
OPERATING CASH FLOWS FROM INTEREST AND DIVIDENDS		
Interest received	49 999	54 810
Interest paid	(11 532)	(13 843)
Dividend received	-	-
COMPONENTS OF CASH AND CASH EQUIVALENTS		
Cash and cash balances with central banks	76 738	73 017
Loans and advances to banks repayable on demand and term loans to banks < 3 months	233 915	462 804
Deposits from banks repayable on demand and redeemable at notice	(30 438)	(143 383)
Total cash and cash equivalents	280 215	392 439

Most of the interest cash flows results from the Group's banking activity and are part of the operating cash flow.

Loans and advances to banks repayable on demand and term loans to banks < 3 months are recorded as Loans and receivables in the consolidated statement of financial position. Deposits from banks repayable on demand and redeemable at notice are presented as financial liabilities measured at amortised cost.

The Group uses the indirect method for presentation of cash flows resulting from operating activities.

Budapest, 30 August 2016

Hendrik Scheerlinck
Chief Executive Officer

Attila Gombás
Chief Financial Officer

Consolidated Management Report

On 30 June 2016, the consolidated total assets of K&H Bank Group (hereunder “the Group”) stood at HUF 2,611 billion. As a financial institution which offers banking and insurance products alike and has a nation-wide branch network of 210 branches, the Group offers the full range of financial services to its clients.

1. Economic environment

The Hungarian economy started the year with a substantial slowdown, which was partly expected due to the falling orders in 2015 and due to the temporary lower inflow of European Union’s funds. At the same time the momentum of the households’ consumption remained fueled by the increasing employment, the growing wages and the accelerating borrowing. Further increase is expected in the majority of the sectors in the second half of the year, especially in construction and manufacturing industries. The country’s external debt has been moderated and the structure of the debt financing has been improved. One of the major rating agencies (Fitch) upgraded the country’s long term foreign currency debt to investment grade.

	2015 actual	2016 forecast*
GDP growth	+2.9%	+2.2%
CPI (average)	-0.1%	0.5%
Investments	+1.9%	-1.0%
Unemployment rate	6.2%	5.1%
Budget deficit (ESA) (in % of GDP)	-2.0%	-1.9%
Debt/GDP rate	75.3%	74.4%
Balance of payments (in % of GDP)	+4.4%	+5.1%

**source: K&H Bank Zrt*

The European Central Bank introduced further monetary easing in order to support the economic growth which also led to government bonds’ yields being pushed down to record low levels. The December rate hike by FED was not followed by a new one due to the mixed macroeconomic figures and the geopolitical developments. As a result of continuous interest rate cuts in H1 the National Bank of Hungary decreased the base rate further from 1.35% to 0.9%. As part of its self-financing programme the central bank has announced further steps to reshape its monetary policy tools (tightening of interest rate corridor, further limitations in the the 3m deposit instrument) and started its Growth Supporting Programme (with the aim of gradual phasing out of Funding for Growth scheme and introducing the new Market based Lending Scheme).

2. The Strategic Objectives of the Group

K&H Bank Group is a universal bank-insurer, providing banking, leasing, asset management and insurance services for individuals and corporate (focusing on SME and Mid-cap) customers.
In order to fulfill our mandate by our shareholder and our clients:

- we combine the best international practice with sound local knowledge;
- we provide our clients with a distinctively modern banking and insurance service which begins with their needs and concludes with the delivery of excellent solutions at competitive prices.

<u>Customer strategy:</u>

Retail: customers are served based on the different segments’ special needs providing convenient banking and insurance services and superior client experience.

Corporate clients: as a stable and independent advisor, building on personal relationship management and deep customer knowledge, we deliver tailor made and convenient financial solutions that best suit our clients' needs.

Product strategy:

Retail:
- Innovative saving products and add-on services to keep up our market leader status
- Growth in lending, based on a good understanding of real client needs and credit risk
- Strong focus on convenient daily banking services and primary banking relationships
- Fast and simple processes

Small and medium-sized enterprises (SME):
- Reliable and convenient transactional banking services
- More standard products fitting client needs with simple, easy to access services
- Fast and simple lending process to support financing SME businesses

Corporate:
- Full service provider, emphasis on advisory to provide tailored solutions to our clients.

Strategy on distribution channels:

Multi-channel distribution approach – best fit combination of:
- extensive branch network
- TeleCenter
- e-bank / mobile bank
- tied agents and brokers

Our intention is to provide a unique customer experience through our seamlessly integrated channels and by offering a simple and easy journey to our clients from the first expression of interest through the application for the product and contracting to the use of our products. To achieve this, the initiatives aimed at digitalization will be supported by 1.5 billion HUF of annual capital expenditures between 2014 and 2017.

Key differentiators of the Bank Group:
- being close to our clients: easy access both physically (via our large branch network) and virtually (via remote channels);
- K&H Group acts as a full service provider for our clients in banking and insurance (universal financial institution);
- expertise and advice in the whole spectrum of financial services;
- speaking our clients' language (simple and easy solutions, client-friendly communication).

3. The Group's consolidated activities

3.1 Balance sheet

The Group's total assets increased by 1.1% in the first half of 2016:

Billion HUF	31 Dec 2015	30 Jun 2016	variance
Total assets	2 583	2 611	+1.1%
Loans and receivables	1 747	1 709	-2.2%
Deposits from customers	1 866	1 939	+3.9%
Equity	221	238	+7.4%

The most important elements in the evolution of the consolidated balance sheet are as follows:

- *Loans and receivables:* similarly to the banking sector, the corporate loan portfolio continued to decrease (amidst increasing market share of K&H), and also loans to SME and retail segments increased further during the period. Regarding SME lending K&H Bank remained one of the most active participants in the Funding for Growth Scheme by the National Bank of Hungary. K&H's market share in retail loans is also further increased.

- *Deposits from customers* increased by 3.9% in the first half of 2016. The decreasing market share in retail savings is related to the changing investment structure of mutual funds (disregarding this technical impact the bank's market position would remain unchanged in retail savings).

Market share	30 June 2015	31 Dec 2015	30 June 2016*
Corporate loans	9.8%	10.1%	10.1%
Retail loans	9.1%	9.5%	9.7%
Retail mortgage loan new production	16.1%	16.0%	14.5%
Corporate deposits	12.0%	11.5%	12.1%
Retail deposits+mutual funds	12.3%	12.6%	12.2%
Retail deposits+mutual funds (excl. funds of funds' investments)	11.8%	11.8%	11.8%

** preliminary data*

- Shareholders' equity increased by 16.4 bln HUF in the first half of the year as a net balance of the following items: profit of year 2016 (+18.9 bln HUF); cash flow hedge reserves (+1.6 bln HUF) and AFS revaluation reserves (-4.1 bln HUF).

	30 June 2015	31 Dec 2015	30 June 2016
Guarantee capital (bln HUF)	184	214	224
Capital adequacy ratio (%)	13.6	13.9	16.1

3.2 Profit & loss

billion HUF	Jan-Jun 2015	Jan-Dec 2015	Jan-Jun 2016
Profit after tax	+9.0	+37.9	+18.9

The Bank Group's profit for 1H16 amounted to 18.9 billion HUF (which is a significant improvement compared to the 9.0 billion HUF profit in the same period of last year).

The evolution of the main P&L items in the first half of 2016:

- The *net interest and interest-type income* decreased by 5.4% compared to previous year (1H16: 34.9 bln HUF, 1H15: 36.9 bln HUF) primarily as a consequence of low interest rate environment and the lower margins/volumes due to consumer FX loan settlement and conversion.

- The 2.4% increase in *net fee and commission income* (1H16: 25.8 bln HUF, 1H15: 25.1 bln HUF) is primarily driven by transactional services.

- The increase in *net gains from financial instruments at fair value* (1H16: 10.5 bln HUF, 1H15: 9.8 bln HUF) is due to higher Treasury related income.

- The significant increase in *net realised gains from available-for-sale* (1H16: 5.3 bln HUF, 1H15: 0.7 bln HUF) is attributable to the gain on VISA transaction (4.6 bln HUF, pre-tax).

- *Other net income* decreased by 2.4 billion HUF (1H16: 0.3 bln HUF, 1H15: 2.7 billion HUF), as 1H 2015 included 2.4 billion HUF positive impact on FX consumer loans settlement[1].

[1] Following the financial settlement with the FX mortgage debtors the realised loss turned out to be lower than the provision set aside in 2014, this positive impact can be seen as part of "other income" in 1H15 arising from the net balance of realised loss and related provision release. Detailed description of the related legislatory changes and their financial impacts is included in the 2014 and 2015 consolidated financial statements.

- The *operating expenses* of the Bank Group for the first half of 2016 amounted to 52.7 billion HUF (1H15: 57.9 billion HUF), the decrease compared to previous year is primarily due to the bank tax for the whole year accounted for in 1H (2016: 7.6 billion HUF, 2015: 15.7 billion HUF) partly counterbalanced by the higher IT costs and increasing regulatory fees.

  In 1H 2016 0.6 billion HUF *impairment* release was recorded (H1 2015: 3.6 bln HUF additional impairment), the lower impairment compared to the previous period was mainly related to the retail business. In corporate and SME segments the portfolio quality and the credit impairment traditionally remained favourable

Non-performing loans	30 June 2015	31 Dec 2015	30 June 2016
Retail	26.8%	24.9%	23.2%
Corporate & SME	6.2%	4.2%	3.5%
Retail Car Leasing	45.7%	59.1%	60.9%
Total	**15.1%**	**13.3%**	**12.5%**

The business performance of the Bank Group is illustrated by the following figures:

	2015 H1	**2016 H1**	**variance**
Cost / income	77.0%	68.6%	-8.4%
Cost / income*	58.0%	58.8%	+0.8%
Non-interest type income/ total income*	52.6%	54.6%	+1.9%
Commission income / total income*	34.5%	33.6%	-1.0%
Operating income */ average headcount(million HUF)	42.1	44.4	+5.4%
Operating expenses* / average headcount (million HUF)	24.5	26.1	+6.8%
Operating profit* / average headcount (million HUF)	17.7	18.3	+3.4%
Credit cost ratio	0.5%	-0.1%	-0.6%
Non-performing loans	15.1%	12.5%	-2.6%
Loan / deposit	75.1%	64.2%	-10.9%
Capital**/total liabilities	8.1%	10.2%	+2.1%
Capital adequacy ratio ***	13.6%	16.1%	+2.5%
ROE (based on average balance of equity)****	17.8%	19.9%	+2.1%
ROE (based on average balance of equity)*****	15.1%	19.9%	+4.8%
ROA (based on average balance sheet total)****	1.3%	1.8%	+0.5%
ROA (based on average balance sheet total)*****	1.1%	1.8%	+0.7%

* excluding bank tax and provision for the new law on consumer loan agreements but including FTL related charges
** in addition to equity it also includes subordinated debt capital
*** IFRS, consolidated
**** bank tax included on a pro rata basis
***** excluding provision for the new law on consumer loan agreements, bank tax included on a pro rata basis

Considering profitability, the Group is still one of the most solid performers in the Hungarian banking sector with stable liquidity and solvency positions.

4. Introduction of important subsidiaries

Leasing operation

At the end of June 2016 the Leasing operation consisted of 3 separate active legal entities next to the leasing operations performed by the bank (3 entities were merged with K&H Bank Zrt. in previous years) and 1 legal entity (K&H Lízing Zrt.) was inactive, under liquidation.

Name	Main profile
K&H Autópark Kft.	Operative leasing, fleet management
K&H Eszközlízing Kft.	Operative leasing
K&H Ingatlanlízing Zrt.	Financial leasing
K&H Lízing Zrt. v. a.	Not active, under liquidation

On 30 June 2016 the **Group's leasing** portfolio stood at HUF 50 billion, which represents a 11% increase compared to the end of the previous year. Retail car financing continued to decrease (reduced by 3 billion HUF, which is a 35% reduction compared to the end of 2015), while the truck, real estate, machinery & equipment and fleet portfolio altogether increased by HUF 8 billion (22%) compared to the end of 2015.

K&H Alapkezelő Zrt. (K&H Fund Management Plc.)

K&H Fund Management Plc. is fully owned by K&H Bank. The assets managed in investment funds decreased from HUF 1.012 billion (31 Dec 2015.) to HUF 893 billion HUF. Main drivers are the low interest rate environment and the fluctuation of capital market which avert the focus of investors from investing in money market funds and equity funds.
The sum of total assets managed in funds represents the third biggest market share among the Hungarian Fund Management companies.
Beside the increase of institutional portfolio managed assets from HUF 152 billion to HUF 154 billion, the total assets managed by K&H FM decreased from HUF 1.164 billion to HUF 1.047 billion in the first half of 2016.
In the first half of 2016, seven derivative closed-end funds were launched.

K&H Csoportszolgáltató Kft. (K&H Shared Service Center Kft.)

In 2005, K&H Group decided to set up a group services centre under the management of K&H Bank, which is the 100% owner of K&H Csoportszolgáltató Kft. (KHCSK). The purpose of this unit was the centralisation and efficient organisation of supplementary service activities closely linked to the core activities of individual group members. Comprehensive service activities performed for the Group include the management of the real estate portfolio, logistical and bank security tasks, operative business responsibilities (the booking of trade receivables and payables, fixed assets etc.; tax accounting and payroll management).

The company takes out service level agreements and contracts with individual group members for each individual service. Since 2007, services offered by KHCSK have also been used by K&H Insurance and K&H Leasing Group's member companies as well. At present, KHCSK acts as a group services centre for 10 companies, including K&H Bank. Since May 1, 2008, KHCSK has also been performing the financial and accounting responsibilities and operative services of the Hungarian branch of KBC Global Services N.V. (KBC GSC). In 2009, the scope of the company's activities was extended with financial and accounting services provided for K&H Factoring, a company 100% owned by K&H Bank. A directorate was established on 1 January 2012 for SZÉP Card operation. The SZÉP card is a cafeteria item and product at K&H Group. KHCSK is responsible for the entire operation of the SZÉP card system and the related transactions.

K&H Faktor Zrt. (K&H Factoring Zrt.)

The K&H Factoring Zrt's main activity is factoring (purchase of receivables, financing, discounting). The company's business activities have started in 2010, (factoring) turnover has been increasing since then (2016 1H: 51 bln HUF, +28% yoy). The amount of trade receivables towards debtors was 12.9 billion HUF on 30 June 2016. The profit after tax of the company has reached 78 million HUF in the first half of the year 2016.

5. Risk Management

Banks are exposed to several types of risks due to their operations. K&H Bank has a system in place for the accurate measurement and appropriate management and limitation of these risks. The system has been adjusted to the risk management system of the shareholder KBC Group both in terms of methodology and work organisation.

5.1 Risk management governance model

The risk management governance model seeks to define the responsibilities and tasks of various bodies and persons within the organisations ensuring the sound management of value creation and all the associated risks to which the banking and insurance businesses are exposed. The Group's risk governance model is organised in three tiers:

- Overarching company and risk committees are the Board of Directors (BoD), the Risk and Compliance Committee (RCC), the Audit Board (AB), the Supervisory Board (SB), the Executive Committee (ExCo), the Country Team (CT) and the Capital and Risk Oversight Committee (CROC). These committees concentrate on overarching risk management and on monitoring value creation.
- Specialised risk councils (Credit Risk Council (CRC), Trading Risk Councils (TRC), Operational Risk Councils (ORC)) concentrate on implementing a group-wide framework for one particular type of risk and monitoring the associated risk management process. The risk councils are composed of representatives from line management and Value and Risk Management Division.
- Line management and activity-specific committees have primary responsibility for value and risk management on the operational level. Value and Risk Management Division measures risks, economic capital and value creation for all relevant business entities and reports its findings directly to line management and the relevant activity-specific committees.
- Within Risk Management Division the Integrated Value and Risk Department is dedicated to overarch the three existing risk centers of competence (Credit Risk, Market and Liquidity Risk and Non-financial Risks), enhance coordination and report to senior management.

The Board of Directors and the Risk and Compliance Committee have an important role to play in value creation and risk governance. Regular reporting to the Risk and Compliance Committee ensures that there is an ample flow of information to the members of the Board over the course of the year. Moreover, through the involvement of the Board in the annual round of approvals of risk-tolerance limits, the Board is able to take informed decisions on the degree of risk it finds acceptable for the Group and on the adequacy of the risk management structure.

5.2 Risk types

Credit risk means the potential loss sustained by the bank if a customer becomes insolvent or cannot perform their payment obligations in due time. Credit risks are managed by risk mitigating techniques approved by the management of the Bank. Regulations cover the entirety of the lending process. The bank constantly monitors the credit portfolio and prepares reports on the findings to the senior management of the Bank.

In the framework of the Basel II program, late 2010 the Bank was granted the permission of the regulator to use the internal rating model (IRB Foundation) which has been applied for regulatory capital calculation for credit risk since 1 January 2011. During the program, the Bank reviewed all debtor rating models and upgraded them in line with the new uniform group-level methodology.

In the subsequent years, the bank paid special attention to the enhancement of the applied risk management methodology, with special regard to the analyses of the various stress scenarios affecting the credit portfolio (macro-economic indicators, foreign exchange rate changes and the changes in real estate values). An additional instrumental component of the further development of the risk management methodology was the revision of the management reports to better highlight the various quantitative risk indicators in order to allow the continuous monitoring of the credit portfolio. Based on MNB permission the Bank shifted to IRB Advanced methodology for regulatory capital calculation from 30 September 2015.

Management reports were further fine-tuned during 2016, and amended with additional information. More emphasis was given to monitoring retail deals affected by the Curia decision, and the settlement and FX conversion acts. The main conclusions for 2016 are:

- Corporate and SME portfolio remained stable with some improvements in risk indicators, both NPL and outstanding loan volumes.

- The quality of the loan portfolio disbursed in the MNB's funding for growth program is stable.
- Retail portfolio remained stable during the first half of 2016, even showing some signs of improvement. After the one-off positive impact of settlement the evolution of default rates and cure rates are very similar to the pre-settlement period.

The economic conditions, especially the evolution of unemployment and the future evolution of the HUF and EUR interest rate levels can considerably influence the future quality of the credit portfolio.

- **Market risk** means the potential loss suffered by the Bank-upon a change in the value of foreign currency and interest positions. Both the asset-liability management and market risk management are based on the methodology applied by the shareholder KBC Group. Accordingly, the Capital and Risk Oversight Committee continuously monitors banking and trading book risks and controls them by setting limits (in compliance with the limit policy of KBC). Interest risks are measured and controlled by the joint application of various methods and limits (gap analysis, interest sensitivity, duration, BPV, NII, stress tests). There's also sovereign exposure monitoring in place.

  The banking book is characterized by slightly increasing interest rate risk taking at full sovereign limit utilization. At year end of 2015 the bank has introduced the new KBC level Internal Capital Calculation Method that follows the accounting logic, and links available capital with the required one.

  Trading risk taking was stabile at around 50% of the available VaR limit. There was no sovereign limit overrun in the first half of 2016, however bpv per curve secondary limit was in overrun a few times, resolution was in line with the official governance practice. Number of VaR model outliers decreased to two.
- **Liquidity risk** means the risk of the inability of an institution to comply with net financing requirements. Liquidity risk may be caused by disturbances on the market, credit downgrading, which may result in the constant cessation of certain financing sources. On process level the bank is managing interest rate risk as part of the ILAAP framework through the cooperation of the affected departments. Management seeks to diversify the financing sources and manages assets with due regard to liquidity requirements, maintaining a healthy balance between cash, liquid funds and promptly marketable securities. Short term liquidity risk is measured by the operational liquidity limit which establishes whether there is sufficient coverage for the 30-day cumulative liquidity gap. From 2011 structural liquidity is determined by the application of the coverage ratio, the calculation of the new regulatory and Basel III liquidity ratios (LCR, NSFR) as well as by liquidity stress tests and liquidity early warning signals. The Risk Management Directorate prepares regular reports to the K&H Bank Capital and Risk Oversight Committee on the various liquidity indicators and limits.

- K&H Bank group manages **operational risks** (the potential loss that may arise as a result of inappropriately operating systems, processes or human errors or external events) based on uniform principles and methodology. The methodology includes various techniques of risk identification, risk analysis such as self-assessments (top-down and bottom-up), analysis of losses incurred and the assessment and implementation of key control principles defined by KBC group. The risk mitigation measures (or risk acceptance) are decided according to the uniform accountability rules (decision-making authority). The identified exposures and handling of the risk is monitored and followed up by the Capital and Risk Oversight Committee and analyzed by the Operational Risk Councils that are established throughout the organization. K&H Bank group applies the standardized method to calculate the Pillar I. capital requirement for operational risk according to the permission of the Hungarian Financial Supervisory Authority that was granted in December 2007 (from 1 January 2008).

6. Operating Conditions of the Bank

Capital investments in the branch network:
- During the first half of 2016 the set-up, full or partial reconstruction of 8 branches was started or completed
- Premium-banker offices were installed in 10 branches
- 30 Cash-In ATM terminals were installed
- By mid 2016, altogether 456 ATMs were serving our customers (incl. 71 Cash-in ATMs).

The most important IT development projects of 2016 are the following:
- Several project size developments were initiated or completed to align with legal regulations (such as EU Interchange fee changes, CLS Trading implementation, monthly client's securities position to MNB, etc.).
- In order to connect to KELER's new back office system the related project is in progress.

- New functional development supporting Deposit module is done as a next step towards an integrated branch front-end application. Safe, Teller and Account developments are finished and after testing these modules will be launched this year.
- Corporate customer terminal application (Electra) was enhanced further.
- Within the Digitalization programme the reshaping of the K&H website has been done, further mobile bank functionalities have been developed, and in order to enhance client’s experience, additional e-bank functionalities have been launched.

Budapest, 30 August 2016

Hendrik Scheerlinck	*Attila Gombás*
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