Kereskedelmi és Hitelbank Zrt.

CONSOLIDATED SEMI-ANNUAL REPORT

30 June 2017

Budapest, 30 August 2017

CONTENT

Statement of the Issuer

K&H Bank Zrt., as the Issuer (represented by David Moucheron, CEO and Attila Gombás, CFO) hereby declare that K&H Bank Zrt.'s consolidated 2017 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 2017

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Not audited 30 June 2017 MHUF	Audited 31 December 2016 MHUF
ASSETS		
Cash and cash balances with central banks	89 776	222 020
Financial assets	2 646 923	2 534 120
Held for trading	108 553	95 274
Available for sale	188 533	193 110
Loans and receivables	1 902 601	1 803 046
Held to maturity	426 472	426 237
Hedging derivatives	20 764	16 453
Tax assets	956	2 750
Current tax assets	576	2 400
Deferred tax assets	380	350
Investments in associated companies	542	542
Investment property	1 402	1 010
Property and equipment	36 712	38 252
Intangible assets	13 206	12 060
Other assets	16 461	14 943
Total assets	2 805 978	2 825 697
LIABILITIES AND EQUITY		
Financial liabilities	2 507 473	2 512 972
Held for trading	30 649	31 806
Designated at fair value through profit or loss	157 173	200 131
Measured at amortised cost	2 316 008	2 277 915
Hedging derivatives	3 643	3 120
FV changes of hedged item under portfolio hedge of interest rate risk	9 236	6 185
Tax liabilities	10	36
Current tax liabilities	10	36
Deferred tax liabilities	0	0
Provisions for risks and charges	1 457	2 437
Other liabilities	47 757	43 020
Total liabilities	2 565 933	2 564 650
Share capital	140 978	140 978
Share premium	48 775	48 775
Statutory risk reserve	13 462	13 462
Available for sale reserve	11 616	12 016
Cash flow hedge reserve	5 374	6 092
Defined benefit plans	53	0
Own credit risk adjusments	56	0
Retained earnings	19 731	39 724
Total equity	240 045	261 047
Total liabilities and equity	2 805 978	2 825 697

Budapest, 30 August 2017

David Moucheron	*Attila Gombás*
Chief Executive Officer	*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	Defined benefit plans MHUF	Own credit risk adjustments MHUF	Retained earnings MHUF	Total equity MHUF
Balance as at 1 January 2016	140 978	48 775	8 749	12 211	4 266	-	-	5 560	220 539
Net profit for the year	-	-	-	-	-	-	-	38 877	38 877
Other comprehensive income for the period	-	-	-	(195)	1 826	-	-	-	1 631
Total comprehensive income	-	-	-	(195)	1 826	-	-	38 877	40 508
Dividend	-	-	-	-	-	-	-	0	0
Transfer from retained earnings to statutory risk reserve	-	-	4 713	-	-	-	-	(4 713)	-
Total change	-	-	4 713	(195)	1 826	-	-	34 164	40 508
Balance as at 31 December 2016	140 978	48 775	13 462	12 016	6 092	-	-	39 724	261 047
of which									
revaluation reserve for shares	-	-	-	(11)	-	-	-	-	(11)
revaluation reserve for bonds	-	-	-	8 144	-	-	-	-	8 144
Balance as at 1 January 2017	140 978	48 775	13 462	12 016	6 092	-	-	39 724	261 047
First time application impact	-	-	-	-	-	-	17	(17)	0
Net profit for the year	-	-	-	-	-	-	-	18 901	18 901
Other comprehensive income for the period	-	-	-	(400)	(718)	53	39	-	(1 026)
Total comprehensive income	-	-	-	(400)	(718)	53	56	18 884	17 875
Dividend	-	-	-	-	-	-	-	(38 877)	(38 877)
Total change	--	--	--	(400)	(718)	53	56	(19 993)	(21 002)
Balance as at 30 June 2017	140 978	48 775	13 462	11 616	5 374	53	56	19 731	240 045
of which									
revaluation reserve for shares	-	-	-	172	-	-	-	-	172
Revaluation reserve for bonds	--	--	--	11 445	--	--	--	--	11 445

Budapest, 30 August 2017

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED INCOME STATEMENT

	Not audited 1st half of year 2017 MHUF	Not audited 1st half of year 2016 MHUF
Interest income	45 281	47 178
Interest expense	(10 049)	(12 319)
Net interest income	35 232	34 859
Fee and commission income	34 970	33 912
Fee and commission expense	(8 771)	(8 160)
Net fee and commission income	26 199	25 752
Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange	9 213	10 476
Net realised gains / (losses) from available-for-sale assets	534	5 288
Dividend income	8	0
Other net income	500	330
Total income	71 686	76 705
Operating expenses	(51 954)	(52 657)
Staff expenses	(16 978)	(16 853)
General administrative expenses	(25 568)	(24 578)
Depreciation and amortisation of tangible and intangible assets	(3 961)	(3 672)
Bank tax	(5 447)	(7 554)
Impairment:	3 017	595
Loans and receivables	3 188	850
Other	(171)	(255)
Share in results of associated companies	27	0
Profit before tax	22 776	24 643
Income tax expense	(3 875)	(5 761)
Profit after tax	18 901	18 882

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Not audited 1st half of year 2017 MHUF	Not audited 1st half of year 2016 MHUF
Profit after tax	18 901	18 882
Other comprehensive income		
Available-for-sale equity instruments		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	116	202
Deferred tax impact on fair value changes	(13)	(42)
Transfer from available for sale reserve to net profit		
(Losses)/ gains on disposal	0	(4 565)
Deferred income tax	0	941
Available for sale debt instruments		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	248	(31)
Deferred tax impact on fair value changes	(27)	6
Transfer from available for sale reserve to net profit		
(Losses)/ gains on disposal	(533)	(723)
Amortisation of reclassified assets	(279)	(19)
Deferred income tax	88	153
Cash flow hedge		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	(861)	1 883
Deferred tax impact on fair value changes	78	(388)
Transfer from cash flow hedge reserve to net profit		
Ineffective part	121	141
Gross amount	(50)	(50)
Deferred income tax	(6)	(19)
		-
Own credit risk		
First time application impact	17	-
Change in own credit risk	45	
Deferred income tax	(6)	
		-
Benefit plans		-
Actuarial gains and losses	58	
Deferred income tax	(5)	-
Total other comprehensive income	(1 009)	(2 511)
Total comprehensive income	17 892	16 371

Budapest, 30 August 2017

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CASH FLOWS

	Not audited 1st half of year 2017 MHUF	Not audited 1st half of year 2016 MHUF
OPERATING ACTIVITIES		
Profit before tax	22 776	24 643
Adjustments for:		
Net transfer from available for sale reserve	(812)	(5 307)
Net transfer from cash flow hedge reserve	71	91
Depreciation and impairment of property, plant and equipment, intangible assets, available-for-sale financial assets and other assets	4 145	3 870
(Profit)/Loss on the disposal of property and equipment	(46)	(92)
(Profit)/Loss on the disposal of investment property	(50)	(6)
(Profit)/Loss on disposal of investment	-	-
Change in impairment on loans and advances*	(3 188)	4 580
Change in other provisions	73	(834)
Interest income	(45 281)	(47 178)
Interest Expense	10 049	12 319
Unrealised valuation differences	5 895	(4 116)
Income from associated companies	(27)	-
Cash flows from operating profit before tax and before changes in operating assets and liabilities	(6 394)	(12 030)
Changes in financial assets held for trading	(15 284)	(46 190)
Changes in financial assets designated at fair value through profit or loss	0	0
Changes in financial assets available for sale	3 478	(48 545)
Changes in loans and receivables	(128 888)	76 500
Changes in financial assets held to maturity	1 609	655
Changes in other assets	(17)	3 034
Changes in operating assets	(139 101)	(14 546)
Changes in financial liabilities held for trading	(1 001)	867
Changes in financial liabilities designated at fair value through profit or loss	(39 614)	26 497
Changes in financial liabilities measured at amortised cost	38 454	38 038
Changes in other liabilities	7 798	(30 123)
Changes in operating liabilities	5 636	35 279
Income taxes paid	(3 795)	(2 097)
Interest received	48 246	49 999
Interest paid	(12 601)	(11 532)
Net cash from/(used in) operating activities	(108 009)	45 072

* Including impairments on loans and receivables and loan commitments.

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2017 MHUF	Not audited 1st half of year 2016 MHUF
INVESTING ACTIVITIES		
Purchase of held-to-maturity securities	(29 970)	(42 856)
Proceeds from the repayment of held-to-maturity securities at maturity	26 950	74 467
Proceeds from the disposal of a subsidiary or a business unit	-	4 565
Dividends received from associated companies	27	-
Purchase of intangible fixed assets	(1 815)	(1 458)
Purchase of property, plant and equipment	(2 442)	(2 039)
Proceeds from the sale of property, plant and equipment	524	257
Net cash from/(used in) investing activities	(6 726)	32 936
FINANCING ACTIVITIES		
Net cash from/(used in) financing activities	(38 877)	-
CHANGE IN CASH AND CASH EQUIVALENTS		
Net increase/(decrease) in cash and cash equivalents	(153 612)	78 008
Net foreign exchange difference	(9 291)	(6)
Cash and cash equivalents at beginning of the period	607 530	202 213
Cash and cash equivalents at end of the period	444 627	280 215

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2017 MHUF	Restated Not audited 1st half of year 2016 MHUF
OPERATING CASH FLOWS FROM DIVIDENDS		
Dividend received	35	-
COMPONENTS OF CASH AND CASH EQUIVALENTS		
Cash and cash balances with central banks	89 776	76 738
Loans and advances to banks repayable on demand and term loans to banks < 3 months	399 830	233 915
Deposits from banks repayable on demand and redeemable at notice	(44 979)	(30 438)
Total cash and cash equivalents	444 627	280 215

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 2017

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

Consolidated Management Report

On 30 June 2017, the consolidated total assets of K&H Bank Group (hereunder “the Group”) stood at HUF 2,806 billion. As a financial institution which offers banking and insurance products alike and has a nation-wide branch network of 208 branches, the Group offers the full range of financial services to its clients.

1. Economic environment

The growth of the Hungarian economy accelerated at the beginning of 2017, it grew by 4.2% YoY in the first quarter of the year. The acceleration of retail sales, industrial production and construction were the main driver. The investments jumped as well, the usage of the EU funds played an important role in that. A balanced, wide range economy expansion is expected for the whole year.
The external debt of the country moderated further, the financing structure of the public debt improved also. The non-performing loan ratio decreased in the financial sector.

	2016 actual	2017 forecast*
GDP growth	+2.0%	+3.7%
CPI (average)	+0.4%	+2.4%
Investments	-15.5%	+27.0%
Unemployment rate	4.4%	4.0%
Budget deficit (ESA) (in % of GDP)	-1.7%	-2.1%
Debt/GDP rate	74.1%	72.9%
Balance of payments (in % of GDP)	+4.9%	+3.5%

**source: K&H Bank Zrt*

The European Central Bank has maintained the loose monetary conditions. Although there were more discussion about the potential stop of asset purchase program, there has been no real decision made yet. The European interest rate environment is still very subdued thanks to the ECB’s policy. The FED has increased the base rate two times (in March and June) by 25-25 basis points, moreover it plans to moderate its balance sheet too.
In 1H17, the Hungarian National Bank (MNB) left its base rate unchanged at 0.9%. On the other hand it reduced further the cap of the 3-month deposit the bank can place into MNB. Additionally MNB pumps extra HUF liquidity into the market via cross currency swaps. The interbank market rates are kept well below the base rate with the above mentioned tools.

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 fulfil our mandate by our shareholder and our clients:

- we put the client at the centre of all our activities,
- we provide our clients with fast & simple access,
- we strive to maintain long-term relationship by making the difference through superior service and personal bond,
- we combine the best international practice with sound local knowledge.

We want to be the reference in bank-insurance.

Customer strategy:

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 advisory 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, remote advisory
- 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 have been supported by 1.5 billion HUF of annual capital expenditures since 2014.

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 decreased by 0.7% in the first half of 2017:

Billion HUF	31 Dec 2016	30 Jun 2017	variance
Total assets	2 826	2 806	-0.7%
Cash and cash balances with central bank	222	90	-59.6%
Loans and receivables	1 803	1 903	+5.5%
Deposits from customers	2 131	2 060	-3.3%
Equity	261	240	-8.0%

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

- *Loans and receivables:* both corporate and retail loan portfolio continued to increase in H1. In comparison with the same period in last year the Bank managed to increase its market share in new production in both segments (the improvement was especially remarkable in cash loans provided to retail clients, where the Bank's new disbursement has been doubled compared to 2016). Interbank placements have also contributed to the growth in loans and receivables during the period.
- *Deposits from customers* decreased by 3.3% in the first half of 2017 as certain large deposits placed for a temporary period by corporate clients at YE 2016 have been withdrawn (while deposits from retail and sme customers continued to increase). The Bank's market position in both retail and corporate deposits strengthened further.

Market share	30 June 2016	31 Dec 2016	30 June 2017
Corporate loans	10.1%	10.4%	9.9%
Retail loans *	9.7%	10.1%	10.1%
Corporate deposits	12.1%	12.3%	12.6%
Retail deposits	9.1%	9.4%	9.7%
Retail deposits+mutual funds	12.2%	11.5%	11.5%
Retail deposits+mutual funds (excl. funds of funds' investments)	11.8%	11.4%	11.4%

** The stagnating market share for **retail loans** (Dec 2016/Jun 2017: 10.1%) is due to technical reasons (as a consequence of a merger between a lease company and its parentbank, banking sector figures as from 1 Jan 2017 are not fully comparable with the previous periods' figures). Excluding car loans, K&H's market share in retail lending would increase from 10.2% in YE 2016 to 10.4% in June 2017.*

- Shareholders' equity decreased by 21.0 bln (8%) in the first half of the year as a net balance of the following items: dividend payment after financial year 2016 (-38.9 bln), profit of 1H17 (+18.9 bln); cash flow hedge reserves (-0.7 bln) and AFS revaluation reserves (-0.4 bln).

	30 June 2016	31 Dec 2016	30 June 2017
Guarantee capital (bln HUF)	224	224	234
Capital adequacy ratio (%)	16.1	15.3	15.1

3.2 Profit & loss

billion HUF	Jan-Jun 2016	Jan-Dec 2016	Jan-Jun 2017
Profit after tax	18.9	38.9	18.9

The Bank Group's profit for 1H17 remained at the level of the comparable period in last year (18.9 bln).

The evolution of the main P&L items in the first half of 2017:

- *Net interest income* increased by 1.1% (1H16: 34.9 bln, 1H17: 35.2 bln), as the impact of lower interest rate environment was compensated by the increasing customer loan and deposit volumes.
- The 1.7% increase in *net fee and commission income* (1H16: 25.8 bln, 1H17: 26.2 bln) is primarily driven by transactional services.
- Both *net gains from financial instruments at fair value* (1H16: 10.5 bln, 1H17: 9.2 bln) and *net realised gains from available-for-sale* (1H16: 5.3 bln, 1H17: 0.5 bln) decreased compared to 2016 (the former is primarily due to lower Treasury related income, while net realised gains from available-for-sale included 4.6 bln pre-tax gain on VISA transaction in 2016).

- The *operating expenses* of the Bank Group for the first half of 2017 amounted to 52.0 bln (1H16: 52.7 bln), the decrease compared to previous year is primarily due to the bank tax for the whole year accounted for in 1H (2017: 5.4 bln, 2016: 7.6 bln) partly counterbalanced by the higher IT costs (impact of significant digitalization and other transformation investments) and increasing regulatory fees.

  There was 3.2 bln positive P&L impact on *impairment on loans and receivables*. Retail portfolio quality continued to improve, while in corporate and SME segments the portfolio quality and the credit impairment traditionally remained favourable (also supported by one-off redemptions).

Non-performing loans ratio	30 June 2016	31 Dec 2016	30 June 2017
Retail	23.2%	18.5%	16.1%
Corporate & SME	3.5%	3.1%	2.8%
Retail car loans	60.9%	55.0%	62.2%
Total	**12.5%**	**9.8%**	**8.6%**

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

	2016 H1	**2017 H1**	**variance**
Cost / income	68.6%	72.5%	+3.9%
Cost / income*	62.6%	64.9%	+2.3%
Non-interest type income/ total income*	51.7%	50.8%	-0.9%
Fee and commission income / total income*	35.7%	36.5%	+0.8%
Operating income */ average headcount(million HUF)	39.4	39.0	-1.0%
Operating expenses* / average headcount (million HUF)	24.6	25.3	+2.7%
Operating profit* / average headcount (million HUF)	14.7	13.7	-7.1%
Credit cost ratio	-0.1%	-0.5%	-0.4%
Non-performing loans	12.5%	8.6%	-3.9%
Loan / deposit	64.2%	62.8%	-1.4%
Capital**/total liabilities	10.2%	9.5%	-0.7%
LCR	159%	224%	+66%
NSFR	157%	134%	-23%
Capital adequacy ratio	16.1%	15.1%	-1.0%
ROE (based on average balance of equity)***	19.9%	17.1%	-2.8%
ROA (based on average balance sheet total)***	1.8%	1.7%	-0.1%

* excluding bank tax and impact of VISA transaction
** in addition to equity it also includes subordinated debt capital
*** bank tax included on a pro rata basis

Considering risk, liquidity and capital adequacy ratios K&H Bank (as the 2nd largest bank based on total assets and customer–deposit volumes) preserved its position as one of the banks with the most favourable financial position in the banking sector.

4. Introduction of important subsidiaries

Leasing operation

At the end of June 2017 the Leasing operation consisted of three separate active legal entities next to the leasing operations performed by the bank (three entities were merged with K&H Bank Zrt. in previous years).

Name	Main profile
K&H Autópark Kft.	Operative leasing, fleet management
K&H Eszközlízing Kft.	Operative leasing
K&H Ingatlanlízing Zrt.	Financial leasing

On 30 June 2017 the **Group's leasing** portfolio stood at 53 billion, which represents a 12% increase compared to the end of the previous year. Retail car financing continued to decrease (reduced by 1.5 billion, which is a 47% reduction compared to the end of 2016), while the truck, real estate, machinery & equipment and fleet portfolio altogether increased by HUF 7.1 billion (16%) compared to the end of 2016.

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

K&H Fund Management is owned fully by K&H Bank. The assets managed in investment funds decreased from 812 billion (YE 2016) to 784 billion. The low interest rate environment and still growing penetration of government bonds drove to the drop of managed assets in money market, bond and structured funds while inflow in traditional balanced and equity funds was not able to compensate it.
The sum of total assets managed in funds means the third biggest market share among the Hungarian Fund Management companies.
Despite the increase of institutional portfolio from 160 billion to 164 billion, the total assets managed by K&H FM decreased from 972 billion to 948 billion in the first half of 2017.

In the first half of 2017 seven derivative closed-end and one balanced fund 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 centralization and efficient organization 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, tax accounting and payroll management).

KHCSK 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 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, accounting and operative services of the Hungarian branch of KBC Group Hungarian Branch (KBC GHB). In 2009, the scope of KHCSK's activities was extended with financial and accounting services provided to K&H Factoring, a company 100% owned by K&H Bank. A directorate was established on 1 January 2012 for SZÉP Card operations. 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.

A new subsidiary, K&H Mortgage Bank Zrt. was established by K&H Bank during the year 2016, therefore KHCSK's clientele was extended with this new K&H entity, too.

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 (2017 1H: 56 bln HUF,

+10% yoy). The amount of trade receivables towards debtors was 15.0 billion HUF on 30 June 2017. The profit after tax of the company has reached 81 million HUF in the first half of the year 2017.

K&H Jelzálogbank Zrt. (K&H Mortgage Bank Zrt.)

As from April 1st 2017 the Hungarian National Bank (MNB) implemented a new indicator (Mortgage Financing Adequacy Ratio) to constrain the banking sector level systemic risk of maturity transformation related to the long term HUF retail mortgage loan portfolio. According to the rules, at least 15% of the retail HUF mortgage loan portfolio is to be financed by long-term sources with maturity over 1 year (be it mortgage bonds or refinancing mortgage loans taken out from mortgage credit institutions). The commercial banks had to decide whether they would turn to an existing mortgage bank to refinance part of their retail mortgage loan portfolio or set up a mortgage bank for refinancing purposes. After careful analysis of the market, K&H Bank opted for establishing a mortgage bank.

The K&H Mortgage Zrt. was established as a 100% subsidiary of K&H Bank Zrt. in January 2016 with HUF 3 billion equity (which was increased by HUF 500 million in Q4 2016).

The total assets of Mortgage Bank stood at 68 billion on 30 June 2017. Its core business activity (refinancing of retail mortgage loan portfolios of K&H Bank Zrt, mortgage bond issuance) started in Q1 2017.

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 2017, and amended with additional information.
  The main conclusions for 2017 are:
  - Corporate and SME portfolio quality remained stable with some improvements in risk indicators in the period (the quality of the loan portfolio disbursed in the MNB's funding for growth program is better than the existing portfolio).
  - Retail portfolio continued to improve during the first half of 2017 driven by the decreasing NPL volume and also the high amount of new disbursements.

  The economic conditions, especially the evolution of unemployment and the level of HUF interest rates 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 decreasing interest rate risk taking, at full sovereign limit utilization. KBC group level Internal Capital Calculation Method was underpinned by the regulatory 200bp stress test result throughout the year to prove its conservative stance.

  Trading risk taking was stable at around 20-25% of the available VaR limit. There was no limit overrun in the examined period.

- **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. Structural liquidity is monitored through Basel III liquidity ratios (LCR, NSFR) as well as FFAR (DMM) indicator, FLST indicator and 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 H1 2017 the set-up, full or partial reconstruction of three branches was completed and eight was under preparation.
- By the end of H1 2017, altogether 453 ATMs were serving our customers (including 150 Cash-in ATMs).

The number of branches at the end of June 2017 was 208.

The most important IT development projects in the first half of 2017 were the followings:

- Several project size developments were initiated or completed to align with legal regulations such as: Personal Data Protection Regulation, MIFID2, IFRS transition, E-invoicing (electronic invoice acceptance), Common Reporting Standard (CRS) report for NAV, Domestic HUF Instant Payment, New AML legislation
- Single Sign On (SSO) ability is being prepared for corporate clients and related to the corporate front-end system further developments were realized.
- Within the Digitalization programme the following developments were delivered in the first half of 2017:
  - website: branch appointment booking development and SME online account opening went live
  - GAP in the market (Üzletet ide!): the 2nd phase went live too
  - Mobilbank: the basic application has been enhanced with new functionalities
  - K&H Invest: developments are ready and IT tests started in connection with the new WEB based investment management application.

Budapest, 30 August 2017

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer