



**Kereskedelmi és Hitelbank Zártkörűen Működő
Részvénytársaság**

ANNUAL REPORT

31 December 2018

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Statement of the Issuer

K&H Bank Zrt., as the Issuer (represented by David Moucheron, CEO and Attila Gombás, CFO) hereby declare that the Year 2018 Annual Report and the Year 2018 Consolidated Annual Report of K&H Bank Zrt. have been prepared to the best of the Issuer's knowledge, in compliance with the applicable accounting laws and regulations, and the financial details contained therein reflect a true and reliable status of the assets, liabilities, financial position and profitability of K&H Bank Zrt. and the companies involved in the consolidation, and the Management Report and Consolidated Management Report show a true and fair picture of the position, development and performance of K&H Bank Zrt. and the companies involved in the consolidation, including the major risks and uncertainties factors.

Budapest, April 30 2019

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

KERESKEDELMI ÉS HITELBANK ZÁRTKÖRŰEN MŰKÖDŐ RÉSZVÉNYTÁRSASÁG

**ANNUAL FINANCIAL STATEMENTS
PREPARED IN ACCORDANCE WITH
INTERNATIONAL FINANCIAL REPORTING STANDARDS
AS ADOPTED BY THE EUROPEAN UNION**

FOR THE YEAR ENDED 31 DECEMBER 2018

WITH THE REPORT OF INDEPENDENT AUDITOR



INDEPENDENT AUDITOR'S REPORT
(Free translation)

To the shareholder of K&H Bank Zrt.

Report on the audit of the financial statements

Opinion

We have audited the accompanying financial statements of K&H Bank Zrt. (the "Bank", the "Company") which comprise the statement of financial position as of 31 December 2018 (in which the balance sheet total is MHUF 3,229,244), the income statement, the statement of comprehensive income (in which the total comprehensive income for the year is MHUF 52,229 profit), the statement of changes in equity, the statement of cash flows for the year then ended and the notes to the financial statements including a summary of the significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the Bank as at 31 December 2018, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards ("IFRS") as adopted by the EU and they have been prepared, in all material respects, in accordance with the supplementary requirements of Act C of 2000 on Accounting ("Accounting Act") relevant for the annual financial statements prepared in accordance with IFRS as adopted by the EU.

Our opinion is consistent with our additional report to the audit committee.

Basis for opinion

We conducted our audit in accordance with Hungarian National Standards on Auditing ("HNSA") and with applicable laws and regulations in force in Hungary. Our responsibilities under those standards are further described in the "Auditor's responsibilities for the audit of the financial statements" section of our report.

We are independent of the Bank in accordance with the applicable laws of Hungary, with the Hungarian Chamber of Auditors' Rules on ethics and professional conduct of auditors and on disciplinary process and, for matters not regulated in the Rules, with the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board (IESBA Code of Ethics) and we also comply with further ethical requirements set out in these.

The non-audit services that we have provided to the Bank, in the period from 1 January 2018 to 31 December 2018, are disclosed in note 39 to the financial statements.

To the best of our knowledge and belief, we declare that non-audit services that we have provided to the Bank are in accordance with the applicable laws and regulations in Hungary and that we have not provided non-audit services that are prohibited under Article 5 of Regulation of the European Parliament and Committee No 537/2014 and Subsection (1) and (2) of Section 67/A of Act LXXV of 2007 on the Chamber of Hungarian Auditors, the Activities of Auditors, and on the Public Oversight of Auditors].

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.



Our audit approach

Overview

<i>Overall materiality</i>	Overall materiality applied was MHUF 2,839
<i>Key Audit Matters</i>	<ul style="list-style-type: none"> • Impairment on loans and advances measured at amortised cost • Hedge Accounting

As part of designing our audit, we determined materiality and assessed the risks of material misstatement in the financial statements. In particular, we considered where management made subjective judgements; for example, in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all of our audits, we also addressed the risk of management override of internal controls, including among other matters, consideration of whether there was evidence of bias that represented a risk of material misstatement due to fraud.

We tailored the scope of our audit in order to perform sufficient work to enable us to provide an opinion on the financial statements as a whole, taking into account the structure of the Bank, the accounting processes and controls, and the industry in which the Bank operates.

Materiality

The scope of our audit was influenced by our application of materiality. An audit is designed to obtain reasonable assurance whether the financial statements are free from material misstatement. Misstatements may arise due to fraud or error. They are considered material if individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Based on our professional judgement, we determined certain quantitative thresholds for materiality, including the overall materiality for the financial statements as a whole as set out in the table below. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and in aggregate on the financial statements as a whole.

<i>Materiality</i>	MHUF 2,839
<i>Determination</i>	5% of the average profit before tax of the last 3 years including the current year
<i>Rationale for the materiality benchmark applied</i>	<p>We chose profit before tax as the benchmark because, in our view, it is the benchmark against which the performance of the Bank is most commonly measured by users, and is a generally accepted benchmark.</p> <p>We chose 5%, which is consistent with quantitative materiality thresholds used for profit-oriented companies in this sector.</p>



Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key audit matter

How our audit addressed the key audit matter

Impairment on loans and advances measured at amortised cost

The net amount of loans and advances to customers (excluding central bank and credit institution, and general government) was MHUF 1,375,127 as at 31 December 2018, representing 43% of the balance sheet total. Impairment recognised in the balance sheet amounted to MHUF 40,493.

The management disclosed the related assumptions, balances and estimates in point 2.3.3 of the notes to the financial statements on accounting policy, as well as in notes 14., 20., 22 and 42.4-42.5.

IFRS9 was implemented by the Bank on 1 January 2018, the relating first time adoption effect is disclosed in note 3.

Impairment recognised on expected credit losses is determined on the basis of subjective criteria and management is required to apply significant judgement when calculating individual and collective impairment.

The first step in the impairment calculation is to identify whether there was significant increase in credit risk, the selected indicators will determine whether a 12 month or a lifetime provision is calculated.

In the calculation of individual impairment, the most significant uncertainty is involved in the estimation of expected future cash flows, and in probability weighting of cash-flow scenarios, where cash flows include recoveries from both collections of contractual cash flows and from collaterals.

We understood and evaluated the lending process from disbursement to monitoring and to the calculation of impairment, identified the main control points, and tested their operational effectiveness, including management's approval.

We performed credit review for individually significant loans on a sample basis, and checked the customer's rating by the Bank based on credit application and/or monitoring documents as well as customer-related financial and non-financial information.

For a sample of individually impaired loans, we checked whether assumptions, estimations and scenario weightings applied in calculations of the recoverable amount are reasonable and whether the calculations are correct.

When assessing the collective impairment, with the support of our internal modelling experts, we assessed the applied methodology, assessed, whether it is in accordance with the standard, reviewed the validation documents, recalculated on a sample basis the selected model parameters and the impairment and assessed the tool used by the Bank to calculate impairment.

We checked input data (including both data for modelling parameters and for the impairment calculation), indicators used to determine whether there was significant increase in credit risk and analysed the development of impairment.

We checked the accounting entries relating to the first time adoption of IFRS 9 as at 1 January 2018.



The Bank applies impairment models to calculate collective impairment. These models quantify the probability of default, exposure at default and the loss given default as the primary parameters in the estimation of the recoverable amount, taking into account forward looking information – in line with the requirements of IFRS 9.

We paid considerable attention to this area during our audit due to the significance of the amounts involved and because of the subjective nature of the judgments and assumptions that management is required to make.

We read points 14, 20., 22. and 42.4-42.5 of the notes to the financial statements to assess whether disclosures are in line with applicable regulations.

We found management's estimations to be within reasonable range.

Hedge accounting

The criteria for applying hedge accounting and its accounting treatment are presented in chapter 2.3.7 of the section of the notes to the financial statements on accounting policy, and appendices 23 and 42.2.-42.3.

The Bank applies derivatives to hedge risks arising from its operation and open positions, i.e. foreign currency and interest rate risks. In the absence of hedge accounting the transactions involving derivatives may be presented in the statement of financial position and the income statement differently from the underlying transactions generating the risks. Therefore, the Bank applies cash flow and fair value hedge accounting to ensure matching of accounting applied to the hedging instruments and hedged transactions.

Application of hedge accounting is subject to stringent accounting rules. It is necessary to prove, among other criteria, that the values of transactions underlying open positions and the transactions conducted to hedge them react to market changes, representing hedged risks in the opposite directions. This is called hedge effectiveness test. Measuring hedge effectiveness requires complex calculations, based on highly sensitive assumptions, depending on the methodology applied to this assessment.

We understood and evaluated key internal controls which are operated by the Bank with the aim of appropriately determining the fair values of derivatives and measuring hedge effectiveness.

We checked the valuation of derivatives and the adequacy of market prices applied on a sample basis, we have examined the documentation of hedge accounting, including the risk strategy of the Bank as well as the hedged transactions designation. We checked whether the effectiveness of the hedging relationship was measured and accounted for in accordance with the relevant accounting standards.

As the Bank's hedging strategy involves also a dynamic portfolio hedge accounting, in which case the hedged items underlying the market risk are constantly adjusted and are determined by using assumptions, we checked the modelling of the hedged portfolio and the determination of the portfolio's maturity structure.

We assessed whether disclosures of hedge accounting in the financial statements are in line with the regulations.



We focused on this matter because the valuation of derivatives applied to manage market risks, and consequently, measurement of the effectiveness of hedging relationships are complex and subject to estimation uncertainty.

Other information: the business report

Other information comprises the 2018. business report of the Bank. Management is responsible for the preparation of the business report in accordance with the provisions of the Accounting Act and other relevant regulations. Our opinion on the financial statements expressed in the “Opinion” section of our independent auditor’s report does not cover the business report.

In connection with our audit of the financial statements, our responsibility is to read the business report and, in doing so, consider whether the business report is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If based on our work performed we conclude that the business report is materially misstated we are required to report this fact and the nature of the misstatement.

Based on the Accounting Act, it is also our responsibility when reading the business report to consider whether the business report has been prepared in accordance with the provisions of the Accounting Act and other relevant regulations, if any, and to express an opinion on this and on whether the business report is consistent with the financial statements.

As the Company is a public interest entity and the conditions in Paragraph a) and b) of Subsection (1) of Section 95/C of the Accounting Act are met at the balance sheet date, the Company shall publish a non-financial statement required by 95/C in its business report. In this respect, we shall state whether the business report includes the non-financial statement required by Section 95/C of the Accounting Act.

In our opinion, the 2018 business report of the Bank, is consistent with the 2018 financial statements in all material respects, and the business report has been prepared in accordance with the provisions of the Accounting Act. As there is no other regulation prescribing further requirements for the business report, we do not express an opinion in this respect.

We are not aware of any other material inconsistency or material misstatement in the business report therefore we have nothing to report in this respect.

The business report includes the non-financial statement required by Section 95/C of the Accounting Act.

Responsibilities of management and those charged with governance for the financial statements

Management is responsible for the preparation of the financial statements that give a true and fair view in accordance with International Financial Reporting Standards as adopted by the EU and to prepare the financial statements in accordance with the supplementary requirements of the Accounting Act relevant for the annual financial statements prepared in accordance with IFRS as adopted by the EU, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.



In preparing the financial statements, management is responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting in the financial statements unless management either intends to liquidate the Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank's financial reporting process.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HNSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with HNSAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting in the financial statements and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that gives a true and fair view.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.



From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on other legal and regulatory requirements

We were first appointed as auditors of the Bank on 28 April 2016. Our appointment has been renewed annually by shareholder resolutions representing a total period of uninterrupted engagement appointment of 3 years.

Budapest, 15 April 2019

Árpád Balázs
Partner
Statutory auditor
Licence number: 006931
PricewaterhouseCoopers Könyvvizsgáló Kft.
1055 Budapest, Bajcsy-Zsilinszky út 78.
Licence Number: 001464

Translation note:

Our report has been prepared in Hungarian and in English. In all matters of interpretation of information, views or opinions, the Hungarian version of our report takes precedence over the English version.

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FOR THE YEAR ENDED 31 DECEMBER 2018****CONTENTS OF THE FINANCIAL STATEMENTS**

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K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****INCOME STATEMENT**

	<u>Notes</u>	<u>2018</u> <u>MHUF</u>	<u>Reclassified</u> <u>2017</u> <u>MHUF</u>
Interest and similar income		88 422	92 722
Interest income calculated using the effective interest method	4	75 268	78 864
Other similar income	4	13 154	13 858
Interest and similar expense	4	<u>(14 262)</u>	<u>(20 749)</u>
Net interest and similar income	4	74 160	71 973
Fee and commission income		77 080	69 167
Fee and commission expense		<u>(19 848)</u>	<u>(17 693)</u>
Net fee and commission income	5	57 232	51 474
Net gains / (losses) from financial instruments at fair value through profit or loss	6	7 352	9 808
Foreign exchange differences		19 826	8 491
Net realised gains / (losses) from available-for-sale assets	7	-	534
Net realised gains / (losses) from financial assets at fair value through other comprehensive income	7	(251)	-
Dividend income	8	1 981	2 225
Gain on the disposal of debt securities at amortised cost	9	1 409	-
Gain on the disposal of held -to -maturity debt instruments	9	-	100
Other income	9	4 187	4 230
Other expense	9	(771)	(971)
Total income		165 125	147 864
Operating expenses excluding impairment losses		(101 713)	(98 346)
Staff expenses	12;37	(32 241)	(32 309)
General administrative expenses	10	(54 719)	(52 432)
Depreciation and amortisation of tangible and intangible assets	29;30	(9 038)	(8 280)
Bank tax	11	(5 715)	(5 325)
Impairment on assets:		2 628	(75)
At amortised cost	22	3 011	763
At fair value through other comprehensive income	21	(2)	3
Other		(381)	(841)
Profit / (loss) before tax		66 040	49 443
Income tax expense	13	<u>(8 990)</u>	<u>(7 774)</u>
Profit / (loss) after tax		<u>57 050</u>	<u>41 669</u>

Approved by the Board of Directors on 15 April 2019.

David Moucheron
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****STATEMENT OF COMPREHENSIVE INCOME**

	<u>Notes</u>	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Profit / (loss) after tax		57 050	41 669
Other comprehensive income			
Items that may be reclassified to the profit or loss			
Revaluation reserve of equity instruments			
Net gain / (loss) from fair value changes		-	298
Deferred tax impact on fair value changes		-	(32)
Revaluation reserve of debt instruments			
Net gain / (loss) from fair value changes		(1 698)	5 229
Deferred tax impact on fair value changes	26	130	(566)
Transfer from available for sale reserve to net profit:			
(Losses)/gains on impairment	21	2	-
(Losses)/ gains on disposal	7	251	(534)
Amortisation of reclassified assets		-	(571)
Deferred income tax	26	(27)	120
Cash flow hedge			
Net gain / (loss) from fair value changes		(3 920)	(273)
Deferred tax impact on fair value changes	26	353	25
Transfer from cash flow hedge reserve to net profit:			
Ineffective part	23	194	233
Gross amount	23	(427)	(129)
Deferred income tax	26	21	(9)
Items that will not be reclassified to the profit or loss			
Revaluation reserve of equity instruments			
Net gain / (loss) from fair value changes	14	368	-
Deferred tax impact on fair value changes	26	(40)	-
Own credit risk adjustments	6	(51)	51
Deferred income tax	26	5	(5)
Actuarial result on defined benefit plans	39	20	45
Deferred income tax	26	(2)	(4)
Total other comprehensive income		(4 821)	3 878
Total comprehensive income		<u>52 229</u>	<u>45 547</u>

Approved by the Board of Directors on 15 April 2019.

David Moucheron
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

STATEMENT OF FINANCIAL POSITION

	Notes	2018 MHUF	Reclassified 2017 MHUF
ASSETS			
Cash and cash balances with central banks and other demand deposits with credit institutions		480 647	437 846
Cash		42 833	36 789
Cash balances with central banks	14-22	361 464	201 542
Other demand deposit with credit institutions	14-22	76 350	199 515
Financial assets	14	2 643 798	2 515 451
Held for trading	14;23	69 817	98 194
Available for sale	14	-	194 209
<i>of which assets pledged as collateral</i>	14	-	69 859
Loans and receivables	14-22	-	1 776 484
<i>of which assets pledged as collateral</i>	14	-	92 568
Held to maturity	14	-	423 500
<i>of which assets pledged as collateral</i>	14	-	114 865
Mandatorily at fair value through profit or loss	14-22	20 066	-
At fair value through other comprehensive income	14-22	95 362	-
<i>of which assets pledged as collateral</i>	14	9 359	-
At amortised cost	14-22	2 441 288	-
<i>of which assets pledged as collateral</i>	14	239 188	-
Hedging derivatives	23	17 265	23 064
Fair value changes of hedged item under portfolio hedge of interest rate risk		7 333	-
Tax assets		2 336	2 633
Current tax assets		1 975	2 633
Deferred tax assets	26	361	-
Investments in associated companies	27	10 904	10 619
Investment property	28	1 689	1 476
Property, plant and equipment	29	35 228	37 909
Intangible assets	30	19 767	14 521
Non-current assets held for sale and disposal groups	24	1 325	1 921
Other assets	25	26 217	18 941
Total assets		3 229 244	3 041 317
LIABILITIES AND EQUITY			
Financial liabilities	14	2 825 275	2 686 541
Held for trading	23	54 388	36 474
Designated at fair value through profit or loss	18,20	88 790	120 509
Measured at amortised cost	14	2 668 531	2 525 455
Hedging derivatives	23	13 566	4 103
Fair value changes of hedged item under portfolio hedge of interest rate risk	23	6 164	12 560
Tax liabilities		-	942
Current tax liabilities		-	-
Deferred tax liabilities	26	-	942
Provisions for risks and charges and credit commitments	31	1 792	1 559
Other liabilities	32	93 218	73 691
Total liabilities		2 926 449	2 775 293
Share capital	33	140 978	140 978
Share premium		48 775	48 775
Accumulated profit		83 572	36 657
Other reserves		29 470	39 614
Total equity	44	302 795	266 024
Total liabilities and equity		3 229 244	3 041 317

Approved by the Board of Directors on 15 April 2019.

David Moucheron
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**
STATEMENT OF CHANGES IN EQUITY

	Share capital MHUF	Share premium MHUF	Statutory risk reserve MHUF	Revaluation reserve of securities MHUF	Cash flow reserve MHUF	Other revaluation reserves MHUF	Retained earnings MHUF	Total equity MHUF
2017								
Balance at the beginning of the period	140 978	48 775	13 463	12 017	6 089	-	38 043	259 365
Early application of IFRS9 (Note 2)	-	-	-	-	-	11	(11)	-
Net profit for the year	-	-	-	-	-	-	41 669	41 669
Other comprehensive income for the period (Note 6)	-	-	-	3 944	(153)	76	-	3 867
Total comprehensive income	-	-	-	3 944	(153)	87	41 658	45 536
Dividend paid	-	-	-	-	-	-	(38 877)	(38 877)
Transfer from retained earnings to statutory risk reserve (Note 43)	-	-	4 167	-	-	-	(4 167)	-
Total change	-	-	4 167	3 944	(153)	87	(1 386)	6 659
Balance at the end of the period	<u>140 978</u>	<u>48 775</u>	<u>17 630</u>	<u>15 961</u>	<u>5 936</u>	<u>87</u>	<u>36 657</u>	<u>266 024</u>
<i>of which revaluation reserve for shares (Note 14)</i>	-	-	-	334	-	-	-	334
<i>of which revaluation reserve for bonds (Note 14)</i>	-	-	-	15 627	-	-	-	15 627
2018								
First time application impact of IFRS9 (Note 3)	-	-	-	(11 023)	-	-	(4 435)	(15 458)
Balance at the beginning of the period after transition to IFRS 9	140 978	48 775	17 630	4 938	5 936	87	32 222	250 566
Net profit for the year	-	-	-	-	-	-	57 050	57 050
Other comprehensive income for the period (Note 6)	-	-	-	(1 014)	(3 779)	(28)	-	(4 821)
Total comprehensive income	-	-	-	(1 014)	(3 779)	(28)	57 050	52 229
Realised result from investments	-	-	-	(5)	-	-	5	-
Transfer from retained earnings to statutory risk reserve (Note 43)	-	-	5 705	-	-	-	(5 705)	-
Total change	-	-	5 705	(12 042)	(3 779)	(28)	46 915	36 771
Balance at the end of the period	<u>140 978</u>	<u>48 775</u>	<u>23 335</u>	<u>3 919</u>	<u>2 157</u>	<u>59</u>	<u>83 572</u>	<u>302 795</u>
<i>of which revaluation reserve for shares (Note 14)</i>	-	-	-	656	-	-	-	656
<i>of which revaluation reserve for bonds (Note 14)</i>	-	-	-	3 263	-	-	-	3 263

Other revaluation reserves include own credit risk adjustments and the actuarial result on defined benefit plans. No dividend was paid in 2018 (the dividend paid on ordinary shares was HUF 38 877 million – 0.275766 HUF/share in 2017). See Note 43 for dividend proposed on ordinary shares in 2018.

Approved by the Board of Directors on 15 April 2019

David Moucheron
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****STATEMENT OF CASH FLOWS**

	<u>Notes</u>	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
OPERATING ACTIVITIES			
Profit / (loss) before tax		66 040	49 443
Adjustments for:			
Interest and similar income	4	(88 422)	(92 722)
Interest and similar expense	4	14 262	20 749
Net transfer from revaluation reserve of securities	7	(253)	(1 105)
Net transfer from cash flow hedge reserve	6	(233)	104
Depreciation and impairment of property, plant and equipment, intangible assets, financial assets at fair value through other comprehensive income and other assets	29;30	9 467	9 138
(Profit)/Loss on the disposal of property, plant and equipment	9	(87)	(46)
(Profit)/Loss on the disposal of investment property	9	(236)	(121)
Change in impairment on financial assets values at amortised cost*	22	(3 042)	(763)
Change in other provisions	31	(48)	(8)
Unrealised valuation differences	6	15 940	2 916
		<hr/>	<hr/>
Cash flows from operating profit / (loss) before tax and before changes in operating assets and liabilities		13 388	(12 415)
Changes in financial assets held for trading		29 848	(4 005)
Changes in financial assets held to maturity		-	3 136
Changes in financial assets available for sale		-	3 034
Changes in loans and receivables		-	(100 161)
Changes in financial assets mandatorily valued at fair value through profit or loss		1 715	-
Changes in financial assets valued at fair value through other comprehensive income		(34 821)	-
Changes in financial assets valued at amortised cost		(306 933)	-
Changes in other assets		7 722	(5 193)
		<hr/>	<hr/>
Changes in operating assets		(302 469)	(103 189)
Changes in financial liabilities held for trading		1 726	6 139
Changes in financial liabilities designated at fair value through profit or loss		(19 483)	(72 974)
Changes in financial liabilities measured at amortised cost		58 805	238 507
Changes in other liabilities		13 666	13 163
		<hr/>	<hr/>
Changes in operating liabilities		(54 714)	184 835
Income taxes paid		(8 022)	(7 082)
Interest received		84 747	94 918
Interest paid		(14 835)	(26 387)
		<hr/>	<hr/>
Net cash from/(used in) operating activities		(172 477)	130 680

* Including impairments on loan commitments for both year and loans and receivables in 2017.

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****STATEMENT OF CASH FLOWS (continued)**

	<u>Notes</u>	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
INVESTING ACTIVITIES			
Purchase of held-to-maturity securities		-	(43 409)
Purchase of securities at amortised cost		(154 451)	-
Proceeds from the disposal of securities at amortised cost		44 918	-
Proceeds from the repayment at maturity of securities at amortised cost*		32 887	41 602
Capital increase in subsidiary		(1 000)	-
Proceeds from the disposal of shares in associated companies	9	824	-
Dividends received		1 981	-
Purchase of intangible fixed assets	30	(9 270)	(6 048)
Purchase of property, plant and equipment	29	(3 929)	(6 713)
Proceeds from the sale of property, plant and equipment	29		46
Purchase of investment property	28	(1 393)	(1 031)
Proceeds from the sale of non-current assets held for sale & disposal groups		1 132	-
Proceeds from the sale of investment property	28	1 447	644
Net cash from/(used in) investing activities		(86 854)	(14 909)
FINANCING ACTIVITIES			
Proceeds from or repayment of subordinated liabilities	14	-	10 765
Dividend paid		-	(38 877)
Net cash from/(used in) financing activities		-	(28 112)
CHANGE IN CASH AND CASH EQUIVALENTS			
Net increase/(decrease) in cash and cash equivalents		(259 330)	87 659
Net foreign exchange difference		(14 105)	(2 993)
Cash and cash equivalents at beginning of the period		685 675	601 009
Cash and cash equivalents at end of the period		412 240	685 675

*Including loans and receivables securities in 2017.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

STATEMENT OF CASH FLOWS (continued)

	Notes	<u>2018</u> MHUF	<u>2017</u> MHUF
OPERATING CASH FLOWS FROM DIVIDENDS			
Dividends received	8	1 981	2 225
COMPONENTS OF CASH AND CASH EQUIVALENTS			
Cash		42 833	36 789
Cash balances with central banks and other demand deposits with credit institutions		361 464	201 542
Loans and advances to banks repayable on demand and term loans to banks < 3 months	14	76 350	199 515
Deposits from banks repayable on demand and redeemable at notice	14	51 290	283 399
		(119 697)	(35 570)
Total cash and cash equivalents		<u>412 240</u>	<u>685 675</u>

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

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

Approved by the Board of Directors on 15 April 2019.

David Moucheron
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTE 1 – GENERAL

Kereskedelmi és Hitelbank Zártkörűen Működő Részvénytársaság ("K&H Bank Zrt." or "the Bank") is a limited liability company incorporated in Hungary. The Bank provide banking services through a nation-wide network of 206 branches. As at 31 December 2018 the Bank's registered office was at Lechner Ödön fasor 9, Budapest. Website: www.kh.hu.

The parent company of the Bank is KBC Bank N.V. The ultimate parent is KBC Group N.V.

David Moucheron Chief Executive Officer (Budapest) and Attila Gombás Chief Financial Officer (Budapest) are obliged to sign these financial statements.

The Bank is required to have its accounts audited under applicable law.

Person in charge of accounting tasks: Ecsedi Paula (Budapest), registration number: 140573.

NOTE 2 – ACCOUNTING POLICIES

The short description of IAS 39 standard in Note 2- Accounting policies ensures users of these financial statements the comparability of periods. The impact of the transition to IFRS 9 is presented in Note 3.

For financial liabilities, IFRS 9 changes the presentation of gains and losses on own credit risk for financial instruments designated at fair value through profit or loss. The Bank early adopted this aspect of IFRS 9 with effect from 1 January 2017 and the gains and losses on own credit risk are recorded in other comprehensive income. The impact of early adoption is minimal given the limited effect of own credit risk (see Statement of changes in equity).

The significant accounting policies adopted in the preparation of these financial statements are summarised below.

2.1 Basis of presentation

The financial statements have been prepared under the historical cost convention, as modified by the initial recognition of financial instruments based on fair value, and by the revaluation of financial instruments categorised at fair value through profit or loss ("FVTPL") and at fair value through other comprehensive income ("FVOCI") (and available for sale according to IAS 39 in 2017). The carrying values of recognized assets and liabilities that are hedged items in fair value hedges, and otherwise carried at amortised cost, are adjusted to record changes in fair value attributable to the risk that are being hedged.

The Bank maintains its accounting records and prepares its statutory accounts in accordance with commercial banking and fiscal regulations prevailing in Hungary. The Bank's functional currency is the Hungarian Forint ("HUF"). All balances are presented in millions of Hungarian Forints ("MHUF") unless otherwise stated.

The accounting policies are consistent with those applied in prior year except for the impact of IFRS 9 and IFRS 15.

2.1.1 Statement of compliance

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") and all applicable IFRSs that have been adopted by the EU.

The Bank prepares consolidated annual financial statements according to the same accounting framework as the separate annual financial statements. The Bank's separate and consolidated annual financial statements are approved and published on the same day.

2.2 Significant accounting judgements and estimates

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

In the process of applying the Banks' accounting policies, Management has used its judgements and made estimates in determining the amounts recognized in the financial statements. The most significant use of judgements and estimates are as follows:

Fair value of financial instruments

The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is not the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. An imbalance between supply and demand (e.g. fewer buyers than sellers, thereby forcing prices down) is not the same as a forced transaction or distress sale.

Where the fair values of financial assets and financial liabilities recorded on the statement of financial position cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The input to these models is taken from observable markets where possible, but where this is not feasible, a degree of judgement is required in establishing fair values. The judgements include considerations of liquidity and model inputs such as correlation and volatility for longer dated derivatives. For the sensitivity of the judgements used for fair value calculation see Note 17 and Note 42.3.

Allowance for impairment of loans and advances, loss allowances of contingent liabilities and provision for commitments

The impairment allowances of loans and advances and loss allowances of contingent liabilities are determined based on the expected credit losses. Calculating ECL requires significant judgments on different aspects for example, but not limited to, the borrowers' financial position and repayment capabilities, the value and recoverability of collaterals, forward looking and macroeconomic information. The Bank applies neutral and free from bias approach when dealing with uncertainties and making decisions based on significant judgments.

The Bank regularly reviews its loans and advances, contingent liabilities and its commitments to assess impairment and provision. The Bank applies its judgement on the basis of experience to estimate the amount of any impairment loss in cases where a borrower is in financial difficulties and where there is little available historical data relating to similar borrowers. Similarly, the Bank estimates changes in future cash flows based on the observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the Bank. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the group of amortised cost assets. Refer to Note 22 for further details.

Provision for litigations and claims

The amount of provision required to meet losses incurred as a result of litigations and claims is another principal area of estimation uncertainty in these financial statements. Refer to Note 31 for further details.

2.3 Significant accounting policies effective from 1 January 2018

2.3.1 Foreign currency translation

The functional and presentational currency of the Bank is HUF. Monetary assets and liabilities denominated in foreign currencies are translated into HUF at exchange rates quoted by the National Bank of Hungary as at the date of the statement of financial position. Negative and positive exchange rate differences are recognized in the income statement. Exceptions to the above general rule are the cases when a monetary asset or liability is involved in a cash flow hedge relationship as a hedging instrument and in accordance with the hedging documentation the foreign exchange translation difference of the hedging instrument is recognized as other comprehensive income. Non-monetary items are translated into the functional currency at a historical exchange rate as at the date of transaction. Non-monetary items measured at FV through OCI, which are denominated in foreign currencies, are translated into HUF at exchange rates quoted by the National Bank of Hungary as at the date of the consolidated statement of financial position. Income and expenses arising in foreign currencies are converted at the rate of exchange on the transaction date. Resulting foreign exchange gains or losses are recorded in the income statement.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

2.3.2 Financial assets

The Bank applies all the requirements of IFRS 9 as from 1 January 2018, except for the hedge accounting transactions which continued to be accounted for in accordance with IAS 39.

2.3.2.1 Financial assets – recognition and derecognition

2.3.2.1.1 Recognition

Financial assets and liabilities are recognised in the balance sheet when the Bank becomes a party to the contractual provisions of the instruments. Regular-way purchases or sales of financial assets are recognised using settlement date accounting. All financial assets are measured initially at fair value plus transaction costs that are directly attributable to its acquisition; with the exception of financial assets measured at fair value through profit or loss.

When the fair value of financial assets and liabilities differs from the transaction price on initial recognition, the Bank recognises the difference as follows:

- When the transaction price in a non-active market differs from the fair value of other observable market transactions in the same instrument or from the fair value based on a valuation technique whose variables include only data from observable markets, the difference between the transaction price and the fair value (day 1 profit) is taken to profit or loss.
- If this is not the case (i.e. the variables do not include only data from observable markets), day 1 profit is deferred and is released in profit or loss during the life and until the maturity of the financial instrument.

2.3.2.1.2 Derecognition and modification

The Bank derecognises a financial asset when the contractual cash flows from the asset expire or the Bank transfers its rights to receive contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership are transferred.

In specific transactions like repurchase agreements and securities lending and borrowing the Bank assesses the transfer of the risks and rewards based on the applicable facts and circumstances and on the predetermined repurchase price. When this indicates that the Bank has retained substantially all risks and rewards then financial assets and liabilities are not derecognised but the relating consideration or financial assets received/paid are presented as separate financial liability/asset. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Bank could be required to repay.

Repo and reverse repo agreements

Assets sold with a simultaneous commitment to repurchase at a specified future date (repos) continue to be recognized in the statement of financial position and are measured in accordance with accounting policies for trading securities or investment securities if the repurchase price is not fair value at the time of reacquisition. The counterparty liability for amounts received under these agreements is included in financial liabilities measured at amortised cost. The difference between sale and repurchase price is treated as interest expense and accrued over the life of the repo agreement. Assets purchased with a corresponding commitment to resell at a specified future date (reverse repos) are not recognized in the statement of financial position, as the Bank does not obtain control over the assets. Amounts paid under these agreements are included in financial assets at amortised cost. The difference between purchase and resale price is treated as interest income and accrued over the life of the reverse repo agreement.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Securities lending and borrowing

Securities lending and borrowing transactions are usually collateralised by securities or cash. The transfer of the securities to counterparties is only reflected on the statement of financial position if the risks and rewards of ownership are also transferred. Cash advanced or received as collateral is recorded as an asset or liability.

Securities borrowed are not recognized on the statement of financial position, unless they are sold to third parties, in which case the obligation to return the securities is recorded as a trading liability and measured at fair value with any gain or losses included in Net gains / (losses) from financial instruments at fair value through profit or loss.

When during the term of a financial asset there is a change in the terms and conditions, then the Bank assesses whether the new terms are substantially different to the original terms indicating that the rights to the cash flows of the initial instruments have expired. In case the conclusion is that the terms are substantially different then the transaction is accounted for as financial asset derecognition, which requires derecognising the existing financial asset and recognising a new financial asset based on the revised terms. Conversely, when the Bank assesses that the terms are not substantially different then the transaction is accounted for as financial asset modification.

Renegotiated loans

Where possible, the Bank seeks to renegotiate loans rather than to take possession of collateral.

The Bank considers a loan (receivable) renegotiated if the loan or credit arrangements are renegotiated, rescheduled (prolonged) and renegotiated upon the debtor's or the financial institution's initiative, within the framework of the amendment of the underlying contract, where the underlying contract is amended with a view to avoiding default because of the considerable deterioration in the financial condition or solvency of the borrower, on account of which he is unable to meet the obligations of repayment as originally contracted. Such amendments result in significant changes in the terms and conditions of the underlying contract, bringing considerably more favourable terms for the client - by way of derogation from the market conditions pertaining to contracts of the same type bearing similar terms and conditions.

The assessment of the substantially different terms is made when loans to customers are renegotiated or otherwise modified. In considering the substantially different terms, the Bank evaluates whether:

- The borrower has changed;
- The loan has been partially written off because the Bank estimates that the part or entirety of the loan became irrecoverable;
- Changes made to a loan or loans of the same borrower resulted in refinancing or consolidation of the loans into a new loan;
- Due to significant financial difficulty of the borrower, the Bank has granted more than one concession;
- Substantial new terms have been introduced, such as profit share/equity-based return significantly modifying the risk profile of the loan;
- The nature of the interest rate or the reference rate has significantly changed;
- The currency of the contract has changed.

The amendments are representing, among others, the deferral of repayments (interest and/or principal) temporarily for a specific period (grace period), payment by instalments, modification of interest rates (for example repricing in the form of discount rates), capitalization of interest, changing the type of currency of denomination, extending the term of the loan, rescheduling instalment payments, reducing the level of collateralization or the level of security requested, or allowing other form of collateral or security, waiving the collateral or security requirement (non-collateralization), introducing new contract terms and conditions or eliminating certain existing terms and conditions. Furthermore a supplementary agreement or a new contract may be concluded between the debtor and the Bank, or between the borrower and an affiliate of the original lender, for a new loan for refinancing the debts (interest and principal) outstanding on account of the existing contract, or for undertaking additional commitments with a view to avoiding any further increase in risk exposure or to cutting losses, upon which the claims of the Bank (including the financial institution participating as the affiliate of the original lender) arising on account of the aforesaid supplementary agreement or new contract are also recognized as renegotiated loans (receivables).

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

The terms are considered as substantially different in any case if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial asset.

The process of financial asset modification requires adjusting the carrying amount of the previously recognised financial asset in order to reflect the changed terms on the contractual cash flows. In doing that the Bank recalculates the gross carrying amount of the financial asset and recognises a modification gain or loss presented as impairment on assets in the income statement. The carrying amount of the financial asset is recalculated as the present value of the estimated future cash payments through the expected life of the changed terms that are discounted at the financial asset's original effective interest rate. Any costs or fees incurred as part of the modification shall adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset.

Loans where the relevant contract had to be amended due to changes in market conditions are not considered as renegotiated loans (receivables), furthermore, where the parties agree in market conditions pertaining to similar agreements and where the solvency of the debtor is such as to ascertain his ability to comply with his ensuing contractual obligations.

If the renegotiation does not result derecognition, the impact of modification will be presented as change in the assets' effective interest rate or change in gross carrying amount.

Derecognition of renegotiated loans

For derecognition of the renegotiated loans the Bank applies the following criteria. An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial asset and the recognition of a new financial asset. A substantial modification of the terms of an existing financial asset or a part of it is accounted for as an extinguishment of the original financial asset and the recognition of a new financial asset.

If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the asset and are amortised over the remaining term of the modified liability.

2.3.2.1.3 Write-offs

A write-off is a direct reduction of the gross carrying amount of a financial asset when the Bank has no reasonable expectations of recovering the financial asset on its entirety or a portion thereof. A write-off constitutes a derecognition event.

Write-offs do not constitute a debt forgiveness and the Bank retains its legal enforceable rights towards the borrower until the official legal proceedings have concluded otherwise.

2.3.2.2 Equity and debt instruments classification

On initial recognition of a financial asset, the Bank first assesses the contractual terms of the instrument in order to classify it as an equity or debt instrument. An equity instrument is defined as any contract that evidences a residual interest in another entity's net assets. In order to satisfy this condition, the Bank reviews whether the instrument includes no contractual obligation for the issuer to deliver cash or exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

Any instruments which do not meet the criteria of equity instruments are classified as debt instruments by the Bank.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

2.3.2.2.1 Classification and measurement – debt instruments

When the Bank concludes that the financial asset is a debt instrument then on initial recognition, it can be categorised in one of the following categories:

- Mandatorily measured at fair value through profit or loss (FVPL);
- Designated at initial recognition at fair value through profit or loss (FVO);
- Fair value through other comprehensive income (FVOCI);
- Amortised cost (AC)

Debt instruments have to be classified in the FVPL category when (i) they are not held in business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets or alternatively (ii) they are held in such business model but the contractual terms of the instrument give rise on specified dates to cash flows that are not solely payments of principal and interest on the principal amount outstanding.

Further, the Bank may in some cases, on initial recognition, irrevocably designate a financial asset that otherwise meets the requirements to be measured at AC or at FVOCI as at fair value (FVO) if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

A debt instrument is measured at FVOCI only if it meets both of the following conditions and is not designated as at FVO:

- the asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets;
- and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A debt instrument is measured at AC only if it meets both of the following conditions and is not designated as at FVO:

- the asset is held within a business model whose objective is to hold assets to collect contractual cash flows;
- and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

2.3.2.2.2 Business model assessment

The business model assessment is relevant for debt instruments to assess whether they are allowed to be measured at AC and FVOCI. In performing the assessment, the Bank reviews the objective of a business model in which an asset is held at a portfolio level because this best reflects the way the business is managed and information is provided to management. The information considered includes:

- the stated policies and objectives for the portfolio and the operation of those policies in practice. In particular, whether management's strategy focuses on earning contractual interest revenue, maintaining a particular interest rate profile, matching the duration of the financial assets to the duration of the liabilities that are funding those assets or realising cash flows through the sale of the assets;
- how the performance of the portfolio is evaluated and reported to key management;
- the risks that affect the performance of the business model (and the financial assets held within that business model) and how those risks are managed;
- how managers of the business are compensated – e.g. whether compensation is based on the fair value of the assets managed or the contractual cash flows collected; and
- the frequency, volume and timing of sales in prior periods, the reasons for such sales and its expectations about future sales activity. However, information about sales activity is not considered in isolation, but as part of an overall assessment of how the Bank's stated objective for managing the financial assets is achieved and how cash flows are realised.

Financial assets that are held for trading or whose performance is evaluated on a fair value basis are measured at FVPL because they are neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

2.3.2.2.3 Assessment whether contractual cash flows are solely payments of principal and interest (SPPI)

For the purposes of this assessment, 'principal' is defined as the fair value of the financial asset on initial recognition. 'Interest' is defined as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs (e.g. liquidity risk and administrative costs), as well as profit margin.

In assessing whether the contractual cash flows are solely payments of principal and interest, the Bank considers the contractual terms of the instrument. This includes assessing whether the financial asset contains a contractual term that could change the timing or amount of contractual cash flows such that it would not meet this condition. In making the assessment, the Bank considers:

- contingent events that would change the amount and timing of cash flows;
- leverage features;
- prepayment and extension terms;
- terms that limit the Bank's claim to cash flows from specified assets (e.g. non-recourse asset arrangements); and
- features that modify consideration of the time value of money – e.g. periodical reset of interest rates.

2.3.2.2.4 Reclassification

Financial assets are not reclassified subsequent to their initial recognition, except in the period after the Bank changes its business model for managing financial assets which could occur when the Bank begins or ceases to perform an activity that is significant to its operations (e.g.: when the Bank acquires, disposes of, or terminates a business line). The reclassification takes place from the start of the first reporting period following the change.

2.3.2.2.5 Classification and measurement – Equity instruments

Financial equity instruments are categorised in one of the following categories:

- Mandatorily measured at fair value through profit or loss (FVPL);
- Equity instruments elected for fair value through other comprehensive income (FVOCI).

For investments in subsidiaries and affiliated undertakings the rules defined in Section "Participations" apply.

In the banking activity all equity instruments is included in the FVOCI category when the investment is not held for trading. This is a specific designation that is be made on a case-by-case basis, applicable to strategic investments. The election to include equity instruments in the FVOCI category is irrevocable on initial recognition and can be done on an investment-by-investment basis which is interpreted by the Bank as share-by-share basis. Equity categorised in the FVOCI category is subsequently measured at fair value with all changes recognised in other comprehensive income and without any recycling into the income statement even when the investments is disposed. The only exception applies to the dividend income which are recognised in the income statement.

2.3.2.2.6 Classification and measurement - Derivatives

The Bank can recognise derivative instruments either for trading purpose or as hedging derivatives. Derivatives can have asset or liability positions depending on their actual market value.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Trading derivatives

Derivative instruments are always measured at fair value and the Bank makes a distinction as follows:

- Derivatives that are held with a hedging intent but for which hedge accounting cannot be or is not applied (economic hedge): hedging instruments can be acquired with the intention of economically hedging an external exposure but without the application of hedge accounting. The interest component of these derivatives is recognised under 'Net interest income', while all other fair value changes are recognised under 'Net result from financial instruments at fair value through profit or loss'.
- Derivatives held without hedging intent (trading derivative): the Bank can also enter into a derivative position without any intention to hedge economically a position. Such activity can relate to closing / selling an external position in the near term or for short-term profit taking purposes. All fair value changes on such derivatives are recognised under 'Net result from financial instruments at fair value through profit or loss'.

Hedging derivatives

Hedging derivatives are derivatives which are specifically designated in a hedge relationship. The accounting process of such derivatives are detailed in the section "Hedge Accounting".

2.3.2.3 Fair value hierarchy of financial instruments

The fair value measurements are classified into the levels of fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

Level 1	quoted prices (unadjusted) in active markets for identical assets or liabilities
Level 2	inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices)
Level 3	inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The level in the fair value hierarchy within which the fair value measurement is categorised in its entirety shall be determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety. For this purpose, the significance of an input is assessed against the fair value measurement in its entirety. If a fair value measurement uses observable inputs that require significant adjustment based on unobservable inputs, that measurement is a Level 3 measurement.

The Bank assesses the significance of fair value adjustments at portfolio level in function of the proportion of the fair value adjustment relative to the size of the underlying portfolio. A fair value adjustment related to the unobservable input is considered to be material for the Bank if this fair value adjustment makes up at least 5% of the nominal exposure of the underlying portfolio.

The amount of the fair value which is calculated on transaction level is adjusted (MVA - Market Value Adjustment) by the Bank taking into account the elements listed below. The adjustment according to the following elements is calculated by instrument / transaction types or on customer level:

- close-out cost of the transactions,
- funding value adjustment,
- illiquidity of the markets,
- counterparty risk.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Changes to the fair value classification

The classification of a financial instrument into the fair value hierarchy is not static. Financial instruments can shift between different fair value levels for various reasons, for instance:

- Market changes: The market can become inactive. As a result, previously observable parameters can become unobservable (possible shift from level 1 to level 2 or 3);
- Model changes: The application of a new refined model that takes more observable input factors into account or reduces the fair value impact of unobservable inputs (possible shift from level 3 to level 2);
- Change in sensitivity: The sensitivity of a valuation input to the entire fair value may change over time. An unobservable input that used to be significant to the entire fair value measurement may become insignificant (or vice versa). The fair value classification in the hierarchy would consequently change from level 3 to level 2 (or vice versa).

Defining the fair value classification of a financial instrument can only be made taking into account changing market circumstances, upgraded models and the sensitivity of the valuation inputs. With this regard, the fair value classification per instrument/portfolio is reassessed by the Bank on a regular basis.

2.3.3 Financial assets - Impairment

2.3.3.1 Definition of default

The Bank uses the definition for defaulted financial assets which is used for internal risk management purposes and it is in line with guidance and standards of the financial industry regulators. A financial asset is considered as defaulted if one or more of the following conditions are fulfilled:

- A significant deterioration in creditworthiness
- The asset is flagged as non-accrual
- The asset is flagged as a forbore asset in line with the internal policies for forbearance
- the Bank has filed for client's bankruptcy
- The counterparty has filed for bankruptcy or sought similar protection measures.
- The credit facility towards the customer is terminated.

The Bank applies a backstop for facilities that have at least 90 days past due status. In this context a backstop is used as a final control to ensure that all the assets that should have been designated as defaulted, are properly identified.

2.3.3.2 Expected credit loss model

The model for impairment of financial assets is called the Expected Credit Loss model (ECL). The scope of the ECL model is based on the classification of financial assets. The ECL model is applicable to the following financial assets:

- Financial assets measured at amortised cost;
- Debt instruments measured at fair value through the other comprehensive income;
- Loan commitments and financial guarantees;
- Finance lease receivables; and
- Trade and other receivables.

No ECL are calculated for equity investments. Financial assets that are in scope for the ECL carry an amount of impairments equal to the life-time ECL if the credit risk has increased significantly since initial recognition. If the credit risk has not increased significantly since initial recognition, the loss allowance equals to an amount of 12 month ECL (see below for the references to the significant increase in credit risk).

To distinguish between the different stages with regards the amount of ECL, the Bank uses the internationally accepted terminology for stage 1, stage 2 and stage 3 financial assets.

**FINANCIAL STATEMENTS
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NOTE 2 – ACCOUNTING POLICIES (continued)

All financial assets at initial recognition, unless they are already credit impaired, are classified at stage 1 and carry 12 month ECL. Once a significant increase in credit risk since initial recognition occurs, the asset migrates to stage 2 and carries life-time ECL. Once an asset meets the definition of default it migrates to stage 3.

IFRS 9 allows for a practical expedient for leasing and trade receivables. The ECL for trade receivable are measured in an amount equal to the life-time ECL. The Bank applies this practical expedient for trade receivables.

Impairment gains and losses on financial assets are recognised under the heading “Impairments” in the income statement.

Financial assets that are measured at amortised cost are presented on the balance sheet at their carrying amount being the gross carrying amount minus loss allowances. Debt instruments measured at fair value through other comprehensive income are presented on the balance sheet at their carrying amount being the fair value at the reporting date. The adjustment for the ECL is recognised as a reclassification adjustment between the income statement and the other comprehensive income. For loan commitments and financial guarantees a provision for ECL is recognized as liability.

2.3.3.3 Significant increase in credit risk since initial recognition

In accordance to the ECL model, a financial assets attracts life-time ECL once the credit risk has increased significantly since initial recognition; therefore the assessment of the significant increase in credit risk defines the staging of financial assets. The assessment of a significant increase in credit risk is a relative assessment based on the credit risk that was assigned at initial recognition. This is a multi-factor assessment, and, thus the Bank has developed a multi-tier approach (MTA).

2.3.3.3.1 Multi-Tier Approach – Bond portfolio

For the bond portfolio the MTA consists of three tiers:

- Low credit exception: Bonds always carry 12-months ECL if they have a low credit risk at the reporting date (i.e. stage 1). The Bank uses the low credit risk exception for bonds which are graded as investment grade.
- Internal rating: only applicable if the first tier is not met. This is a relative assessment comparing the Probability of Default (PD) at initial recognition to the PD at the reporting date. The Bank makes the assessment on a facility level at each reporting period.
- Management assessment: Finally management reviews and assesses the significant increase in credit risk for financial assets at an individual and a portfolio level.

If none of these triggers results in a migration to stage 2, then the bond remains in stage 1. A financial asset is considered impaired (i.e. stage 3) as soon as it meets the definition of default. The MTA is symmetrical, i.e. a credit that has migrated to stage 2 or 3 can return to stage 2 or 1 if the Tier that triggered the migration is not present in a subsequent reporting date.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

2.3.3.3.2 Multi-tier approach – Loan portfolio

For the loan portfolio the Bank uses a five-tier approach. This MTA is a waterfall approach, i.e. if after assessing the first Tier, doesn't result in migrating to stage 2, then the second Tier is assessed and so on. At the end, if all Tiers are being assessed without triggering a migrations to stage 2, then the financial asset remains in stage 1.

- Internal rating: the internal rating is used as the main criterion for assessing the increase in credit risk. This is a relative assessment comparing the PD at initial recognition to the PD at the reporting date. The Bank makes the assessment on a facility level at reach reporting period.
- Forbearance: Forborne financial assets are always considered as stage 2, unless they are already impaired. In the latter case, they migrate to stage 3.
- Days past due: the Bank uses the backstop described in the standard. A financial asset that has more than 30 days past due, migrates to stage 2.
- Internal rating backstop: the Bank uses an absolute level of PD as a backstop for financial assets to migrate to stage 2. This backstop corresponds to the highest PD (i.e. PD9 based on the Bank internal rating) before a financial asset is considered to be impaired.
- Management assessment: Finally management reviews and assesses the significant increase in credit risk for financial assets at an individual and a portfolio level.

A financial asset is considered impaired (i.e. stage 3) as soon as it meets the definition of default. The MTA is symmetrical, i.e. a credit that has migrated to stage 2 or 3 can return to stage 2 or 1 if the Tier that triggered the migration is not met at the reporting date.

2.3.3.4 Measurement of ECL

The ECL is calculated as the product of the probability of default (PD), the estimated exposure at default (EAD) and the loss given default (LGD).

The ECL are calculated in a way that reflect:

- an unbiased, probability weighted amount;
- the time value of money; and
- information about the past events, current conditions and forecast economic conditions.

The life-time ECL represents the sum of the ECL over the life time of the financial asset discounted at the original effective interest. The 12 months ECL represent the portion of the life time ECL that results from a default in 12-month period after the reporting date.

The Bank uses specific IFRS 9 models for PD, EAD and LGD to calculate ECL. To the extent possible the Bank uses similar modelling techniques that have been developed for prudential purposes (i.e. Basel models) for efficiency purposes. Having said that, the Bank ensures that the Basel models are adapted to be in compliance with IFRS 9, for example:

- the Bank removes the conservatism which is required by the regulator for Basel models
- the Bank adjusts the way that macroeconomic parameters affect the outcome to ensure that the IFRS 9 models reflect a "point-in-time" rather than "through-the-cycle" estimate (the latter is required by the regulator).
- the Bank applies forward looking macroeconomic information in the models.

The Bank also considers three different forward looking macro-economic scenarios with different weights in the calculation of ECL. The base case macro-economic scenario represents the Bank's estimations for the most probable outcome and it also serves as a primary input for other internal and external purposes.

The maximum period for measurement of the ECL is the maximum contractual period (including extensions) with the exception of specific financial assets which include a drawn and an undrawn amount available on demand which is not limited the exposure to the contractual period. Only for such assets a measurement period can extend beyond the contractual period.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

2.3.3.5 Purchased or originated credit impaired (POCI)

The Bank defines POCI assets as financial assets in scope of the IFRS 9 impairment which at origination are already defaulted (i.e. meet the definition of default).

POCI assets are recognised initially at an amount net of impairments and are measured at amortised cost using a credit adjusted effective interest rate. In subsequent period any changes to the estimated lifetime ECL are recognised in the income statement. Favourable changes are recognised as an impairment gain even if the lifetime ECL at the reporting date is lower than the estimated lifetime ECL at origination.

2.3.4 Cash, cash balances with central banks and other demand deposits

Cash comprises cash on hand and demand deposits, e.g. cheques, petty cash and central bank balances as well as other bank balances. For the purposes of reporting cash flows, cash and cash equivalents comprise balances with an original maturity less than 90 days, including cash, balances due from banks and balances with the National Bank of Hungary (including obligatory reserves) decreased with deposits from banks repayable on demand.

2.3.5 Financial liabilities

Financial instruments or their component parts are classified as liabilities or as equity in accordance with the substance of the contractual arrangements on initial recognition and the definitions of financial liabilities and equity instruments. A financial instrument is classified as a liability if:

- the Bank has a contractual obligation to deliver cash or another financial asset to the holder or to exchange another financial instrument with the holder under conditions that are potentially unfavourable to the Bank; or
- the Bank has a contractual obligation to settle the financial instrument in a variable number of its own equity instruments.

A financial instrument is classified as an equity instrument if both of the conditions are not met and in that case is covered under the section “Equity”.

2.3.5.1 Financial liabilities – recognition and derecognition

The Bank recognises a financial liability when it becomes a party to the contractual provisions of the instrument which is typically the date when the consideration received in the form of cash or other financial asset has been received. At initial recognition the financial liability is recognised at fair value and less transaction costs that are directly attributable to its issuance, except for financial liabilities at fair value through profit or loss.

Financial liabilities are derecognised when they are extinguished, i.e. when the obligation specified in the contract is discharged, cancelled or expires. The Bank can also derecognise the financial liability and recognise a new one when there is an exchange between the Bank and the lenders of the financial liability with substantially different terms, as well as substantial modifications of the terms of the existing financial liabilities. In assessing whether terms are different, the Bank compares the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, and the discounted present value of the remaining cash flows of the original financial liability. If the difference is at least 10% or more then the Bank derecognises the original financial liabilities and recognises a new one. When the exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment.

Financial liabilities held for trading

Held-for-trading liabilities are those incurred principally for the purpose of generating a profit from short-term fluctuations in price or dealer’s margin. A liability also qualifies as a trading liability if it belongs to a portfolio of financial instruments held for trading separately by the trading desk and for which there is a recent pattern of short-term profit-taking.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Trading liabilities can include derivative liabilities, short positions in debt and equity instruments, time deposits and debt certificates. In connection with derivative liabilities the Bank makes similar distinction between trading and hedging derivatives as in case for derivative assets.

Initially, held-for-trading liabilities are measured at fair value. At the end of the reporting date, trading liabilities are measured at fair value. Fair value adjustments are always recorded in the income statement.

Financial liabilities upon initial recognition designated by the entity at fair value through profit or loss

IFRS 9 allows measuring a (group of) financial liability(s) on initial recognition at fair value, whereby fair value changes are recognized in profit or loss except for fair value changes related to the changes in own credit risk which are presented separately in OCI. The fair value designation is used by the Bank for the following reasons:

- the Bank designates a financial liability or group of financial liabilities at fair value when these are managed and their performance are evaluated on a fair value basis.
- Fair value option can be used when the use eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.
- A financial instrument is regarded as a hybrid instrument when it contains one or more embedded derivatives that are not closely related to the host contract. The fair value option can be used when it is not possible to separate the non-closely related embedded derivative from the host contract and then the entire hybrid instrument can be designated at fair value. This results that both the embedded derivative and the host contract are measured at fair value. the Bank uses this option when, for example, structured products contain non closely related embedded derivatives, in which case both the host contract and the embedded derivative are measured at fair value.

Financial liabilities measured at amortised cost

The Bank classifies most of its financial liabilities under this category, also those used to fund trading activities, when the trading intent is not present in the financial liabilities (e.g.: issued bonds). These financial liabilities are initially measured at cost, which is the fair value of the consideration received including transaction costs. Subsequently they are measured at amortised cost, which is the amount at which the funding liability was initially recognised minus principal repayments and plus or minus the cumulative amortisation of any difference between that initial amount and the maturity amount. The difference between the amount made available and the nominal value is recorded on an accruals basis as an interest expense. Interest expenses accrued, but not yet paid, are recorded under accruals and deferrals.

2.3.5.2 Financial liabilities – own credit risk

For financial liabilities designated at fair value, IFRS 9 requires measuring the financial liability on initial recognition at fair value. Thereafter fair value changes are recognized in the income statement, except for fair value changes related to the changes in own credit risk which are presented separately in OCI.

Accordingly, the fair value movement of the liability is presented in different parts: changes in own credit risk are presented in OCI and all other fair value changes are presented in the income statement under the line item “Net result from financial instruments at fair value through profit or loss”. The amounts recognized in OCI relating to the own credit risk are not recycled to the income statement even when the liability is derecognized and the amounts are realized. Although recycling is prohibited, the Bank transfers the amounts in OCI to other reserves within equity at derecognition. The only situation when the presentation of the own credit risk in OCI is not applied when this would create an accounting mismatch in the income statement.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

2.3.5.3 Financial liability – financial guarantee contract

A financial guarantee contract is a contract that requires the Bank to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. Such a contract is initially recognised at fair value and is subsequently measured at the higher of

- the amount determined in accordance with impairment provisions of IFRS 9 (see section “Financial Assets – Impairment”) and
- the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with the revenue recognition principle of IFRS 15.

2.3.6 Offsetting

The Bank offsets and presents only a net amount in the balance sheet of a financial asset and financial liability when and only when it has currently a legally enforceable right to set off the recognized amounts and intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

2.3.7 Hedge accounting

For the purposes of hedge accounting, hedges are classified into two categories: (a) fair value hedges which hedge the exposure to changes in the fair value of a recognized asset or liability; and (b) cash flow hedges which hedge exposure to variability in cash flows that is either attributable to a particular risk associated with a recognized asset or liability or a forecasted transaction.

At inception of the hedge relationship, the Bank formally documents the relationship between the hedged item and the hedging instrument, including the nature of the risk, the objective and strategy for undertaking the hedge and the method that will be used to assess the effectiveness of the hedging relationship.

Also at the inception of the hedge relationship, a formal assessment is undertaken to ensure the hedging instrument is expected to be highly effective in offsetting the designated risk in the hedged item. Hedges are formally assessed regularly. The frequency is defined in the hedging document. A hedge is regarded as highly effective if the changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated are expected to offset in a range of 80% to 125%. For situations where that hedged item is a forecast transaction, the Bank assesses whether the transaction is highly probable and presents an exposure to variations in cash flows that could ultimately affect the income statement.

Fair value micro hedging: In relation to fair value hedges which meet the conditions for hedge accounting, any gains or losses from the changes in fair value of the derivative are recognized immediately in the income statement together with changes in the fair value of the hedged item that are attributable to the hedged risk. Accrued interest income from interest rate swaps is recognized in Net Interest Income. If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then the hedge accounting is discontinued prospectively. Any adjustment up to the point of discontinuation that is made to a hedged item for which the effective interest method is used is amortised to the income statement over its remaining life or recognized directly when the hedged item is derecognized.

Fair value macro hedging: a group of derivatives can be viewed in combination and jointly designated as a hedging instrument. The Bank uses interest rate swaps to hedge the interest rate risk for a portfolio of financial instruments (loans, deposits, securities). Interest rate swaps are measured at fair value, with fair-value changes being reported in the income statement. Accrued interest income from interest rate swaps is recognized in Net Interest Income. The hedged amount of loans is measured in fair value as well, with fair value changes being reported in the income statement. If a hedge is ineffective, the cumulative fair value change in the hedged amount will be amortised to the income statement over the remaining lifetime of the hedged assets or will be immediately removed from the balance sheet if ineffectiveness is due to derecognition of the corresponding loans.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Cash flow hedges: In relation to cash flow hedges which meet the conditions for hedge accounting, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognized initially in the other comprehensive income in the cash flow hedge reserve. Any ineffective portion of changes in the fair value of a derivative is immediately recognized in the income statement. The amount recognized in OCI is reclassified to the income statement as a reclassification adjustment in the same period as the hedged cash flows affect the income statement. Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point in time, the cumulative gain or loss on a cash flow hedge recognized in the other comprehensive income remains in the other comprehensive income until the forecasted transaction occurs, when it is then transferred to the income statement for the period.

For hedges which do not qualify for hedge accounting and trading derivatives, any gains or losses arising from changes in the fair value of the hedging instrument are taken directly to the income statement for the period.

2.3.8 Participations

In the separate financial statement of the Bank, participations in subsidiaries and affiliated undertakings are measured at cost based on IAS 27, reduced by impairment determined in accordance with IAS 36. The carrying amount of other equity instruments with participating nature is determined in accordance with IFRS 9, such equity instruments are measured at fair value and impairment is not applied.

The Bank considers a participation in a subsidiary or in affiliated undertakings impaired, if there is a significant and permanent decrease in the fair value (and therefore the value of the participation decreases under the purchase value), or there is any objective evidence that the participation is impaired. Determining “Significant” and „permanent” requires a decision. „Significant” means generally 15% or more and “permanent” means more than 1 year.

2.3.9 Leasing

All leases need to be classified as either finance leases or operating leases. The classification under IAS 17 is based on the extent to which risk and rewards incidental to ownership of leased assets lie with the lessor or the lessee. A finance lease transfers substantially all the risks and rewards incidental to ownership of an asset.

2.3.9.1 The Bank, as a lessee

The starting date of a lease term is the date from when the lessee is eligible for the right to use the leased asset. This is the date of initial recognition, when all assets, liabilities, income and expenses are recognised.

Finance leases, which effectively transfer to the Bank substantially all the risks and benefits incidental to ownership of the leased item, are capitalized at the lower of the present value of the minimum lease payments or the fair value of the leased asset at the inception of the lease term, against a lease liability at the same amount. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Capitalized leased assets are depreciated over the shorter of the estimated useful life of the asset and the lease term.

The impairment requirements of non-financial assets must be applied to leased assets. Derecognition requirements of financial lease liabilities are based on IFRS 9.

Leases where the lessor effectively retains substantially all the risks and benefits of ownership of the leased asset, are classified as operating leases. Operating lease payments are recognized as an expense in the income statement on a straight-line basis over the lease term.

2.3.9.2 The Bank, as a lessor

When assets held are subject to a finance lease, the present value of lease payments and the unguaranteed residual value are recognized as a receivable. The difference between the gross receivable and the present value of the receivable is recognized as unearned finance income.

**FINANCIAL STATEMENTS
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NOTE 2 – ACCOUNTING POLICIES (continued)

Lease income is recognized over the term of the lease so as to achieve a constant rate of interest on the remaining balance of the receivable. The requirements on subsequent measurement are based on IAS 17, but for the impairment and derecognition of finance lease assets IFRS 9 must be applied.

Assets subject to operating leases are included in bank premises and equipment in the statement of financial position and lease payments received are presented as income in the income statement. When the Bank provides lease incentive to the lessee, the aggregate cost of incentives are treated as a reduction of rental income over the lease term.

In case of financing the purchase of a vehicle or other equipment, the main collateral is the vehicle or the other equipment, on which the Bank has got the right to buy. When the contract is extraordinarily terminated the assets received in the debt settlement are measured at cost which is defined as the fair value of the vehicle or other the equipment. If the carrying amount of the received asset differs from the value defined at the subsequent valuation of the asset then impairment is accounted for or the formerly booked impairment is fully or partially released.

2.3.10 Equity (Reserves)

Reserves in the financial statements of the Bank contains the following:

- In Other Comprehensive Income
 - revaluation reserve of financial instruments measured through other comprehensive income, where the fair value changes of FVOCI financial instruments are recognised.
 - accumulated amount of financial liabilities designated at fair value through profit or loss that is attributable only to the own credit changes of the Bank
 - hedging reserve, which is the gain or loss on the hedging instrument included in a cash flow hedge that is determined to be an effective hedge.
 - remeasurement of defined benefit plans: the actuarial gains and losses recognised as remeasurements of the net defined benefit (e.g. effect of change in yield curves applied for estimating or discounting, or changes in tax rates related to the benefit)
- Statutory risk reserve which is set aside as 10% of the profit calculated in accordance with Hungarian Accounting Regulations for use against future losses.
- Share premium which is the excess amount received by the Bank over the par value of its shares at the time of capital increase.

2.3.11 Dividend on ordinary shares

Dividends on ordinary shares are recognized as a liability and deducted from equity when they are approved by the shareholders. Interim dividends are deducted from equity when they are declared and no longer at the discretion of the Bank.

2.3.12 Share based payment transactions

A number of employees of the Bank receive remuneration in the form of share-based payment transactions. They are granted share appreciation rights, which can only be settled in cash (“cash-settled transactions”). The cost of cash-settled transactions is measured at fair value at the grant date, using the KBC share price determining the fair value. The value of the share-based payment is expensed in the year of the remunerated performance with recognition of a corresponding liability. The liability is valued at the closing price of the underlying share at the end of the period. The liability is released at the date of pay-out.

2.3.13 Investment property

Investment property is defined as a real estate property either built, purchased or acquired under a finance lease by the Bank, which is held to earn rentals or capital appreciations rather than used by the Bank for the supply of services or for administrative purposes.

The Bank subsequently measures investment property at initial cost minus accumulated depreciation and impairment losses.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Depreciation is provided on a straight-line basis during the useful life of the asset. The useful life of investment property is generally 33 years, except if the consideration of certain special circumstances results different useful lifetime.

2.3.14 Property, plant and equipment

Property, plant and equipment are tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and are expected to be used during more than one period. An item of property, plant and equipment is recognized as an asset only when it is probable that future economic benefits associated with the asset will flow to the entity and the cost of the asset can be measured reliably.

The Bank considers movables as tangible asset only above HUF 100,000 initial cost. Items under this amount – including decorative elements, art works with low value – are accounted for as material cost.

Property, plant and equipment is initially measured at cost. Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

After initial recognition subsequent cost can increase the carrying amount of an asset or can be recognized as a separate asset, if it is probable that future economic benefits associated with the asset will flow to the Bank and the cost can be measured reliably. The carrying amount of replaced components are derecognized. Repairs and maintenance are charged to the income statement as incurred

In case of compound assets, main components of these can differ regarding the economic characteristics. In this case the initial cost is divided among main components. Useful life, residual value and depreciation method is determined individually for every main components.

The subsequent measurement of property, plant and equipment is based on the cost model, i.e. property, plant and equipment are carried at initial cost less accumulated depreciation and any accumulated impairment losses.

Every part of property, plant and equipment, which represents significant value compared to the total initial cost of the asset is depreciated separately. Depreciation is calculated on a straight-line basis under the estimated useful life of the asset. Land, art works have unlimited useful lives, therefore are not depreciated.

The estimated useful lives of property, plant and equipment are the following:

Buildings	10-50 years
Leasehold rights	10-50 years
Leasehold improvements	3-20 years
Furniture, fixtures and equipment	3-7 years
System software	5 years

System software (operating systems) are initial software linked to the purchase of hardware, without whose installation the hardware will not function or operate. Such software regulates the internal operation of the computer and ensures communication with the configuration or the network, and thus includes operating systems, support software and compilers, therefore system software forms an integral part of related hardware.

The Bank prepares reassessment for the useful lives and the residual values at least on a yearly basis.

2.3.15 Intangible assets

An intangible asset shall be recognised if, and only if it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably.

Intangible assets can have a finite or indefinite useful life. The Bank owns intangible assets with finite useful life.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Intangible assets with finite lives are amortised over the useful economic life; the amortisation expense is recorded as operating expense in the income statements. The impairment assessment of intangible assets with finite lives is the same as tangible assets. Intangible assets with finite lives have no residual value, as the Bank does not intend to dispose the intangible assets before their economic useful lives.

The subsequent measurement of intangible assets is based on the cost model i.e. are carried at initial cost less accumulated amortisation and any accumulated impairment losses. Depreciation is calculated on a straight-line basis under the estimated useful life of the asset:

Standard software and other intangibles	5 years
Core banking software	8 years

Core banking systems are software handling back-end data processing applications for processing all transactions that have occurred during the day and posting updated data on account balances to the mainframe. Core systems typically include deposit account processing, loan and credit processing, interfaces to the general ledger and reporting tools.

The Bank owns purchased trademarks, the depreciation is based on the useful life determined in the purchase agreement.

2.3.16 Impairment of non-financial assets

When the Bank prepares financial statements it ensures that the carrying amount of the non-financial asset does not exceed the amount what could be obtained from either using or selling it (“recoverable amount”). Property, plant and equipment, investment property and software are subject to the impairment review only when an objective evidence of impairment indicator exists. The Bank reviews at least annually whether there are any indicators of impairment.

When an impairment indicator is present, or the impairment test of an asset must be prepared, the Bank estimates the asset’s recoverable amount. The recoverable amount is defined as the higher of fair value less cost to sell or the value in use, determined individually by assets, except if the economic benefits realized on the asset can not be separated from economic benefits realized on other assets or group of assets. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

2.3.17 Contingent liabilities

In the ordinary course of its business, the Bank enters into off-statement of financial position commitments such as guarantees, commitments to extend credit, letters of credit, warranties and transactions with financial instruments. These commitments are recorded in the financial statements if and when they become payable.

Taking into account that IFRS 9 and IAS 37 do not contain specific requirements related to the accounting treatment of commitments for issuing non-financial guarantees, the Bank treats them in the same way as financial guarantees.

To determine the allowance for losses on contingent liabilities the Bank uses the Expected Credit Loss model (ECL) (for details see Note 2.3.3 Financial assets – Impairment).

2.3.18 Provisions

Provisions are recognised at the reporting date if and only if there is a present obligation (legal or constructive) due to a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

When the timing effect is material, the amount recognised as a provision is the net present value of the best estimate.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Any compensation that arises in relation to provisions for operational losses from claims and legal disputes regarding commercial activity are presented in other income / (expense) when they become virtually certain.

When it is virtually certain that another party will repay the expenditure of the provisions, the reimbursement is treated as a separate asset.

2.3.19 Revenue recognition

2.3.19.1 Net interest and similar income

Net Interest Income falls under the scope of IFRS 9. Interest income and expense are calculated and recognised based on the effective interest rate method, or, if considered appropriate, based on a method that results in an interest income or interest expense that is a reasonable approximation of using the effective interest rate method as basis for the calculation. The effective interest includes fees considered to be part of the effective interest rate of a financial instrument (generally fees received as compensation for risk).

Interest income calculated using effective interest method is presented as a separate line item on the face of the income statement. Interest income related to assets held for trading, mandatorily at fair value through profit or loss and hedging derivatives are presented in a separate line item as “other similar income”.

Interest income and expenses from financial instruments are, with the exceptions described below classified as “Net Interest Income”.

For financial assets measured at amortised cost or debt instruments measured at fair value through other comprehensive income, the calculation of the interest income depends on the stage of the asset used in the calculation of ECL. For assets that are in stage 1 and stage 2 the interest recognition is based on the gross carrying amount while for assets in stage 3 on the carrying amount (including POCI). The gross carrying amount of a financial asset is defined as the amortised cost before adjusting for any loss allowance.

2.3.19.2 Net fee and commission income

The Bank presents the revenue of different transaction under this line item. Most of these fall under the scope of IFRS 15 Revenue from Contracts with Customers as they cover services and goods provided by the Bank to its customers while certain transactions reported under Commitment credit are accounted for under IFRS 9. The revenue recognised on these transactions reflect the amount of consideration to which it expects to be entitled in exchange for transferring goods or service to the customers. For the recognition of revenue the Bank needs to identify the contract and define what the promises are (performance obligations) in the transaction. Thereafter the transaction price is calculated and allocated to all performance obligations identified in the contract. Revenue is recognised only when the Bank has satisfied the performance obligation.

The revenue from fiduciary and trading services falls under the scope of IFRS 15. These transactions are straightforward because the Bank provides series of distinct services which is consumed by the customer simultaneously when the benefits are provided. The Bank is remunerated after executed transactions or on a timely basis, the fee is determined as a fixed amount or a percentage. The fee arrangements do not include variable compensation and revenue is estimated and recognised straightforward. Due to the nature of the promises the Bank recognises these revenues at that point in time or over time.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

Commitment credit represents revenue on fees received from lending and financial leasing business that are not considered as part of the Effective Interest Rate and consequently, have to be recognised under the scope of IFRS 15, except for financial guarantees which are accounted for in accordance with IFRS 9. This includes typically credit-related fees like loan administration fees or fees charged as prepayment fees. The Bank also recognises fees received for the issuance of guarantees, letters of credit, standby credit agreement and similar transactions. It also includes fees charged to companies with specific financing needs requiring integrated or highly complex structure. The terms applied by the Bank on these revenue do not contain complex arrangements and relates to a certain percentage of the transaction and variability is limited. The terms of the provided services are straightforward and are recognised in general at the point when the actual service has been performed or transferred to the customer except for financial guarantees for which the received fees are treated as income and recognised in general over time until expiry of the guarantee.

Fee income also contains fees related to payment services whereby the Bank charges the customer for different transactions linked with its current accounts, domestic or foreign payments, payment services through ATM, etc. These services are mainly completed when the actual transaction is executed therefore the relating consideration can be recognised directly at that point in time.

2.3.20 Employee benefits

2.3.20.1 Short-term employee benefits

Short-term employee benefits, such as salaries, paid absences, performance-based cash awards and social security costs are recognised over the period in which the employees provide the related services. The relating expenses are presented under the income statement as Staff expenses.

2.3.20.2 Post-employment benefits

A number of employees of the Bank receive post-employment benefits in the form of defined benefit plans. The defined benefit plan belongs to post-employment benefits. The components of the benefit costs related to the program are recorded as follows in the financial statements:

- vested benefits and costs arising from the change of the program's conditions as personal expenses in the income statement
- interest expenses related to the defined benefit plan as interest expense in the income statement
- the revaluation of the defined benefit plan (e.g. impact of change of the curves used to the estimation and discount calculation or change of the tax rate related to the benefit) in other comprehensive income.

2.3.21 Government grants

Government grants are assistance by government in the form of transfers of resources to the Bank in return for past or future compliance with certain conditions relating to the operating activities of the entity.

Government grants are recognised when there is a reasonable assurance that the grant will be received and the conditions attached to it will be met. The grants are recognised in the income statement in a systematic basis to match the way that the Bank recognises the expenses for which the grants are intended to compensate.

Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset. The Bank applies the deferred income (gross) presentation method.

2.3.22 Levies

Public authorities could impose different levies on the Bank. The amount of the levies can be dependent on the amount of revenue (mainly interest) generated by the Bank, on the amount of deposits accepted from customers, on the total balance sheet volume with corrections based on some specific ratio's. Levies are recognised, in accordance with IFRIC 21, when the obligating event that gives rise to the recognition of the liability, as stated in the relevant legislation, has occurred. Depending on the obligating event, levies can be recognised at one point or over time. The majority of the levies imposed on the Bank have to be recognised at one point, which occurs mainly at the beginning of the financial year. The Bank recognises the levies as part of Operating Expenses (See Note 2.6).

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

2.3.23 Income tax

Income tax consists of two elements: current year's taxes paid/payable and changes in deferred tax assets/liabilities. Income tax is accounted for either in the income statement or in the Other Comprehensive Income depending on where the items that triggered the tax are accounted for. Income taxes that are initially accounted for in the Other Comprehensive Income and that relate to gains/losses that are subsequently recognised in the income statement, are recycled in the income statement in the same period that the item is accounted for in the income statement. Current taxation is provided for in accordance with the fiscal regulations of Hungary.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date.

Deferred tax liabilities are recognized for all taxable temporary differences. Deferred tax assets are recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized.

Deferred tax assets are recognised for the carry-forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.

Deferred and current tax assets and liabilities are offset only if the Bank has a legally enforceable right to set off, and the Bank intend to settle them on a net basis or to realize the assets and settle the liabilities simultaneously

2.3.24 Non-current assets held-for-sale, liabilities associated with disposal groups

Non-current assets or group of assets and liabilities held for sale are those for which the Bank will recover the carrying amount from a sale transaction that is expected to qualify as a sale within a year, instead of through continuing use. Non-current assets held for sale and liabilities held for sale are reported separately from the other assets and liabilities in the balance sheet at the end of the reporting date.

Non-current assets held for sale (disposals groups) are not depreciated but measured at the lower of their carrying amount and fair value less costs to sell.

2.3.25 Fiduciary assets

Assets held in trust or in a fiduciary capacity are not assets of the Bank and accordingly are not included in these financial statements.

2.3.26 Events after reporting period

Events after the reporting date are defined as favourable or unfavourable events that occur between the reporting date and the date that the financial statements are authorised for issue. There are two types of events after the reporting period:

- those which provide evidence of conditions that existed at the reporting date (adjusting events)
- those that are indicative of conditions that arose after the reporting date (non-adjusting events).

The impact of adjusting events has already been reflected in the financial position and performance of the current year.

The impact and consequences of the non-adjusting events are disclosed in the notes of the financial statements.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTE 2 – ACCOUNTING POLICIES (continued)****2.4 Transition from IAS 39 to IFRS 9 Financial Instruments**

In July 2014, the IASB issued IFRS 9 Financial Instruments on the classification and measurement of financial instruments, as a replacement for the relevant requirements of the present IAS 39 Financial Instruments: Recognition and Measurement. The mandatory effective date for IFRS 9 was 1 January 2018.

Classification and measurement

Under IAS 39, how assets are classified generally determines the basis for their measurement. Under IFRS 9, the reverse is true—the basis on which assets are measured is the way they are classified.

Comparison of classification and measurement categories of IAS 39 and IFRS 9 are the following:

IAS 39 classification – measurement	IFRS 9 classification and measurement
Loans and receivables – Amortized Cost	Amortized cost
Held for trading – FVPL	FVPL
Available for sale – FVOCI	FVOCI
Held to maturity – Amortized Cost	

Impairment

Under IAS 39 the Bank assessed at each statement of financial position date whether there was any objective evidence that a financial asset or group of financial assets was impaired. A financial asset or group of financial assets was deemed to be impaired if, and only if, there was objective evidence of impairment as a result of one or more events that had occurred after the initial recognition of the asset (an incurred “loss event”) and that loss event (or events) had an impact on the estimated future cash flows of the financial asset or the group of financial assets that could be reliably estimated.

Under IFRS 9 Financial instruments that are subject to impairment are classified into three stages, namely

- stage 1: performing;
- stage 2: underperforming (where lifetime expected credit losses are required to be measured); and
- stage 3: non-performing.

For 'stage 1' and 'stage 2' – under IAS 39 – the Bank recorded incurred-but-not-reported (IBNR) impairment losses, which were influenced by emergence periods. Under IFRS 9, impairment of financial assets is calculated on a 12-month expected credit loss (ECL) basis for 'stage 1' and on a lifetime ECL basis for 'stage 2'.

Hedge accounting

The Bank used the option to continue with hedge accounting under IAS 39 and await further developments at the IASB regarding macro hedging.

This Note contains only a summary of the main elements, detailed IAS 39 accounting policies were presented in the previous year's financial statements.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

2.5 Changes in accounting policies

2.5.1 Adoption of new or revised standards and interpretations

Adoption of IFRS 9 “Financial Instruments” (issued on 24 July 2014 and effective for annual periods beginning on or after 1 January 2018). The Bank adopted IFRS 9 Financial Instruments, from 1 January 2018. The Bank elected not to restate comparative figures and recognised any adjustments to the carrying amounts of financial assets and liabilities in the opening retained earnings as of the date of initial application of the standard, 1 January 2018. Consequently, the revised requirements of the IFRS 7 Financial Instruments: Disclosures, have only been applied to the current period. The comparative period disclosures repeat those disclosures made in the prior year.

In May 2014, the IASB issued IFRS 15 concerning the recognition of revenue. The new standard became effective on 1 January 2018. The Bank has identified the relevant contracts and assessed them using the new five-step model for revenue recognition. The main focus related to the

- identification of the performance obligations
- variable consideration in certain asset management contracts.

No major impact was identified.

The significant new accounting policies applied in the current period are described in Note 3. Accounting policies applied prior to 1 January 2018 and applicable to the comparative information are disclosed in Note 2.4.

The following amendments are applied for annual periods beginning on or after 1 January 2018, but their impact is negligible:

- Amendments to IFRS 15 Revenue from Contracts with Customers
- Amendments to IFRS 2 Share-based Payment
- Annual Improvements to IFRSs 2014-2016 cycle - Amendments to IFRS 1 and IAS 28
- IFRIC 22 - Foreign Currency Transactions and Advance Consideration
- Transfers of Investment Property - Amendments to IAS 40

2.5.2 New accounting pronouncements

The Bank has not applied the following IASs, IFRSs and Interpretations of the International Financial Reporting Interpretations Committee (IFRIC) that have been issued but are not yet effective. The Bank will apply these standards when they become mandatory.

IFRS 16 Leases

In January 2016, the IASB issued IFRS 16, which became effective on 1 January 2019. The new standard sets out the principles for the recognition, measurement, presentation and disclosure of leases. All leases result in the lessee obtaining the right to use an asset at the start of the lease and, if lease payments are made over time, also obtaining financing. Accordingly, IFRS 16 eliminates the classification of leases as either operating leases or finance leases as is required by IAS 17 and, instead, introduces a single lessee accounting model. Lessees will be required to recognise: assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value; and depreciation of lease assets separately from interest on lease liabilities in the income statement. IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently. The Bank decided that it will apply the standard using the modified retrospective method, without restatement of comparatives.

The Bank recognised a right of use asset of HUF 11 909 million against a corresponding discounted lease liability on 1 January 2019. The lease liability was determined by using the recognition exemptions of IFRS 16 (short term and low value leases are out of scope).

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

IFRS 17 Insurance contracts

In May 2017, the IASB issued IFRS 17 (Insurance contracts), which will become effective on 1 January 2021. IFRS 17 is a single principle-based standard to account for all types of insurance contracts, including reinsurance contracts that an insurer holds.

As the Bank does not provide insurance services, no major impact was identified.

Other changes

The IASB published several limited amendments to existing IFRSs in the course of 2018. They will be applied when they become mandatory, but their impact is currently estimated to be negligible.

The list of amendments:

- IFRIC 23 Uncertainty over Income Tax Treatments
Effective from: 1 January 2019
- Long-term Interests in Associates and Joint Ventures - Amendments to IAS 28
Effective from: 1 January 2019
- Annual Improvements to IFRSs 2015-2017 cycle
Effective from: 1 January 2019
- IAS 19 - "Plan Amendment, Curtailment or Settlement"
Effective from: 1 January 2019
- Conceptual framework
Effective from: 1 January 2019
- Prepayment Features with Negative Compensation – Amendments to IFRS 9
Effective from: 1 January 2019
- Definition of a business – Amendments to IFRS 3
Effective from: 1 January 2020
- Definition of materiality – Amendments to IAS 1 and IAS 8
Effective from: 1 January 2020

2.6 Taxes and levies payable by financial institutions

Credit institutions and financial institutions are exposed to pay the so called "bank tax" introduced in 2010 in Hungary (see Note 11). The actual bank tax and its reversal (if any) are recorded as expense in the financial period in which it is legally payable. As the bank tax is payable based on non-net income measures it does not meet the definition of income tax under IFRS and is therefore presented as an operating expense in the income statement.

The IFRIC 21 Levies interpretation identifies the obligating event for the recognition of a liability as the activity that triggers the payment of the levy in accordance with the relevant legislation. Based on the interpretation of IFRIC 21 the "bank tax" amount is recognized at the beginning of the year in a lump sum in the Bank's Financial Statements.

In 2013 a tax called financial transaction levy (FTL) has been introduced. The FTL is payable based on specified type of transactions (including cash movements and money transfers). Subject of the levy are financial service providers (with seat or branch in Hungary). The FTL is recorded as part of general administrative expenses when the underlying business transaction occurs.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 2 – ACCOUNTING POLICIES (continued)

In the case of bankcard transactions the FTL is recognized at the beginning of the year in a lump sum, because the base of this levy is the bankcard transactions of the previous year that triggers the payment obligation of the levy at the beginning of the year.

The Investor Protection Fund (IPF) is established to provide indemnity to investors against property damages arising from the potential insolvency of investment service providers. Members make annual contribution payments to the IPF. Based on the interpretation of IFRIC 21 the amount is recognized at the beginning of the year in a lump sum in the Bank's Financial Statements.

The Resolution Fund was established in 2014 to shift the costs of crisis management in the financial sector to the members of the sector. The Fund is financed by credit institutions and investment firms from the annual fees paid by the members. According to IFRIC 21 the Bank records the total annual fee at the beginning of the period.

2.7 Change in estimate

The Bank has not changed the valuation methods used for valuation of the assets and liabilities presented in the Financial statement except from the transition to IFRS 9 (see Note 3) in 2018.

2.8 Reclassifications

Some of the notes in the Financial Statements were changed in comparison with the previous year's presentation. The changed categories are marked in the concerned notes.

The reclassified notes are the following:

- Income statement
- Statement of financial position
- Note 6 - Net gains / (losses) from financial instruments at fair value through profit or loss
- Note 9 – Other income and expense
- Note 14 - Financial assets and financial liabilities, breakdown by portfolio and product
- Note 36 – Finance and operating leases
- Note 39 – Auditor's remuneration

Foreign exchange differences and gains on the disposal of debt securities at amortised cost (held-to maturity in 2017) are shown separately in the income statement. The related notes were changed accordingly.

In Note 14 the table presenting Assets pledged as collateral, securities pledged to ensure the safety of the Continuous Linked Settlement (CLS) system are not presented anymore whereas mortgage loans pledged for mortgage refinancing loans were added to the table. The changes were applied retrospectively. Related changes were done in the statement of financial position.

In Note 36 – Finance and operating leases the future minimum lease payments of finance leases (lessee position) were amended by the residual values.

The classification of services provided by external auditors into the audit fee categories used in Note 39 were reviewed and fine-tuned in 2018. Some types of audit fees were reclassified from statutory audit services to non-audit services provided by statutory auditor.

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FOR THE YEAR ENDED 31 DECEMBER 2018****NOTE 2 – ACCOUNTING POLICIES (continued)**

The reclassifications caused the following changes in the Income Statement in 2017.

	Before reclassification 2017	Reclassifi- cation	After reclassification 2017
	MHUF	MHUF	MHUF
Income statement			
Net gains / (losses) from financial instruments at fair value through profit or loss	18 299	(8 491)	9 808
Foreign exchange differences	-	8 491	8 491
Other income	4 330	(100)	4 230
Gains on the disposal of held-to-maturity debt instruments	-	100	100
	Before reclassification 2017	Reclassifi- cation	After reclassification 2017
	MHUF	MHUF	MHUF
Statement of financial position			
Loans and receivables assets pledged as collateral	15 852	76 716	92 568
Held to maturity assets pledged as collateral	221 365	(106 500)	114 865

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 3 – TRANSITION TO IFRS 9

Classification and measurement

The Bank reclassified its financial assets due to the transition to IFRS 9 and changed their valuation accordingly.

- 1) The Bank did not change the classification and measurement of cash and cash balances with central banks and other demand deposits with credit institutions, held-for-trading financial assets, hedging derivatives, other assets and financial and non-financial liabilities.
- 2) In some cases the change in the classification did not result in the change of measurement:
 - available-for-sale debt securities with a fair value of HUF 70 176 million and available-for-sale equity instruments in an amount of HUF 1 857 million were reclassified to financial assets valued at fair value through other comprehensive income
 - debt securities of HUF 14 148 million classified as loans and receivables under IAS 39 were shifted to financial assets valued at amortised cost
 - net carrying amount of loans and advances classified as loans and receivables amounted to HUF 1 740 885 million under IAS 39 and were reclassified to financial assets valued at amortised cost under IFRS 9
- 3) Debt securities in an amount of HUF 122 176 million were reclassified from available-for-sale debt securities to debt securities valued at amortised cost. From the fair value of HUF 11 176 million a positive fair value adjustment of HUF 10 479 million was reversed against accumulated revaluation reserve of securities.

The fair value of reclassified debt securities not matured at the end of the period amounted to HUF 29 375 million in 2018. The fair value result that would have been recognised in other comprehensive income during the period if debt securities had not been reclassified was HUF 2 173 million loss in 2018 (no result would have been recorded in the income statement in 2018).

- 4) For a portfolio of the previously mentioned debt securities fair value hedge accounting was applied under IAS 39. Since the valuation of these debt securities changed from fair value to amortised cost, hedge accounting was discontinued under IFRS 9. The positive fair value adjustment on the hedged item was derecognised in accumulated revaluation reserve of securities.
- 5) Some loan contracts valued as loans and receivables under IAS 39 failed the SPPI test according to IFRS 9 therefore the Bank changed their valuation to fair value instead of amortised cost and reclassified them to financial assets valued mandatorily at fair value through profit or loss. The fair value adjustment of the loans amounted to HUF 913 million loss as at the date of transition although the loss was compensated in the accumulated result by the gain resulting from the reversal of the impairment recognised previously under IAS 39.
- 6) The Bank had held-to-maturity debt securities under IAS 39 which were reclassified from the available-for-sale portfolio in previous years. The fair value adjustment of these securities had been frozen at the date of reclassification under IAS 39 and amortised into the profit or loss during the lifetime of the asset. By the implementation of IFRS 9 the frozen fair value adjustment had to be reversed against accumulated revaluation reserve of securities. The reversal of frozen available-for-sale reserve on held-to maturity debt securities caused a loss of HUF 3 302 million in accumulated revaluation reserve of securities.

Impairment

The Bank changed its policy related to the recognition of impairments according to IFRS 9. The first time application impact of the transition to IFRS 9 impairments amounted to a loss of HUF 4 805 million at the date of transition and was recorded in the accumulated result. The detailed impact of the change is presented in the tables below.

Deferred tax

The transition to IFRS 9 had a tax impact of HUF 1 768 million gain from which a gain of HUF 370 million was recorded in the accumulated profit and a gain of HUF 1 398 million in accumulated revaluation reserve of securities.

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 3 – TRANSITION TO IFRS 9 (continued)

Assets under IAS 39 at 31 December 2017	Cash and cash bal. and other dem. depo. MHUF	Held-for-trading MHUF	Available-for-sale		Held-to-maturity MHUF	Loans and receivables			Total assets under IAS 39 MHUF	Total FTA on assets MHUF	Total assets under IFRS 9 MHUF
			Debt securities MHUF	Equity instruments MHUF		Debt securities MHUF	Loan and advances MHUF	Other* MHUF			
Assets under IFRS 9 at 1 January 2018											
Cash and cash bal. and other dem. depo.											
Carrying amount according to IAS 39	437 846	-	-	-	-	-	-	-	437 846		
Impact of transition to IFRS 9	5	-	-	-	-	-	-	-		5	
Carrying amount according to IFRS 9	437 851	-	-	-	-	-	-	-			437 851
Financial assets											
Held-for-trading	-	98 193	-	-	-	-	-	-	98 193		98 193
Mand. at fair value through profit or loss											
Carrying amount according to IAS 39	-	-	-	-	-	-	21 451	-	21 451		
Reversal of IBNR impairment	-	-	-	-	-	-	25	-		25	
Reversal of specific impairment	-	-	-	-	-	-	842	-		842	
Recognition of fair value adjustment	-	-	-	-	-	-	(913)	-		(913)	
Carrying amount according to IFRS 9	-	-	-	-	-	-	21 405	-			21 405
At fair value through other comp. income	-	-	70 176	1 857	-	-	-	-	72 033		72 033

*Other includes all financial and non-financial assets in the statement of financial position not mentioned in separate column in this table.

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**FINANCIAL STATEMENTS
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NOTE 3 – TRANSITION TO IFRS 9 (continued)

Assets under IAS 39 at 31 December 2017	Cash and cash bal. and other dem. depo. MHUF	Held-for-trading MHUF	Available-for-sale		Held-to-maturity MHUF	Loans and receivables			Total assets under IAS 39 MHUF	Total FTA on assets MHUF	Total assets under IFRS 9 MHUF
			Debt securities MHUF	Equity instruments MHUF		Debt securities MHUF	Loan and advances MHUF	Other* MHUF			
Assets under IFRS 9 at 1 January 2018											
At amortised cost											
Carrying amount according to IAS 39	-	-	122 176	-	423 500	14 148	1 740 885	-	2 300 709		
Reversal of fair value adjustment recognised as frozen AFS reserve	-	-	-	-	(3 302)	-	-	-		(3 302)	
Reversal of fair value adj. due to reclass.	-	-	(10 479)	-	-	-	-	-		(10 479)	
Reversal of IBNR impairment	-	-	-	-	69	-	3 209	-		3 278	
Reversal of specific impairment	-	-	-	-	-	-	30 121	-		30 121	
Recognition of stage 1 impairment	-	-	(119)	-	(419)	-	(1 904)	-		(2 442)	
Recognition of stage 2 impairment	-	-	-	-	-	-	(5 706)	-		(5 706)	
Recognition of stage 3 impairment	-	-	-	-	-	-	(29 728)	-		(29 728)	
Carrying amount according to IFRS 9	-	-	111 578	-	419 848	14 148	1 736 877	-			2 282 451
Hedging derivatives	-	-	-	-	-	-	-	23 064	23 064		23 064

*Other includes all financial and non-financial assets in the statement of financial position not mentioned in separate column in this table.

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**FINANCIAL STATEMENTS
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NOTE 3 – TRANSITION TO IFRS 9 (continued)

Assets under IAS 39 at 31 December 2017	Cash and cash bal. and other dem. depo. MHUF	Held-for-trading MHUF	Available-for-sale			Loans and receivables			Total assets under IAS 39 MHUF	Total FTA on assets MHUF	Total assets under IFRS 9 MHUF
			Debt securities MHUF	Equity instruments MHUF	Held-to-maturity MHUF	Debt securities MHUF	Loan and advances MHUF	Other* MHUF			
Assets under IFRS 9 at 1 January 2018											
Fair value changes of hedged item under portfolio hedge of interest rate risk											
Carrying amount according to IAS 39	-	-	-	-	-	-	-	-	-	-	-
Reversal of FV adj. of hedged item due to reclass.	-	-	-	-	-	-	-	1 360		1 360	
Carrying amount according to IFRS 9	-	-	-	-	-	-	-	1 360			1 360
Deferred tax assets											
Carrying amount according to IAS 39	-	-	-	-	-	-	-	-	-	-	-
Impact of transition to IFRS 9	-	-	-	-	-	-	-	826		826	
Carrying amount according to IFRS 9	-	-	-	-	-	-	-	826			826
Other assets*											
Carrying amount according to IAS 39	-	-	-	-	-	-	-	88 020	88 020		
Recognition of stage 2 impairment	-	-	-	-	-	-	-	(18)		(18)	
Carrying amount according to IFRS 9	-	-	-	-	-	-	-	88 002			88 002
Total carrying amount according to IAS 39	437 846	98 193	192 352	1 857	423 500	14 148	1 762 336	111 084	3 041 316		
Total FTA on assets	5	-	(10 598)	-	(3 652)	-	(4 054)	2 168		(16 131)	
Carrying amount according to IFRS 9	437 851	98 193	181 754	1 857	419 848	14 148	1 758 282	113 252			3 025 185

*Other includes all financial and non-financial assets in the statement of financial position not mentioned in separate column in this table.

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTE 3 – TRANSITION TO IFRS 9 (continued)

Liabilities under IAS 39 at 31 December 2017	Deferred tax liability MHUF	Provisions for risks and charges and credit commitments MHUF	Total liabilities concerned under IAS 39 MHUF	Total FTA on liabilities MHUF	Total liabilities concerned under IFRS 9 MHUF
Liabilities under IFRS 9 at 1 January 2018					
Deferred tax liability					
Carrying amount according to IAS 39	942	-	942		
<i>Impact of transition to IFRS 9</i>	(942)	-		(942)	
Carrying amount according to IFRS 9	-	-			-
Provisions for risks and charges and credit commitments					
Carrying amount according to IAS 39	-	1 559	1 559		
<i>Reversal of IBNR impairment</i>	-	(277)		(277)	
<i>Reversal of specific impairment</i>	-	(1 097)		(1 097)	
<i>Recognition of stage 1 impairment</i>	-	218		218	
<i>Recognition of stage 2 impairment</i>	-	641		641	
<i>Recognition of stage 3 impairment</i>	-	784		784	
Carrying amount according to IFRS 9	-	1 828			1 828
Total carrying amount according to IAS 39	942	1 559	2 501		
<i>Total FTA on liabilities</i>	(942)	269		(673)	
Carrying amount according to IFRS 9	-	1 828			1 828
Total FTA on assets and liabilities	-	-	-	(15 458)	-

The table includes only the liabilities concerned by transition to IFRS 9.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 3 – TRANSITION TO IFRS 9 (continued)

The following tables present the first time application impact of transition to IFRS 9 for loans and advances by asset classes (also including cash balances with central banks and other demand deposits to credit institutions) as at 1 January 2018.

	Gross carrying amount according to IAS 39	Accumulated impairment according to IAS 39	Gross carrying amount according to IFRS 9	Accumulated fair value adjustment according to IFRS 9
	MHUF	MHUF	MHUF	MHUF
Loans and advances mandatorily fair value through profit or loss under IFRS 9				
General government	123	-	124	-
Corporate	6 129	(9)	6 131	(7)
of which: Small and Medium enterprises	638	(6)	640	(6)
Households	15 697	(489)	16 044	(887)
Mortgage loan	15 680	(489)	16 027	(887)
Term loan	17	-	17	-
	<u>21 949</u>	<u>(498)</u>	<u>22 299</u>	<u>(894)</u>
Total	<u>21 949</u>	<u>(498)</u>	<u>22 299</u>	<u>(894)</u>

The Bank believes that the net carrying amount of the loans at the date of transition best represented their fair value.

	Gross carrying amount according to IAS 39	Accumulated impairment according to IAS 39	Gross carrying amount according to IFRS 9	Accumulated impairment according to IFRS 9
	MHUF	MHUF	MHUF	MHUF
Cash balances with central banks and other demand deposits with credit institutions and loans and advances at amortised cost under IFRS 9				
Central bank and credit institutions	832 394	(9)	832 409	(31)
General government	48 977	(4)	48 978	(12)
Corporate	727 152	(12 152)	727 465	(12 838)
of which: Small and Medium enterprises	457 376	(10 691)	457 567	(11 285)
Households	566 250	(20 667)	575 380	(33 395)
Consumer credit	36 351	(1 175)	37 023	(1 864)
Credit card	5 980	(132)	5 980	(195)
Current account	13 825	(888)	13 821	(997)
Finance lease	3 002	(400)	3 004	(414)
Mortgage loan	485 531	(17 900)	494 558	(29 822)
Term loan	21 561	(172)	20 994	(103)
	<u>2 174 773</u>	<u>(32 832)</u>	<u>2 184 232</u>	<u>(46 276)</u>
Total	<u>2 174 773</u>	<u>(32 832)</u>	<u>2 184 232</u>	<u>(46 276)</u>

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 3 – TRANSITION TO IFRS 9 (continued)

The following tables present how the transition impacted the accumulated profit and other comprehensive income.

	Total FTA	FTA recognised in accumulated profit	FTA recognised in accumulated revaluation reserve of securities
	MHUF	MHUF	MHUF
Change of assets			
Cash and cash balances with central banks and other demand deposits to credit institutions			
Carrying amount according to IAS 39			
<i>Recognition of stage 1 impairment</i>	5	5	-
Carrying amount according to IFRS 9			
Financial assets			
Held-for-trading	-	-	-
Mandatorily at fair value through profit or loss			
Carrying amount according to IAS 39			
<i>Reversal of IBNR impairment</i>	25	25	-
<i>Reversal of specific impairment</i>	842	842	-
<i>Recognition of fair value adjustment</i>	(913)	(913)	-
Carrying amount according to IFRS 9			
At fair value through other comp. income	-	-	-
At amortised cost			
Carrying amount according to IAS 39			
<i>Reversal of fair value adjustment recognised as frozen AFS reserve</i>	(3 302)	-	(3 302)
<i>Reversal of fair value adj. due to reclass.</i>	(10 479)	-	(10 479)
<i>Reversal of IBNR impairment</i>	3 278	3 278	-
<i>Reversal of specific impairment</i>	30 121	30 121	-
<i>Recognition of stage 1 impairment</i>	(2 442)	(2 442)	-
<i>Recognition of stage 2 impairment</i>	(5 706)	(5 706)	-
<i>Recognition of stage 3 impairment</i>	(29 728)	(29 728)	-
Carrying amount according to IFRS 9			
Hedging derivatives	-	-	-

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS****NOTE 4 – NET INTEREST AND SIMILAR INCOME**

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Financial assets at amortised cost	72 815	-
Loans and receivables	-	52 670
Held to maturity	-	19 566
Financial assets at fair value through other comprehensive income	2 076	-
Available-for-sale assets	-	5 427
Positive interest on financial liabilities	377	1 201
Interest income calculated using the effective interest method	75 268	78 864
Financial assets held for trading	283	1 612
Financial assets mandatorily fair value through profit or loss other than held for trading	681	-
Asset/liability management derivatives	1 222	722
Hedging derivatives	10 968	11 524
Other similar income	13 154	13 858
Total interest and similar income	88 422	92 722
Financial liabilities measured at amortised cost	(6 501)	(10 625)
Other	(661)	(703)
Negative interest on financial assets	(2 043)	(1 352)
Interest expense calculated using the effective interest method	(9 205)	(12 680)
Financial liabilities held for trading	0	(30)
Asset/liability management derivatives	(829)	(181)
Hedging derivatives	(2 059)	(3 838)
Other financial liabilities at fair value through profit or loss	(2 157)	(4 004)
Interest and similar expense of defined benefit plans	(12)	(16)
Other similar expense	(5 057)	(8 069)
Total interest and similar expense	(14 262)	(20 749)
Net interest and similar income	74 160	71 973

The Bank recorded HUF 101 million interest income (unwinding discount effect) on impaired assets in 2018 (HUF 147 million in 2017).

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS****NOTE 5 – NET FEE AND COMMISSION INCOME**

	2018	Reclassified 2017
	MHUF	MHUF
Credit and guarantee fee income	3 885	3 472
Structured finance	442	81
Total fee income related to financial instruments not at fair value through profit or loss	<u>4 327</u>	<u>3 553</u>
Brokerage services	1 270	1 558
Trust and fiduciary activities	7 398	6 601
Payment services	47 685	43 058
Card services	13 236	11 949
Other	<u>3 164</u>	<u>2 448</u>
Fee and commission income	<u>77 080</u>	<u>69 167</u>
Brokerage services	(963)	(714)
Credit and guarantee fee expense	(2 146)	(1 964)
Commissions to agents	(239)	(214)
Structured finance	(60)	(5)
Payment transactions	(5 208)	(5 060)
Card services	(7 669)	(6 700)
Insurance commissions	(3 279)	(2 993)
Other	<u>(284)</u>	<u>(43)</u>
Fee and commission expense	<u>(19 848)</u>	<u>(17 693)</u>
Net fee and commission income	<u><u>57 232</u></u>	<u><u>51 474</u></u>

Front-end fees related to financial assets at amortised cost (loans and receivables) are part of the effective interest rate method calculation and are recorded as interest income or expenses over the life of the underlying asset.

Although the Bank is in the scope of IFRS 15, the disclosures prescribed by the standard are not presented due to immateriality.

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS****NOTE 6 – NET GAINS / (LOSSES) FROM FINANCIAL INSTRUMENTS AT FAIR VALUE THROUGH PROFIT OR LOSS**

	<u>2018</u> <u>MHUF</u>	<u>Reclassified</u> <u>2017</u> <u>MHUF</u>
Trading securities	(90)	(1 054)
Interest rate derivatives (including interest and fair value changes in trading derivatives)	7 303	2 138
Other financial liabilities designated at fair value through profit or loss	2 643	1 355
Mandatorily at fair value through profit or loss other than held for trading	1 554	-
Foreign exchange trading (including interest and fair value changes in trading foreign exchange derivatives)	(4 291)	7 473
Fair value adjustments in hedge accounting*	233	(104)
	<u>7 352</u>	<u>9 808</u>
Net gains / (losses) from financial instruments at fair value through profit or loss	<u>7 352</u>	<u>9 808</u>

*Results of cash flow hedge derivatives transferred from other comprehensive income to the income statement amounted to HUF 427 million gain in 2018 (HUF 129 million gain in 2017) and HUF 194 million loss was recorded as the unrealised revaluation of the ineffective cash flow hedge transactions (HUF 233 million loss in 2017).

The initial positive net present value on MIRS (Monetary Interest Rate Swap) deals conducted with the National Bank of Hungary resulted in a HUF 6 171 million income in 2018 and is included in Interest rate derivatives in this note.

The change in the fair value of financial instruments at fair value through profit or loss, where the fair value calculation is based on non-observable parameters was HUF 423 million gain in 2018 (HUF 9 million gain in 2017).

HUF 748 million income was accounted for in 2018 due to the lending activity related interest rate swap deals linked to the National Bank of Hungary's Market Lending Scheme (HUF 805 million income in 2017) according to the accounting treatment of government grants described in Note 2.

NOTE 7 – NET REALISED GAINS FROM AVAILABLE-FOR-SALE SECURITIES AND SECURITIES AT FAIR VAUE THROUGH OTHER COMPREHENSIVE INCOME

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Fixed-income assets	(251)	534
Net realised gains from fixed income assets	<u>(251)</u>	<u>534</u>

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 8 – DIVIDEND INCOME

The Bank recognised HUF 1 981 million dividend income in 2018 (HUF 2 225 million in 2017).

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
K&H Befektetési Alapkezelő Zrt.	1 827	2 078
K&H Csoportszolgáltató Kft	45	27
K&H Ingatlanlízíng Zrt.	100	80
HAGE Zrt.	-	27
VISA inc	9	13
	<u>1 981</u>	<u>2 225</u>

NOTE 9 – OTHER INCOME AND EXPENSE

	<u>2018</u> <u>MHUF</u>	<u>Reclassified</u> <u>2017</u> <u>MHUF</u>
Gain on property, plant and equipment	2 587	168
Gain on sale of goods	179	204
Gain on other services	391	375
Recoveries related to operational risk	59	108
Other income - other	689	3 375
Gain on the sale of associated companies	282	-
	<u>4 187</u>	<u>4 230</u>

The Bank sold one of its buildings located in Budapest in January 2018. The building was presented as non-current assets held for sale and disposal groups in the financial position and was measured at the carrying amount since it was lower than its fair value less costs to sell in 2017. The Bank realised a HUF 2 257 million gain on the disposal in 2018.

The Bank sold its investment in HAGE Zrt. in 2018. The result realised on the sale was HUF 282 million gain and was recorded as Other income in the Income statement.

The income of HUF 391 million reported as revenue on other services in 2018 (HUF 375 million 2017) results from finance and accounting, business management, technical, logistics and bank security services granted by the Bank to other KBC Group entities operating in Hungary.

In case of impaired loans and advances converted to HUF the subsequent increase in future cash-flow estimation due to credit quality improvement recorded within "Other income" resulted in a HUF 2 737 million gain in 2017. The subsequent decrease in future cash-flow estimation due to credit quality worsening was recorded as part of impairments for all loans and advances. Under IFRS 9 these loans are reported as loans purchased or originated as credit impaired (POCI) and the changes in their credit risk is reflected as impairment in the Income statement.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 9 – OTHER INCOME AND EXPENSE (continued)

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Losses on property, plant and equipment	(7)	-
Losses due to operational risks	(423)	(659)
Other expense - other	(341)	(312)
	<hr/>	<hr/>
Other expense	(771)	(971)
	<hr/> <hr/>	<hr/> <hr/>

NOTE 10 – GENERAL ADMINISTRATIVE EXPENSES

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
IT expenses	(9 296)	(8 839)
Rental expenses	(2 553)	(2 475)
Repair and maintenance	(1 500)	(1 314)
Marketing expenses	(1 365)	(1 455)
Professional fees	(3 265)	(3 213)
Other facilities expenses	(4 984)	(4 882)
Communication expenses	(323)	(343)
Travel expenses	(125)	(113)
Training expenses	(553)	(594)
Personnel related expenses	(248)	(180)
Financial transaction levy	(25 177)	(23 407)
Other administrative expenses	(5 330)	(5 617)
	<hr/>	<hr/>
Total general administrative expenses	(54 719)	(52 432)
	<hr/> <hr/>	<hr/> <hr/>

NOTE 11 – BANK TAX

The Bank paid a bank tax of HUF 5 715 million in 2018 (HUF 5 325 million in 2017). The basis of the tax amounted to HUF 2 700 093 million for 2018 and HUF 2 511 401 million for 2017. The effective tax rate was 0.212 percent in 2018 (0.212 percent in 2017).

The bank tax payable by the Bank for the year 2018 is calculated as follows.

For credit institutions the tax base includes the total asset value as at 31 December 2016, less:

- Hungarian interbank loan receivables, including bank deposits and repo transactions;
- bonds and shares issued by Hungarian credit institutions, financial enterprises and investment enterprises;
- loan receivables, subordinated and supplementary subordinated loan receivables with respect to capital provided to Hungarian financial enterprises and investment enterprises (including receivables under repos, collateralized repos, repos settled in kind);
- receivables deriving from EU inter-bank credits, bonds and shares issued by other credit institutions.

In 2017 the tax base of credit institutions was the total asset value as at 31 December 2015 adjusted by the above mentioned decreasing items.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 11 – BANK TAX (continued)

The bank tax for credit institutions is payable at 0.15% on tax base below HUF 50 000 million and 0.21% on tax base above HUF 50 000 million in 2018 (at 0.15% on tax base below HUF 50 000 million and 0.214% on tax base above HUF 50 000 million in 2017).

The bank tax for the Bank is expected to be HUF 5 529 million in 2019. The decrease of the bank tax expected in 2019 is caused by the change of the tax rate to 0.2% in case of credit institutions. In 2019 the tax base of credit institutions is the total asset value as at 31 December 2017 adjusted by the above mentioned decreasing items.

For the Bank the liability of HUF 5 529 million is established on January 1, 2019.

NOTE 12 – AVERAGE NUMBER OF PERSONNEL AND STAFF EXPENSES

	<u>2018</u>	<u>2017</u>
White-collar staff	3 348	3 442
Management	35	35
Total average number of persons employed	<u>3 383</u>	<u>3 477</u>

	<u>2018</u>	<u>2017</u>
	<u>MHUF</u>	<u>MHUF</u>
Wages and salaries	22 790	22 684
Social security charges	6 304	6 648
Defined benefit plan	(38)	(36)
Share based payments	64	68
Other staff expenses	3 121	2 945
Total staff expenses	<u>32 241</u>	<u>32 309</u>

NOTE 13 – INCOME TAXES

The components of income tax expense for the year ended 31 December 2018 and 2017 are:

	<u>Notes</u>	<u>2018</u>	<u>2017</u>
		<u>MHUF</u>	<u>MHUF</u>
Statutory income tax expense		(4 130)	(3 169)
Statutory income tax from self-revision of prior years		(9)	(42)
Local business tax expense		(3 883)	(3 871)
Investment services tax		-	-
Deferred taxes on income	26	(968)	(692)
Income tax (expense) / benefit		<u>(8 990)</u>	<u>(7 774)</u>

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 13 – INCOME TAXES (continued)

Statutory income tax expense

In 2018 and 2017 corporate income tax was payable at 9% on yearly profits.

Considering their non-turnover characteristics, local business taxes are presented as an income tax expense for IFRS purposes. Local business taxes include local government tax and innovation tax.

There is no procedure for final agreement of tax assessments in Hungary. The tax authorities may examine the accounting records and revise assessments for up to six years after the period to which they relate. Consequently, the Bank may be subject to further assessments in the event of an audit by the tax authorities. The corporate tax returns for the Bank have been reviewed and closed off by the taxation authorities for the years up to 2013. Management is not aware of any additional significant non-accrued potential tax liability which might arise relating to years not audited by the tax authorities.

The effective income tax rate varied from the statutory income tax rate due to the following items:

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Profit / (loss) before tax	66 040	49 443
Income tax rate	9.00%	9.00%
Income tax calculated	(5 944)	(4 450)
Plus/minus tax effects attributable to:		
Tax base decreasing items	699	673
Adjustments related to prior years	(9)	(42)
Adjustment on opening balance of deferred taxes due to change in tax rate	-	-
Local taxes and investment services tax	(3 883)	(3 871)
Tax base increasing items	(82)	(84)
Other	229	
Total tax effects	(3 046)	(3 324)
Income tax expense (income tax calculated + total tax effects)	<u>(8 990)</u>	<u>(7 774)</u>

The effective income tax rate for 2018 is 13.61% (2017: 15.72%).

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES BY PORTFOLIO AND PRODUCT

	<u>Held for trading</u> MHUF	<u>Mandatorily fair value through profit or loss</u> MHUF	<u>At fair value through other comprehensive income</u> MHUF	<u>At amortised cost*</u> MHUF	<u>Hedging derivatives</u> MHUF	<u>Total</u> MHUF
Financial assets at 31 December 2018						
Securities	4 700	-	95 362	618 311	-	718 373
Loans and advances	-	20 066	-	2 260 791	-	2 280 857
Derivatives	<u>65 117</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>17 265</u>	<u>82 382</u>
Total	<u>69 817</u>	<u>20 066</u>	<u>95 362</u>	<u>2 879 102</u>	<u>17265</u>	<u>3 081 612</u>
	<u>Held for trading</u> MHUF	<u>Available-for-sale</u> MHUF	<u>Held-to-maturity</u> MHUF	<u>Loans and receivables*</u> MHUF	<u>Hedging derivatives</u> MHUF	<u>Total</u> MHUF
Financial assets at 31 December 2017						
Securities	59 042	194 209	423 500	14 148	-	690 900
Loans and advances	-	-	-	2 163 393	-	2 163 393
Derivatives	<u>39 152</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>23 064</u>	<u>62 215</u>
Total	<u>98 194</u>	<u>194 209</u>	<u>423 500</u>	<u>2 177 541</u>	<u>23 064</u>	<u>2 916 508</u>

*Including cash balance with central banks and other demand deposits to credit institutions.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

**NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT
(continued)**

	Held for trading	Designated at fair value through profit or loss	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF
Financial liabilities as at 31 December 2018					
Deposits from central banks	-	-	-	92 747	92 747
Deposits from credit institutions and investment firms*	-	-	-	225 826	225 826
Deposits from customers and debt certificates	-	88 790	-	2 349 403	2 438 193
Deposits from customers	-	82 844	-	2 308 368	2 391 212
Demand deposits	-	-	-	1 887 071	1 887 071
Time deposits	-	82 844	-	118 136	200 980
Savings deposits	-	-	-	303 161	303 161
Debt certificates	-	5 946	-	41 035	46 981
Certificates of deposits	-	-	-	233	233
Non-convertible bonds	-	5 946	-	-	5 946
Non-convertible subordinated liabilities	-	-	-	40 802	40 802
Derivatives	54 263	-	13 566	-	67 829
Short positions	-	-	-	-	-
In debt instruments	-	-	-	-	-
Other	125	-	-	554	679
	-	-	-	-	-
Total carrying value	<u>54 388</u>	<u>88 790</u>	<u>13 566</u>	<u>2 668 530</u>	<u>2 825 274</u>

*Of which HUF 26 748 million is deposits from banks repayable on demand.

Deposits from credit institutions and investment firms includes repo transactions of HUF 10 748 million.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

**NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT
(continued)**

	Held for trading	Designated at fair value through profit or loss	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF
Financial liabilities as at 31 December 2017					
Deposits from central banks	-	-	-	117 154	117 154
Deposits from credit institutions and investment firms*	-	-	-	185 839	185 839
Deposits from customers and debt certificates	-	120 509	-	2 221 934	2 342 443
Deposits from customers	-	110 973	-	2 182 339	2 293 312
Demand deposits	-	-	-	1 743 180	1 743 180
Time deposits	-	110 973	-	146 820	257 793
Savings deposits	-	-	-	292 339	292 339
Debt certificates	-	9 536	-	39 595	49 131
Certificates of deposits	-	-	-	233	233
Non-convertible bonds	-	9 536	-	-	9 536
Non-convertible subordinated liabilities	-	-	-	39 362	39 362
Derivatives	27 637	-	4 103	-	31 740
Short positions	7 964	-	-	-	7 964
In debt instruments	7 964	-	-	-	7 964
Other	873	-	-	528	1 401
Total carrying value	<u>36 474</u>	<u>120 509</u>	<u>4 103</u>	<u>2 525 455</u>	<u>2 686 541</u>

*Of which HUF 35 570 million is deposits from banks repayable on demand.

Deposits from credit institutions and investment firms includes repo transactions of HUF 11 124 million.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

Details of financial instruments

Securities

Debt securities at fair value through other comprehensive income and at amortised cost are performing, non-past due bonds classified as stage 1 under IFRS 9.

The breakdown of securities is presented in the tables below.

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
<u>Held for trading</u>		
Hungarian Treasury bills	4 291	16 405
Hungarian government bonds issued in HUF	-	28 953
Hungarian government bonds issued in foreign currency	-	13 180
Hungarian Listed equity instruments	409	504
	<hr/>	<hr/>
Total held for trading securities	<u>4 700</u>	<u>59 042</u>

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
<u>Available for sale securities</u>		
Hungarian government bonds issued in HUF	-	171 196
Hungarian government bonds issued in foreign currency	-	21 156
Unlisted equity instruments	-	1 857
	<hr/>	<hr/>
Total available for sale	<u>-</u>	<u>194 209</u>

For further details on the reclassification from the available-for-sale portfolio due to the transition to IFRS 9 see Note 3.

Securities at fair value through other comprehensive income are presented in the table below.

	<u>Gross carrying</u> <u>amount</u> <u>MHUF</u>	<u>Impairment</u> <u>MHUF</u>
<u>Fair value through other comprehensive income</u>		
Hungarian government bonds issued in HUF	93 018	(73)
Listed equity instrument	1 571	-
Unlisted equity instruments	11 736	(187)
Mortgage bonds	201	-
	<hr/>	<hr/>
Total fair value through other comprehensive income	<u>106 526</u>	<u>(260)</u>

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

FVOCI equity instruments contain as at 31 December 2018 unlisted equity instruments in a value of HUF 645 million (HUF 646 million AFS at the end of 2017) for which a fair value cannot be measured reliably. These investments are not traded on active markets. Management believes that the carrying value of the investments held at cost approximates their fair value.

These FVOCI investments contain long term investments in companies where the Bank does not have significant influence.

FVOCI investments disclosed on their net carrying amount are:

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Garantiqa Hitelgarancia Zrt.	640	640
SWIFT S.C.	5	6
	<u>645</u>	<u>646</u>

The Bank recorded HUF 1 568 million losses after tax in other comprehensive income as a result of the fair value revaluation of FVOCI debt securities in 2018 (HUF 4 664 million gain after tax for AFS in 2017).

The unrealised result of FVOCI debt securities is cumulatively HUF 3 263 million gain after tax as at 31 December 2018 (HUF 15 627 million gain for AFS as at 31 December 2017).

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
<u>Loans-and-receivables debt securities</u>		
Bonds issued by municipality – issued in HUF	-	924
Bonds issued by financial corporations in HUF	-	13 224
Total loans-and-receivables debt securities	<u>-</u>	<u>14 148</u>

Bonds issued by financial corporations include bonds issued by the Investor Protection Fund and the National Deposit Insurance Fund of Hungary.

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
<u>Held to maturity</u>		
Hungarian government bonds issued in foreign currency	-	28 122
Hungarian government bonds issued in HUF	-	395 378
Total held to maturity	<u>-</u>	<u>423 500</u>

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

Debt securities at amortised cost consisted of the following types of securities in 2018.

	<u>Gross carrying amount MHUF</u>	<u>Impairment MHUF</u>
<u>At amortised cost</u>		
Government bonds issued in HUF	558 764	(538)
Government bonds issued in foreign currency	48 246	(24)
Bonds issued by municipality issued in HUF	674	-
Bonds issued by financial corporations in HUF	11 200	(10)
Total at amortised cost	<u>618 884</u>	<u>(572)</u>

The Bank realised a HUF 1 409 million gain on disposal of debt securities at amortised cost in 2018 (reported separately in the income statement). The disposal was not in contradiction with the prescription of the concerned business model.

Assets pledged as collateral for liabilities and contingent liabilities

	<u>2018 MHUF</u>	<u>Reclassified 2017 MHUF</u>
Assets pledged for:		
Repo liabilities	10 283	10 534
Funding for Growth Scheme launched by the National Bank of Hungary	97 023	124 200
Derivative transactions	11 589	4 838
Clearing transactions	15 072	61 004
Mortgage refinancing loans	114 580	76 716
Total assets pledged as collateral	<u>248 547</u>	<u>277 292</u>

Assets pledged as collateral for refinancing credits, derivatives and clearing transactions contain cash and cash equivalents and securities. These assets are not transferred to the counterparty. In case of derivatives the terms and conditions of collateral settlement are defined in separate CSAs (Credit Support Annexes) between the counterparties. In case of securities the collateral requirement is defined on portfolio basis and it is held in custody at a central clearing house (KELER).

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

The following table presents the breakdown of financial assets mandatorily at fair value through profit or loss and at amortised cost by portfolio and product as at 31 December 2018.

	Mandatorily at fair value through profit or loss			At amortised cost		
	Gross carrying amount	Accumulated negative changes in fair value due to credit risk	Total	Gross carrying amount	Accumulated impairment	Total
		MHUF			MHUF	
Loans and advances at 31 December 2018*						
Central bank and credit institutions	-	-	-	857 903	(15)	857 888
General government	95	-	95	28 156	(380)	27 776
Corporate	4 460	-	4 460	811 655	(13 316)	798 339
of which: Small and Medium enterprises	274	-	274	504 606	(11 594)	493 012
Households	16 051	(540)	15 511	603 965	(27 177)	576 788
Consumer credit	-	-	-	48 445	(1 559)	46 886
Credit card	-	-	-	6 177	(168)	6 009
Current account	-	-	-	13 976	(1 031)	12 945
Finance lease	-	-	-	2 488	(122)	2 366
Mortgage loan	16 045	(540)	15 505	511 889	(24 216)	487 673
Term loan	6	-	6	20 990	(81)	20 909
Total	20 606	(540)	20 066	2 301 679	(40 888)	2 260 791

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

The following table presents the breakdown of loans and advances by portfolio and product as at 31 December 2017.

	Loans and advances		
	Gross carrying amount	Accumulated impairment	Total
	MHUF	MHUF	MHUF
Loans and advances at 31 December 2017*			
Central bank and credit institutions	832 394	(9)	832 385
General government	49 100	(4)	49 096
Corporate	733 281	(12 161)	721 120
of which: Small and Medium enterprises	458 014	(10 697)	447 317
Households	581 948	(21 156)	560 792
Consumer credit	36 351	(1 175)	35 176
Credit card	5 980	(132)	5 848
Current account	13 825	(888)	12 937
Finance lease	3 002	(400)	2 602
Mortgage loan	501 212	(18 389)	482 823
Term loan	21 578	(172)	21 406
Total	<u>2 196 723</u>	<u>(33 330)</u>	<u>2 163 393</u>

*From the total balance of loans and advances to Central bank and credit institutions HUF 489 105 million is either repayable on demand or is maturing in less than 90 days (HUF 684 456 million in 2017). There were no repo transactions in 2018 (reverse repo HUF 8 206 million in 2017).

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 14 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

Refinancing credits

The Bank has entered into several refinancing credit facilities with financial institutions (such as FHB – Mortgage Bank, MFB – Development Bank, EXIM Bank) for the purpose of funding portions of the Bank's activities. There are several covenants governing the determination of qualified recipients, the on-going monitoring process of the ultimate recipients and the repayment process. In all cases the Bank assumes all credit risk related to the ultimate borrower and must check compliance with all covenants.

The National Bank of Hungary (NBH) launched a program called Funding for Growth Scheme in 2013. The aim of the program is the refinancing of small and medium enterprises (SME) through the Hungarian bank system. The NBH funds the credit institutions attending the program through below market rate refinancing loans during a temporary period and in a limited amount. These funds are used by the credit institutions for granting credits to SMEs with similar, favourable conditions for pre-determined purposes. The maximum maturity of the refinancing loans is 10 years at initiation and it corresponds to the maturity of the loans granted to the customers.

At 31 December 2018, Management believes that the Bank is in compliance with all significant covenants. Refinancing credits are presented as financial liabilities at amortised cost in the statement of financial position.

	<u>2018</u> MHUF	<u>2017</u> MHUF
Refinancing credits in the frame of the Funding for Growth Scheme	92 747	117 154
Other refinancing credits	<u>180 410</u>	<u>138 829</u>
Total refinancing credits	<u><u>273 157</u></u>	<u><u>255 983</u></u>

Non-convertible subordinated liabilities

	<u>2018</u> MHUF	<u>2017</u> MHUF
Subordinated loan from KBC Group	40 802	39 362

In June 2006, the Bank borrowed EUR 60 million (HUF 19 291 million in 2018 and HUF 18 577 million in 2017) of subordinated debt from KBC Bank N.V. Dublin branch, a member of the KBC Group. In 2014 KBC Bank N.V. has taken over the facility from its branch. In March 2015 the loan's original maturity of 30 June 2016 was extended with 10 years. The loan bears a variable interest rate of 3 month-EURIBOR plus 2.70 percent per annum.

In September 2015 the Bank agreed on an additional subordinated debt of EUR 30 million (HUF 9 645 million in 2018 and HUF 9 306 million in 2017) with KBC Bank N.V. with conditions of 10 years maturity and a variable interest rate of 3 month-EURIBOR plus 3.05 percent per annum.

The third subordinated loan contract between the Bank and KBC Bank N.V. was made in December 2017. KBC Bank N.V. granted an additional EUR 37 million (HUF 11 899 million in 2018 and HUF 11 479 million in 2017) loan to the Bank with a maturity of 10 years and a variable interest rate of 3 months-EURIBOR plus 1.53 percent per annum.

Non-convertible subordinated liabilities are presented as financial liabilities at amortised cost in the statement of financial position.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 15 – TRANSFERRED FINANCIAL ASSETS

The following table includes transferred financial assets continued to be recognised in their entirety.

	2018		2017	
	Carrying amount of transferred asset MHUF	Carrying amount of associated liability MHUF	Carrying amount of transferred asset MHUF	Carrying amount of associated liability MHUF
Held-to-maturity debt instruments	-	-	10 534	11 124
Debt securities at amortised cost	10 283	10 748	-	-
Total transferred assets and associated liabilities	10 283	10 748	10 534	11 124

Repo and reverse repo agreements

Under reverse repo transactions, the Bank obtains legal ownership of the respective collateral received and, thus, is permitted to utilise the collateral; however, the same collateral must be delivered back to the borrower of the funds on maturity, which generates a liability recorded as financial liability held at amortised cost in the financial position. The Bank had no reverse repo transaction as at 31 December 2018 (the fair value of securities accepted as collateral in connection with reverse repo transactions was HUF 8 131 million in 2017, of which HUF 7 964 million has been sold and reported as short positions in the statement of financial position).

The terms of repos and reverse repo transactions are less than three months and the interest rate is based on HUF interbank rates (BUBOR).

The Bank has no associated liabilities which have recourse limited only to the transferred assets.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 16 – OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES

The following tables present the financial assets and liabilities which are subject to enforceable master netting agreements as at 31 December 2018:

	<u>Amounts presented in the statement of financial position</u>			<u>Amounts not set off in the statement of financial position</u>			
	<u>Gross amount of recognised financial assets</u>	<u>Gross amount of financial liabilities set off</u>	<u>Net amounts of financial assets</u>	<u>Financial instruments</u>	<u>Cash collateral received</u>	<u>Securities collateral received</u>	<u>Net amount</u>
	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>
Derivatives	82 382	-	82 382	66 471	3 007	-	12 904
Reverse repurchase agreements	-	-	-	-	-	-	-
Total financial assets subject to offsetting or master netting agreements	<u>82 382</u>	<u>-</u>	<u>82 382</u>	<u>66 471</u>	<u>3 007</u>	<u>-</u>	<u>12 904</u>
	<u>Amounts presented in the statement of financial position</u>			<u>Amounts not set off in the statement of financial position</u>			
	<u>Gross amount of recognised financial liabilities</u>	<u>Gross amount of financial assets set off</u>	<u>Net amounts of financial liabilities</u>	<u>Financial instruments</u>	<u>Cash collateral pledged</u>	<u>Securities collateral pledged</u>	<u>Net amount</u>
	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>
Derivatives	67 829	-	67 829	66 471	449	21	888
Repurchase agreements	10 748	-	10 748	-	-	10 283	465
Total financial liabilities subject to offsetting or master netting agreements	<u>78 577</u>	<u>-</u>	<u>78 577</u>	<u>66 471</u>	<u>449</u>	<u>10 304</u>	<u>1 353</u>

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 16 – OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES (continued)

The following tables present the financial assets and liabilities which are subject to enforceable master netting agreements as at 31 December 2017:

	<u>Amounts presented in the statement of financial position</u>			<u>Amounts not set off in the statement of financial position</u>			
	<u>Gross amount of recognised financial assets</u>	<u>Gross amount of financial liabilities set off</u>	<u>Net amounts of financial assets</u>	<u>Financial instruments</u>	<u>Cash collateral received</u>	<u>Securities collateral received</u>	<u>Net amount</u>
	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>
Derivatives	62 216	-	62 216	29 740	23 278	-	9 198
Reverse repurchase agreements	8 206	-	8 206	-	-	8 131	75
Total financial assets subject to offsetting or master netting agreements	<u>70 422</u>	<u>-</u>	<u>70 422</u>	<u>29 740</u>	<u>23 278</u>	<u>8 131</u>	<u>9 273</u>
	<u>Amounts presented in the statement of financial position</u>			<u>Amounts not set off in the statement of financial position</u>			
	<u>Gross amount of recognised financial liabilities</u>	<u>Gross amount of financial assets set off</u>	<u>Net amounts of financial liabilities</u>	<u>Financial instruments</u>	<u>Cash collateral pledged</u>	<u>Securities collateral pledged</u>	<u>Net amount</u>
	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>
Derivatives	31 740	-	31 740	29 740	350	9	1 641
Repurchase agreements	11 124	-	11 124	-	-	10 534	590
Total financial liabilities subject to offsetting or master netting agreements	<u>42 864</u>	<u>-</u>	<u>42 864</u>	<u>29 740</u>	<u>350</u>	<u>10 543</u>	<u>2 231</u>

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 16 – OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES (continued)

Derivatives, repurchase and reverse repurchase agreements are subject to different netting agreements as ISDA (International Swaps and Derivatives Association) Master Agreements, CSAs (Credit Support Annex) and GMRAs (Global Master Repurchase Agreement) in case of institutional clients (credit institutions and investment firms) or treasury limits in case of corporate customers.

Financial assets and liabilities subject to master netting agreements are not netted in the statements of financial position, since the Bank has no intention to settle these instruments on a net basis in the normal course of business.

Given cash collaterals are recognised in the loans-and-receivables portfolio as loans and advances to credit institutions and investment firms repayable on demand. Cash collaterals received are included in financial liabilities held on amortised cost and are recognised as demand deposits from credit institutions and investment firms.

Securities collaterals received are not recorded in the statements of financial position. Securities collaterals pledged are recognised in the statements of financial position in the appropriate portfolio (and are presented as assets pledged as collateral for liabilities and contingent liabilities in Note 14).

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 17 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES

The table below presents information concerning the fair value of financial assets and liabilities for year 2018:

	Fair value			Total fair value MHUF	Total carrying amount MHUF	Accumulated difference between FV and carrying amount not recognised in PL or equity MHUF	Recognised in other comprehensiv e income: un- observable input MHUF	Recognised in profit or loss un- observable inputs* MHUF
	Quoted market price (level 1) MHUF	Valuation techniques - observable inputs (level 2) MHUF	Valuation techniques - un- observable inputs (level 3) MHUF					
Cash and cash balances with central banks and other demand deposits with credit institutions	42 833	437 814	-	480 647	480 647	-	-	-
Financial assets	729 897	524 733	1 427 739	2 682 369	2 643 798	38 571	360	4 098
Held for trading	35	65 486	4 296	69 817	69 817	-	-	3 774
Mandatorily at fair value through profit or loss other than held for trading	-	-	20 066	20 066	20 066	-	-	324
Fair value through other comprehensive income	92 945	201	2 216	95 362	95 362	-	360	-
Measured at amortised cost	636 917	441 781	1 401 161	2 479 859	2 441 288	38 571	-	-
Hedging derivatives	-	17 265	-	17 265	17 265	-	-	-
Total financial assets and cash and cash balances with central banks and other demand deposits with credit institutions	772 730	962 547	1 427 739	3 163 016	3 124 445	38 571	360	4 098
Financial liabilities								
Held for trading	21	50 095	4 272	54 388	54 388	-	-	(3 750)
Fair value option	-	88 790	-	88 790	88 790	-	-	-
Measured at amortised cost	-	107 979	2 558 082	2 666 061	2 668 531	2 470	-	-
Hedging derivatives	-	13 566	-	13 566	13 566	-	-	-
Total financial liabilities	21	260 430	2 562 354	2 822 805	2 825 275	2 470	-	(3 750)

*Recognised as Net gains / (losses) from financial instruments at fair value through profit or loss in the income statement.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 17 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

The table below presents information concerning the fair value of financial assets and liabilities as at 31 December 2017:

	Fair value			Total fair value MHUF	Total carrying amount MHUF	Accumulated difference between FV and carrying amount not recognised in PL or equity MHUF	Recognised in other comprehensiv e income: un- observable input MHUF	Recognised in profit or loss un- observable inputs* MHUF
	Quoted market price (level 1) MHUF	Valuation techniques - observable inputs (level 2) MHUF	Valuation techniques - un- observable inputs (level 3) MHUF					
Cash and cash balances with central banks and other demand deposits with credit institutions	36 789	401 057	-	437 846	437 846	-	-	-
Financial assets	661 036	575 000	1 333 539	2 569 575	2 515 451	54 124	299	2 057
Held for trading	50 679	45 113	2 402	98 194	98 194	-	-	2 057
Designated at fair value through profit or loss	-	-	-	-	-	-	-	-
Available for sale	161 664	30 689	1 856	194 209	194 209	-	-	-
Loans and receivables	-	449 453	1 329 281	1 778 734	1 776 484	2 250	299	-
Held to maturity	448 693	26 681	-	475 374	423 500	51 874	-	-
Hedging derivatives	-	23 064	-	23 064	23 064	-	-	-
Total financial assets and cash and cash balances with central banks and other demand deposits with credit institutions	<u>697 825</u>	<u>976 057</u>	<u>1 333 539</u>	<u>3 007 421</u>	<u>2 953 297</u>	<u>54 124</u>	<u>299</u>	<u>2 057</u>
Financial liabilities								
Held for trading	7 973	26 108	2 393	36 474	36 474	-	-	(2 047)
Designated at fair value through profit or loss	-	120 509	-	120 509	120 509	-	-	-
Measured at amortised cost	-	120 132	2 407 070	2 527 202	2 525 455	(1 747)	-	-
Hedging derivatives	-	4 103	-	4 103	4 103	-	-	-
Total financial liabilities	<u>7 973</u>	<u>270 852</u>	<u>2 409 463</u>	<u>2 688 288</u>	<u>2 686 541</u>	<u>(1 747)</u>	<u>-</u>	<u>(2 047)</u>

*Recognised as Net gains / (losses) from financial instruments at fair value through profit or loss in the income statement.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 17 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

Hungarian government bonds have quoted market price except for some treasury bills and bonds maturing within 3 months, which are valued based on BUBOR yield curve within 3 months maturity. In 2018 no debt instruments were transferred from Quoted market price to Valuation techniques-market observable inputs category due to this change in valuation (HUF 2 614 million held-for-trading securities in 2017).

The following evaluation tables present the change in the fair value of financial instruments for which no market observable inputs are available.

Financial assets	Held-for trading-derivatives	Mandatorily fair value through profit or loss	Fair value other comprehensive income	Total
	MHUF	MHUF		MHUF
Balance as at 31 December 2017	2 402	-	1 211	3 613
Conversion IFRS 9	-	21 405	-	21 405
Net gains / (losses)				
In profit or loss	99	324	-	423
In other comprehensive income	-	-	360	360
Acquisitions	3 675	3 006	-	6 681
Settlement	(1 880)	(5 109)	-	(6 989)
Other	-	440	-	440
Balance as at 31 December 2018	4 296	20 066	1 571	25 933

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 17 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

Financial assets	Held-for trading-derivatives	Available-for-sale equity instruments	Total
	MHUF	MHUF	MHUF
Balance as at 31 December 2016	3 443	912	4 355
Net gains / (losses)			
In profit or loss	(244)	-	(244)
In other comprehensive income	-	299	299
Settlement	(797)	-	(797)
Balance as at 31 December 2017	2 402	1 211	3 613

Financial liabilities	Held-for-trading derivatives
	MHUF
Balance as at 31 December 2017	2 393
Net (gains) / losses	
In profit or loss	99
Acquisitions	3 651
Settlement	(1 871)
Balance as at 31 December 2018	4 272

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 17 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

Financial liabilities	Held-for-trading derivatives
	MHUF
Balance as at 31 December 2016	<u>3 350</u>
Net (gains) / losses	
In profit or loss	(383)
Settlement	<u>(574)</u>
Balance as at 31 December 2017	<u>2 393</u>

Fair value of financial instruments

Financial instruments at fair value

Held-for-trading instruments, financial instruments designated at fair value through profit or loss, financial assets mandatorily at fair value through profit or loss, available-for-sale instruments, financial assets at fair value through other comprehensive income and hedging derivatives are carried at their fair value.

Financial instruments which have an active market with regularly published price quotations are marked to market. Usually treasury bills, Hungarian government bonds, other listed bonds and listed equity instruments belong to this category, excluding Hungarian government bonds denominated in HUF and maturing within 3 months, premium Hungarian government bonds denominated in EUR, bonus Hungarian government bonds denominated in HUF and some treasury bills. There are no price quotations for Hungarian government bonds denominated in HUF and maturing within 3 months therefore they are valued based on BUBOR yield curve within 3 months maturity. For premium Hungarian government bonds denominated in EUR no active secondary market exists therefore they are valued at the price quoted at issuance. Since the Government grants the repurchase of the bonds at the issuance price Management believes that the carrying amount of these bonds approximates their fair value.

If there is no active market or quoted prices for a financial instrument then valuation techniques based on observable market parameters are used, such as discounted cash flow analysis or option pricing models. Bonus Hungarian government bonds denominated in HUF, most of the financial liabilities designated at fair value through profit or loss and most of the derivatives are valued based on these techniques, such as currency forwards and swaps, foreign exchange and interest rate options, cross currency- and interest rate swaps and forward rate agreements.

When market parameters are not available, the Bank uses its best estimations and assumptions to determine the relevant circumstances which have to be taken into account during the model valuation. Valuation techniques based on unobservable market parameters are used in case of held-for-trading exotic derivatives.

Exotic derivatives are primarily revalued by built-in models of the front office system using market observable parameters. For which no system model exists, there are two alternatives; (1) position is either back-to-back hedged, and the Bank accepts the hedging partner prices (when hedging bank acts as valuation agent) or (2) valuation is based on internal model based best estimates (e.g. in case of municipality bonds embedded swaption valuation).

The Bank provides exotic derivatives on back to back basis, accordingly immaterial result is recorded on held-for-trading exotic derivatives in the consolidated income statement. From the same reason, applying alternative assumptions for the fair value calculation would cause no result in the consolidated income statement.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 17 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

The calculation of the fair value of Visa Inc. preferred shares is based on the amount of shares the Bank holds, the conversion rate to Visa Inc. listed shares, the Visa Inc. share price as listed on the New York Stock Exchange and the illiquidity discount. Management believes that changing the measure of illiquidity gap (as the only level 3 component of the fair value calculation) would not change the calculated fair value intrinsically.

For the loan portfolios, which failed the IFRS9 SPPI test, the Bank uses the net carrying amount as proxy for the fair value. Management believes that alternative calculations would bring non-reliable result.

The difference between the fair value and the transaction price of financial instruments not recognised in profit or loss as at the beginning and the end of the period was immaterial in 2018 and 2017.

The following describes the methodology and assumptions used to determine fair values for those financial instruments which are not recorded at fair value in the financial statements.

Available-for-sale/FVOCI equity instruments held at cost

Available-for-sale/FVOCI equity instruments contain as at 31 December 2018 equity instruments in a value of HUF 645 million (HUF 646 million as at 31 December 2017) which fair value cannot be measured reliably.

Management believes that the carrying value of the investments held at cost approximates their fair value (for more information see Note 14).

Underlying the definition of fair value is the presumption that the Bank is a going concern without any intention or requirement to curtail materially the scale of its operations or to undertake a transaction on adverse terms.

Financial assets and financial liabilities measured at amortised cost

Debt securities at amortised cost include Hungarian government bonds issued in HUF and EUR. The fair value of Hungarian government bonds denominated in HUF and maturing over 3 months disclosed in this Note is calculated based on regularly quoted market prices, since these instruments have an active market. Hungarian government bonds denominated in HUF and maturing within 3 months are valued based on BUBOR yield curve within 3 months maturity. Hungarian government bonds issued in EUR have an active market with regularly published price quotations and are marked to market.

For premium Hungarian government bonds denominated in EUR no active secondary market exists therefore premium Hungarian government bonds are held at the price quoted at issuance in the statement of financial position. Since the Government grants the repurchase of the bonds at an exit price of 98% the Bank considers this exit price for calculation of the fair value in this note.

Bonus Hungarian government bonds denominated in HUF are valued by a valuation technique where the future cash flow is discounted by a curve calculated from IRS curves modified by asset swap and illiquidity spreads. Although illiquidity spread is non-market observable input, due to its immaterial effect in the fair value of the asset the bond is classified as financial instrument valued by valuation techniques – market observable inputs in the fair value hierarchy.

Municipality bonds in the were issued in HUF. There is an embedded option which assures that the municipality can change the denomination of the bond at any point of time during its duration to EUR or CHF at the spot rate of the conversion date. Nevertheless, the interest spread remains unchanged over the reference rate.

This optionality corresponds to a sold, deferred premium, American type multicurrency differential swaption from the Bank's point of view. Cross-currency swaption of this kind is an instrument for which no market value is available but its intrinsic value can be calculated from available market parameters. The value of the swaption is not material.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 17 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

The municipality bond as such can be split to two components which fair values give the total fair value of the bond. The two instruments are (1) bonds and, (2) swaptions. The market value of the bonds is calculated using discounted present value of the future cash flows. The future cash flow of the bond is predicted by the default money market yield curve. The value of swaptions is calculated regularly.

There is no active market for these municipality bonds to get market observable parameters for the revaluation especially for credit spread which is a risk on the top of the Hungarian government bonds. To challenge the fair valuation model, the Bank uses a reasonably possible alternative assumption to increase the applied credit spread.

Municipality bonds did not fail the IFRS 9 SPPI test since the reference interest follows the concerned currency before and after the conversion as well.

For loans and advances and financial liabilities that are liquid or have a short term remaining maturity (less than one year) it is assumed that the carrying amounts approximate to their fair value. This assumption is also applied to demand deposits, savings accounts without a specific maturity, and variable rate financial instruments. Fair value adjustments of refinanced loans with fixed or variable interest are included in unrecognised gain / (loss) of financial assets at amortised cost, fair value adjustments of refinancing liabilities with fixed or variable interest are included in unrecognised gain / (loss) of financial liabilities measured at amortised cost.

The estimated fair value of fixed interest bearing deposits with more than one year remaining maturity and refinancing liabilities (carried at amortised cost) is based on discounted cash flows using current interbank market yield curve appropriate for the remaining term to maturity.

The estimated fair value of fixed interest bearing assets with more than one year remaining maturity and refinanced loans (carried at amortised cost) is based on discounted cash flows using current interbank market yield curve appropriate for the remaining term to maturity which is adjusted with the average margin of the retail and corporate loan portfolio of the Bank to arrive at the estimated market yield curve of the asset.

The Bank believes that the carrying amount of the impaired loans is the best estimation of their fair value and therefore does not present any unrecognised gain or loss on impaired loans and advances in this Note.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 18 – FINANCIAL ASSETS MANDATORILY AT FAIR VALUE AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
<u>Financial assets mandatorily at fair value through profit or loss</u>		
Loans to customers	20 066	-
	<u>20 066</u>	<u>-</u>
	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
<u>Financial liabilities designated at fair value through profit or loss</u>		
Term deposits:		
-general government	-	31
- retail	3 552	332
- corporate	6 419	2 284
- investment funds	72 873	108 326
Other issued bonds	5 946	9 536
	<u>88 790</u>	<u>120 509</u>

Loans to customers measured mandatorily at fair value through profit or loss include customer loans which failed the SPPI test at the IFRS 9 transition date due to their interest conditions.

In 2007 the Bank established a bond issuance program. The Bank, as issuer sells dematerialised bonds via public placement. The bonds may be denominated in HUF, EUR or USD. The maturities are between 60 days and 20 years with the interest rates being fixed or floating, linked to an index (equity, currency or commodity), or credit linked.

Upon initial recognition the bonds were designated by the Bank at fair value through profit or loss as the bonds are economically hedged by derivatives which do not achieve the criteria for hedge accounting.

Included in financial liabilities designated at fair value through profit or loss are retail and corporate term deposits combined with currency options which are accounted for as embedded derivatives. The fair value of the deposits and the options are not separated.

Based on the Bank's treasury policy the long term fixed rate deposits from investment funds included in financial liabilities designated at fair value through profit or loss are economically hedged by interest rate derivatives, and do not qualify for hedge accounting.

The amount that the Bank would contractually be required to pay at maturity is HUF 1 420 million higher than the fair value of the deposits and issued bonds (HUF 2 124 million higher as at 31 December 2017).

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 19 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND GEOGRAPHIC LOCATION

The Bank's financial assets, and financial liabilities before taking into account any collateral held or other credit enhancements as at 31 December 2018 can be analysed by the following geographical regions.

	Cash balances with central banks and other demand deposits with credit institutions	Held for trading	Designated at fair value through profit or loss	Mandatory fair value through profit or loss	At fair value through other comprehensive income	Amortised cost	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial assets								
Hungary	364 150	21 514	-	20 066	93 786	2 045 745	633	2 545 894
EMU countries	66 847	47 650	-	-	5	392 218	15 650	522 370
East-European countries	737	58	-	-	-	667	-	1 462
Russia	131	-	-	-	-	2 216	-	2 347
Other European countries	1 306	595	-	-	-	208	982	3 091
Non-European countries	4 643	-	-	-	1 571	234	-	6 448
Total	437 814	69 817	-	20 066	95 362	2 441 288	17 265	3 081 612
Financial liabilities								
Hungary	-	5 030	88 719	-	-	2 556 164	97	2 650 010
EMU countries	-	48 754	-	-	-	92 336	12 784	153 874
East-European countries	-	43	71	-	-	7 347	-	7 461
Russia	-	-	-	-	-	1 994	-	1 994
Other European countries	-	561	-	-	-	3 751	685	4 997
Non-European countries	-	-	-	-	-	6 939	-	6 939
Total	-	54 388	88 790	-	-	2 668 531	13 566	2 825 275

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS**

NOTE 19 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND GEOGRAPHIC LOCATION (continued)

The geographical breakdown of financial assets and financial liabilities as at 31 December 2017 is presented below:

	Cash balances with central banks and other demand deposits with credit institutions	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial assets									
Hungary	202 600	71 146	-	192 993	1 362 245	423 500	-	-	2 252 484
EMU countries	187 127	24 548	-	6	407 896	-	18 286	-	637 863
East-European countries	651	17	-	-	2 690	-	-	-	3 358
Russia	1 263	-	-	-	3 249	-	-	-	4 512
Other European countries	950	2 483	-	-	163	-	4 778	-	8 374
Non-European countries	8 466	-	-	1 210	241	-	-	-	9 917
Total	401 057	98 194	-	194 209	1 776 484	423 500	23 064	-	2 916 508
Financial liabilities									
Hungary	-	13 136	120 478	-	-	-	-	2 375 516	2 509 130
EMU countries	-	22 209	-	-	-	-	3 684	126 522	152 415
East-European countries	-	54	31	-	-	-	-	7 128	7 213
Russia	-	-	-	-	-	-	-	1 627	1 627
Other European countries	-	1 075	-	-	-	-	419	9 686	11 180
Non-European countries	-	-	-	-	-	-	-	4 976	4 976
Total	-	36 474	120 509	-	-	-	4 103	2 525 455	2 686 541

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 20 – LOANS AND ADVANCES, BREAKDOWN BY PORTFOLIO AND QUALITY

Credit quality per class of financial assets

The table below presents the credit quality by asset classes as at 31 December 2018:

	Loans and advances mandatorily at fair value through profit or loss			
	Gross carrying amount		Accumulated negative changes in fair value due to credit risk	Total MHUF
	Performing MHUF	Non-performing MHUF	Non-performing MHUF	
Loans and advances at 31 December 2018				
Central bank and credit institutions	-	-	-	-
General government	95	-	-	95
Corporate	4 460	-	-	4 460
of which: Small and Medium enterprises	274	-	-	274
Households	15 321	730	(540)	15 511
Consumer credit	-	-	-	-
Credit card	-	-	-	-
Current account	-	-	-	-
Finance lease	-	-	-	-
Mortgage loan	15 315	730	(540)	15 505
Term loan	6	-	-	6
Trade receivables	-	-	-	-
Total	19 876	730	(540)	20 066

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 20 – LOANS AND ADVANCES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

	Loans and advances at amortised cost*					
	Gross carrying amount			Accumulated impairment		
	Performing MHUF	Non- performing MHUF	Total MHUF	Performing MHUF	Non- performing MHUF	Total MHUF
Loans and advances at 31 December 2018						
Central bank and credit institutions	857 893	10	857 903	(15)	-	(15)
General government	27 775	381	28 156	(16)	(364)	(380)
Corporate	795 622	16 033	811 655	(2 296)	(11 020)	(13 316)
of which: Small and Medium enterprises	489 836	14 770	504 606	(1 775)	(9 819)	(11 594)
Households	558 956	45 009	603 965	(4 903)	(22 274)	(27 177)
Consumer credit	47 716	729	48 445	(956)	(603)	(1 559)
Credit card	6 118	59	6 177	(129)	(39)	(168)
Current account	12 456	1 520	13 976	(331)	(700)	(1 031)
Finance lease	2 383	105	2 488	(17)	(105)	(122)
Mortgage loan	469 367	42 522	511 889	(3 426)	(20 790)	(24 216)
Term loan	20 916	74	20 990	(44)	(37)	(81)
Trade receivables	-	-	-	-	-	-
Total	<u>2 240 246</u>	<u>61 433</u>	<u>2 301 679</u>	<u>(7 230)</u>	<u>(33 658)</u>	<u>(40 888)</u>

The table includes the net carrying amount of loans and advances at amortised cost, cash and cash balances with central banks and other demand deposits to credit institutions.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 20 – LOANS AND ADVANCES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

The credit quality of assets as at 31 December 2017 can be presented as follows:

	Loans and advances*					
	Gross carrying amount			Accumulated impairment		
	Performing MHUF	Non- performing MHUF	Total MHUF	Performing MHUF	Non- performing MHUF	Total MHUF
Loans and advances at 31 December 2017						
Central bank and credit institutions	832 394	-	832 394	(9)	-	(9)
General government	49 100	-	49 100	(4)	-	(4)
Corporate	715 135	18 146	733 281	(957)	(11 204)	(12 161)
of which: Small and Medium enterprises	441 122	16 892	458 014	(722)	(9 975)	(10 697)
Households	529 611	52 337	581 948	(2 240)	(18 916)	(21 156)
Consumer credit	35 310	1 041	36 351	(295)	(880)	(1 175)
Credit card	5 908	72	5 980	(89)	(43)	(132)
Current account	12 865	960	13 825	(165)	(723)	(888)
Finance lease	2 573	429	3 002	(5)	(395)	(400)
Mortgage loan	451 563	49 649	501 212	(1 664)	(16 725)	(18 389)
Term loan	21 392	186	21 578	(22)	(150)	(172)
Trade receivables	-	-	-	-	-	-
Total	2 126 240	70 483	2 196 723	(3 210)	(30 120)	(33 330)

*The table includes the net carrying amount of loans and advances in the loans and receivables portfolio, cash and cash balances with central banks and other demand deposits to credit institutions.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 20 – LOANS AND ADVANCES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

Aging analysis of loans per class of financial assets

	Loans and advances*							Total MHUF
	Performing				Non-performing			
	Not past due MHUF	Past due <= 30 days MHUF	Past due > 30 days <= 90 days MHUF	Past due > 90 days MHUF	Past due <= 30 days MHUF	Past due > 30 days <= 90 days MHUF	Past due > 90 days MHUF	
Loans and advances at 31 December 2018								
Central bank and credit institutions	857 878	-	-	-	10	-	-	857 888
General government	26 347	1 497	-	10	10	-	7	27 871
Corporate	795 420	1 955	306	105	3 709	146	1 158	802 799
of which: Small and Medium enterprises	486 146	1 783	303	103	3 699	146	1 106	493 286
Households	548 836	17 956	2 559	23	3 359	996	18 570	592 299
Consumer credit	45 436	1 187	137	-	10	5	111	46 886
Credit card	5 787	184	18	-	5	1	14	6 009
Current account	10 266	1 756	85	18	626	19	175	12 945
Finance lease	2 362	4	0	-	-	-	-	2 366
Mortgage loan	464 205	14 732	2 314	5	2 718	971	18 233	503 178
Term loan	20 780	93	5	-	-	-	37	20 915
Trade receivables	-	-	-	-	-	-	-	-
Total	2 228 481	21 408	2 865	138	7 088	1 142	19 735	2 280 857

*The table includes the net carrying amount of loans and advances mandatorily at fair value through profit or loss and at amortised cost, cash and cash balances with central banks and other demand deposits to credit institutions.

As of 2018, the financial information is prepared in accordance with IFRS 9. For more information on the impact of the transition see Note 3. The accompanying notes on pages 12 to 164 are an integral part of these financial statements.

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 20 – LOANS AND ADVANCES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

Past due assets include those that are past due even by one day.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 20 – LOANS AND ADVANCES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

	Loans and advances*							Total MHUF
	Performing				Non-performing			
	Not past due	Past due <= 30 days	Past due > 30 days <= 90 days	Past due > 90 days	Past due <= 30 days	Past due > 30 days <= 90 days	Past due > 90 days	
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	
Loans and advances at 31 December 2017								
Central bank and credit institutions	832 385	-	-	-	-	-	832 385	
General government	47 595	1 501	-	-	-	-	49 096	
Corporate	711 046	2 576	556	-	5 7421	85	1 116	721 120
of which: Small and Medium enterprises	438 085	1 765	550	-	5 737	85	1 095	447 317
Households	502 501	21 447	3 415	8	5 070	1 561	26 790	560 792
Consumer credit	33 737	1 062	216	-	12	4	145	35 176
Credit card	5 613	183	23	-	11	1	17	5 848
Current account	10 606	1 984	106	4	30	17	190	12 937
Finance lease	2 543	19	6	-	1	1	32	2 602
Mortgage loan	428 763	18 085	3 047	4	5 016	1 538	26 370	482 823
Term loan	21 239	114	17	-	-	-	36	21 406
Trade receivables	-	-	-	-	-	-	-	-
Total	2 093 527	25 524	3 971	8	10 811	1 646	27 906	2 163 393

*The table includes the net carrying amount of loans and advances in the loans and receivables portfolio, cash and cash balances with central banks and other demand deposits to credit institutions.

As of 2018, the financial information is prepared in accordance with IFRS 9. For more information on the impact of the transition see Note 3. The accompanying notes on pages 12 to 164 are an integral part of these financial statements.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 20 – LOANS AND ADVANCES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

Maximum exposure to credit risk without taking into account of any collateral and credit enhancements

The table below presents the maximum exposure to credit risk for the components of the statement of financial position, including derivatives. The maximum exposure is shown gross, before the effect of mitigation through the use of master netting and collateral agreements.

	2018	2017
	MHUF	MHUF
Debt instruments*	715 748	688 538
Loans and advances	2 323 689	2 200 182
Derivatives*	67 829	62 216
Other assets	26 217	18 941
	<hr/>	<hr/>
Total assets	3 133 483	2 969 877
	<hr/>	<hr/>
Commitments to extend credit	630 560	585 668
Guarantees	240 780	213 406
Letters of credit	12 098	16 152
	<hr/>	<hr/>
Total commitments and contingent liabilities	883 438	815 226
	<hr/>	<hr/>
Total credit exposure	<u>4 016 921</u>	<u>3 785 103</u>

The amounts shown above represent the current credit risk exposure, which may change over time as a result of changes in values (derivative financial instruments, financial investments, etc.) and changes in FX rates (due to FCY lending). The effect of collateral and other risk mitigation techniques is shown in NOTE 42.4.

Risk concentration of the maximum exposure to credit risk

Concentration of risk is managed by client/client group and by industry sector. The maximum credit exposure to any client or counterparty as of 31 December 2018 was 50 286 million (HUF 32 880 million as of 31 December 2017) before taking account of any collateral or other credit enhancements.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 20 – LOANS AND ADVANCES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

Gross carrying amount transfers between impairment stages

	From Stage 1 to Stage 2	From Stage 2 to Stage 1	From Stage 2 to Stage 3	From Stage 3 to Stage 2	From Stage 1 to Stage 3	From Stage 3 to Stage 1	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Loans and advances at 31 December 2018*							
Central bank and credit institutions	-	1 779	-	-	-	-	1 779
General government	10	404	-	-	381	-	795
Corporate	22 583	26 953	311	6	-	24	24 164
of which: Small and Medium enterprises	12 033	11 791	311	6	-	23	24 164
Households	85 537	15 029	2 263	3 608	584	28	107 049
Consumer credit	66 231	30	35	-	57	-	66 353
Credit card	453	578	43	10	35	7	1 126
Current account	3 026	1 987	211	66	114	10	5 414
Finance lease	401	353	-	-	3	-	757
Mortgage loan	13 934	6 740	1 894	3 532	375	11	26 486
Term loan	1 492	5 341	80	-	-	-	6 913
Trade receivables	-	-	-	-	-	-	-
Total	108 130	44 165	2 574	3 614	965	52	159 500
Loan commitments	41 516	70 111	156	5	98	9	111 895
Financial guarantees	8 959	15 519	3	-	-	-	24 481
Other commitments	96	-	-	-	-	-	96
Total	51 571	85 630	159	5	98	9	136 472

*The table includes the gross carrying amount of loans and advances in the loans and receivables portfolio, cash and cash balances with central banks and other demand deposits to credit institutions.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 21 – IMPAIRMENT ON FINANCIAL ASSETS AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME AND AVAILABLE-FOR-SALE FINANCIAL ASSETS

The Bank recorded an additional impairment of HUF 2 million on debt securities at fair value through other comprehensive income in 2018. No impairment was recognised on available-for-sale assets in 2017.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018 NOTES TO THE FINANCIAL STATEMENTS

NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS

	Changes recorded in the income statement												
	Opening balance (IAS39) MHUF	Trans. to IFRS 9 MHUF	Incr. due to origin. MHUF	Decr. due to derecog. MHUF	Chg in cr. risk – no stage transfers MHUF	Chg in cr. risk – transf. fr. stage 1 MHUF	Chg in cr. risk – transf. fr. stage 2 MHUF	Chg in cr. risk – transf. fr. stage 3 MHUF	Chg due to modif. MHUF	Decr. due to write-offs MHUF	Other MHUF	Transl. diff. MHUF	Total MHUF
Impairment on financial assets at amortised cost classified as stage 1 at 31 December 2018													
Debt securities	70	471	156	(125)	-	-	-	-	-	-	-	-	572
Loans and advances*													
Central bank and credit institutions	9	8	7	(23)	6	-	-	-	-	-	8	-	15
General government	4	5	8	(4)	1	-	2	-	-	-	-	-	16
Corporate	728	(17)	657	(274)	71	(40)	296	-	-	(17)	3	(4)	1 403
of which: Small and Medium enterprises	520	(24)	479	(213)	88	(19)	283	-	-	(13)	(1)	-	1 100
Households	725	441	497	(84)	(431)	(374)	65	-	-	(16)	28	-	851
of which: POCI	-	-	-	-	-	-	-	-	-	-	-	-	-
Consumer credit	177	250	457	(37)	(238)	(24)	18	-	-	(11)	(1)	-	591
Credit card	46	5	9	(5)	(5)	(3)	4	-	-	(1)	-	-	50
Current account	46	9	6	(6)	(5)	(9)	5	-	-	(1)	-	-	45
Finance lease	5	1	5	-	(2)	(1)	1	-	-	-	-	-	9
Mortgage loan	438	165	36	(33)	(175)	(336)	31	-	-	(3)	1	-	124
Term loan	13	11	(16)	(3)	(6)	(1)	6	-	-	-	28	-	32
Total impairment on loans and advances	1 466	437	1 169	(385)	(353)	(414)	363	-	-	(33)	39	(4)	2 285

* Also including Cash and cash balances with central banks and other demand deposits to credit institutions.

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS (continued)

	Changes recorded in the income statement												
	Opening balance (IAS39) MHUF	Trans. to IFRS 9 MHUF	Incr. due to origin. MHUF	Decr. due to derecog. MHUF	Chg in cr. risk – no stage transfers MHUF	Chg in cr. risk – transf. fr. stage 1 MHUF	Chg in cr. risk – transf. fr. stage 2 MHUF	Chg in cr. risk – transf. fr. stage 3 MHUF	Chg due to modif. MHUF	Decr. due to write-offs MHUF	Other MHUF	Transl. diff. MHUF	Total MHUF
Impairment on financial assets at amortised cost classified as stage 2 at 31 December 2018													
Debt securities													
Loans and advances*													
Central bank and credit institutions	-	-	-	-	-	-	-	-	-	-	-	-	-
General government	-	2	-	(2)	-	-	(1)	-	-	-	1	-	-
Corporate	295	624	137	(121)	(65)	286	(404)	-	143	(2)	1	(1)	893
of which: Small and Medium enterprises	272	585	81	(101)	(75)	141	(371)	-	143	(1)	1	-	675
Households	1 480	3 305	1 832	(265)	(938)	1 434	(1 290)	(1 203)	-	(80)	(223)	-	4 052
of which: POCI	-	-	-	-	-	-	-	-	-	-	-	-	-
Consumer credit	117	204	1 108	(21)	(39)	101	(147)	1	-	(42)	(917)	-	365
Credit card	31	64	11	(11)	3	29	(43)	1	-	(6)	-	-	79
Current account	118	200	49	(44)	(23)	81	(72)	5	-	(28)	-	-	286
Finance lease	1	4	5	(1)	-	2	(3)	-	-	-	-	-	8
Mortgage loan	1 204	2 790	657	(184)	(872)	1 219	(992)	(1 210)	-	(4)	694	-	3 302
Term loan	9	43	2	(4)	(7)	2	(33)	-	-	-	-	-	12
Total impairment on loans and advances	1 775	3 931	1 969	(388)	(1 003)	1 720	(1 695)	(1 203)	143	(82)	(221)	(1)	4 945

*Also including Cash and cash balances with central banks and other demand deposits to credit institutions.

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS (continued)

Changes recorded in the income statement

	Opening balance (IAS39) MHUF	Trans. to IFRS 9 MHUF	Incr. due to origin. MHUF	Decr. due to derecog. MHUF	Chg in cr. risk – no stage transfers MHUF	Chg in cr. risk – transf. fr. stage 1 MHUF	Chg in cr. risk – transf. fr. stage 2 MHUF	Chg in cr. risk – transf. fr. stage 3 MHUF	Chg due to modif. MHUF	Decr. due to write- offs MHUF	Other MHUF	Transl. diff. MHUF	Total MHUF
Impairment on financial assets at amortised cost classified as stage 3 at 31 December 2018													
Debt securities													
Loans and advances*													
Central bank and credit institutions	-	-	-	-	-	-	-	-	-	-	-	-	-
General government	-	-	-	-	-	7	-	-	356	-	3	(2)	364
Corporate	11 076	132	2 004	(1 718)	(130)	384	171	(1)	(7)	(892)	11	(10)	11 020
of which: Small and Medium enterprises	9 852	93	2 004	(1 663)	(123)	384	171	(1)	(7)	(890)	(1)	-	9 819
Households	19 015	8 428	296	(7 295)	2 319	293	931	(532)	(12)	(8 802)	7 658	(25)	22 274
of which: POCI	6 151	6 277	42	(5 254)	1 514	-	-	197	(11)	(5 977)	7 642	-	10 581
Consumer credit	879	88	175	(561)	17	109	95	(17)	-	(107)	(54)	(21)	603
Credit card	43	5	3	(12)	(2)	8	10	(5)	-	(11)	-	-	39
Current account	714	(90)	111	(177)	176	23	41	(24)	-	(75)	1	-	700
Finance lease	388	38	4	(331)	5	1	-	-	-	-	-	-	105
Mortgage loan	16 842	8 385	33	(7 138)	2 121	152	773	(486)	(12)	(7 587)	7 711	(4)	20 790
Term loan	149	2	(30)	924	2	-	12	-	-	(1 022)	-	-	37
Total impairment on loans and advances	<u>30 091</u>	<u>8 560</u>	<u>2 300</u>	<u>(9 013)</u>	<u>2 189</u>	<u>684</u>	<u>1 102</u>	<u>(533)</u>	<u>337</u>	<u>(9 694)</u>	<u>7 672</u>	<u>(37)</u>	<u>33 658</u>

*Also including Cash and cash balances with central banks and other demand deposits to credit institutions.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS
NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS (continued)

Decrease due to write-offs presents the amount of impairments used for the compensation of net realised losses on loan and advances. Net realised losses includes the result of disposals as well. The gross carrying amount of loans and advances which were sold by the Bank amounted to HUF 16 307 million in 2018 (HUF 13 865 million in 2017). The Bank recorded a HUF 8 631 million income on the disposals (HUF 5 338 million in 2017). The gross carrying amount of loans simply written-off instead of selling them amounted to HUF 2 262 million in 2018 (HUF 156 million in 2017).

Stage transfers show shifts between stages having impact on profit or loss. 'Stage transfers from' columns decrease the balance of impairments in the old stage category and increase the balance in the new stage category.

The breakdown of impairments on cash balances with central banks and other demand deposits to credit institutions and financial assets at amortised cost recorded in the income statement in 2018 is presented below.

	<u>Stage 1</u> MHUF	<u>Stage 2</u> MHUF	<u>Stage 3</u> MHUF	<u>Total</u> MHUF
Impairment on financial assets at amortised cost at 31 December 2018				
Debt securities	(31)			(31)
Loans and advances*				
Central bank and credit institutions	10	-	-	10
General government	(7)	3	(363)	(367)
Corporate	(710)	24	(703)	(1 389)
of which: Small and Medium enterprises	(618)	182	(765)	(1 201)
Households	327	430	4 000	4 757
of which: POCI	-	-	3 512	3 512
Consumer credit	(176)	(1 003)	182	(997)
Credit card	-	10	(2)	8
Current account	9	4	(150)	(137)
Finance lease	(3)	(3)	321	315
Mortgage loan	477	1 382	4 557	6 416
Term loan	20	40	(908)	(848)
Total	<u>(411)</u>	<u>457</u>	<u>2 934</u>	<u>2 980</u>

*Also including Cash and cash balances with central banks and other demand deposits to credit institutions.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS
NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS (continued)

	Changes recorded in the income statement												
	Opening balance (IAS39) MHUF	Trans. to IFRS 9 MHUF	Incr. due to origin. MHUF	Decr. due to derecog. MHUF	Chg in cr. risk – no stage transfers MHUF	Chg in cr. risk – transf. fr. stage 1 MHUF	Chg in cr. risk – transf. fr. stage 2 MHUF	Chg in cr. risk – transf. fr. stage 3 MHUF	Chg due to modif. MHUF	Decr. due to write-offs MHUF	Other MHUF	Transl. diff. MHUF	Total MHUF
Impairment on loan commitments and guarantees classified as stage 1 at 31 December 2018													
Loan commitments	206	(35)	63	(28)	31	(7)	14	-	-	-	7	-	251
Financial guarantees	66	(59)	4	(2)	(34)	-	34	-	-	-	-	-	9
Other commitments	5	(2)	-	(1)	(1)	-	-	-	-	-	-	-	1
Total	277	(96)	67	(31)	(4)	(7)	48	-	-	-	7	-	261
Impairment on loan commitments and guarantees classified as stage 2 at 31 December 2018													
Loan commitments	31	328	15	(38)	(11)	60	(219)	-	-	-	2	-	168
Financial guarantees	5	313	10	(313)	(1)	1	(2)	-	-	-	-	-	13
Other commitments	-	-	-	-	-	-	-	-	-	-	-	-	-
Total	36	641	25	(351)	(12)	61	(221)	-	-	-	2	-	181

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS (continued)

	Changes recorded in the income statement											Total MHUF	
	Opening balance (IAS39) MHUF	Trans. to IFRS 9 MHUF	Incr. due to origin. MHUF	Decr. due to derecog. MHUF	Chg in cr. risk – no stage transfers MHUF	Chg in cr. risk – transf. fr. stage 1 MHUF	Chg in cr. risk – transf. fr. stage 2 MHUF	Chg in cr. risk – transf. fr. stage 3 MHUF	Chg due to modif. MHUF	Decr. due to write- offs MHUF	Other MHUF		Transl. diff. MHUF
Impairment on loan commitments and guarantees classified as stage 3 at 31 December 2018													
Loan commitments	227	-	(35)	(104)	(13)	-	-	-	-	-	35	-	110
Financial guarantees	764	(276)	1 034	(488)	-	-	-	-	-	-	1	-	1 035
Other commitments	70	(1)	68	(55)	(13)	-	-	-	-	-	(1)	-	68
Total	1 061	(277)	1 067	(647)	(26)	-	-	-	-	-	35	-	1 213

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS****NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS (continued)**

The breakdown of provision on loan commitments and guarantees recorded in the income statement in 2018 is presented below.

	<u>Stage 1</u> <u>MHUF</u>	<u>Stage 2</u> <u>MHUF</u>	<u>Stage 3</u> <u>MHUF</u>	<u>Total</u> <u>MHUF</u>
Loan commitments	(73)	193	152	272
Financial guarantees	(2)	305	(546)	(243)
Other commitments	2	-	-	2
Total	<u>(73)</u>	<u>498</u>	<u>(394)</u>	<u>31</u>

2017
MHUF

Impairments and provisions on loans and receivables and credit commitments

Specific impairments for loans and receivables	(361)
Specific provisions on credit commitments	875
Portfolio-based impairments and provisions	<u>249</u>

Total impairments and provisions on loans and receivables and credit commitments

763

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS****NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS (continued)**

	<u>2018</u> MHUF	<u>2017</u> MHUF
Impairment on other		
Intangible assets	(4)	(575)
Investment property	1	(26)
Property, plant and equipment	(198)	(251)
Other	(180)	11
	<u>(381)</u>	<u>(841)</u>
Total impairment on other	<u>(381)</u>	<u>(841)</u>

	<u>2017</u> MHUF
Breakdown by type	
Specific impairment for loans and receivables	30 121
Specific provision on credit commitments	1 097
Portfolio-based impairment and provision	<u>3 488</u>
Total Impairment and provision on loans and receivables and credit commitments	<u>34 706</u>

	<u>2017</u> MHUF
Breakdown by counterparty	
Impairment for loans and advances to customers (excluding banks)	33 331
Impairment for debt instruments issued by municipalities	1
Specific and portfolio based provision, credit commitments	<u>1 374</u>
Total impairment and provision on loans and receivables and credit commitments	<u>34 706</u>

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 22 – IMPAIRMENT ON FINANCIAL ASSETS AT AMORTISED COST AND PROVISION FOR CREDIT COMMITMENTS (continued)

	Specific impairment for loans and receivables	Specific provision on credit commitments	Portfolio-based impairments and provisions	Total
	MHUF	MHUF	MHUF	MHUF
Opening balance as at 1 January 2017	39 159	1 978	3 741	44 878
Movements with an impact on results				
Loan loss expenses	15 255	436	7 216	22 907
Loan loss recoveries	(14 894)	(1 311)	(7 465)	(23 670)
Discount effect	(147)	1	-	(146)
Movements without an impact on results				
Write-offs	(8 683)	-	-	(8 683)
Other	(569)	(7)	(4)	(580)
Closing balance as at 31 December 2017	<u>30 121</u>	<u>1 097</u>	<u>3 488</u>	<u>34 706</u>

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 23 – DERIVATIVE FINANCIAL INSTRUMENTS

	Year ended 31 December 2018				Year ended 31 December 2017			
	Notional amount Assets MHUF	Notional amount Liabilities MHUF	Positive fair value Assets MHUF	Negative fair value Liabilities MHUF	Notional amount Assets MHUF	Notional amount Liabilities MHUF	Positive fair value Assets MHUF	Negative fair value Liabilities MHUF
Derivatives held for trading								
Foreign exchange derivatives								
Currency forwards	76 976	76 733	659	(245)	63 267	63 558	306	(460)
Currency futures	28 476	28 596	35	(21)	20 456	20 471	15	(9)
Currency swaps	1 027 260	1 027 354	4 588	(4 989)	476 339	474 893	2 979	(1 490)
Currency options bought and sold	368 101	368 101	4 702	(4 712)	221 397	221 397	3 093	(2 725)
Total foreign exchange derivatives	1 500 813	1 500 784	9 984	(9 967)	781 459	780 319	6 393	(4 684)
Interest rate derivatives								
Interest rate swaps	3 042 939	3 042 939	53 481	(41 586)	651 219	651 219	30 604	(19 740)
Cross currency interest rate swaps	192 629	192 457	1 373	(2 431)	159 363	159 545	1 864	(2 922)
Interest rate options	10 857	10 857	31	(31)	7 018	7 018	25	(25)
Forward rate agreements	-	-	-	-	6 203	-	-	-
Total interest rate derivatives	3 246 425	3 246 253	54 885	(44 048)	823 803	817 782	32 493	(22 687)
Equity options	-	228	-	-	-	228	-	-
Commodity swaps	2 191	2 191	85	(85)	1 167	1 167	41	(41)
Commodity options	4 657	4 657	163	(163)	3 325	3 325	225	(225)
Total derivatives held for trading	4 754 086	4 754 113	65 117	(54 263)	1 609 754	1 602 821	39 152	(27 637)
Derivatives designated as micro fair value hedges								
Interest rate swaps	19 666	19 666	-	(109)	222 811	222 811	6 389	(193)
Derivatives designated as portfolio fair value hedges								
Interest rate swaps	683 375	683 375	11 282	(8 423)	591 602	591 602	16 675	(3 910)
Derivatives designated as cash flow hedges								
Interest rate swap	440 298	443 070	5 983	(5 034)	-	-	-	-
Total derivatives held for hedging	1 143 339	1 146 111	17 265	(13 566)	814 413	814 413	23 064	(4 103)
Total derivative financial instruments	5 897 425	5 900 224	82 382	(67 829)	2 424 167	2 417 234	62 216	(31 740)

As of 2018, the financial information is prepared in accordance with IFRS 9. For more information on the impact of the transition see Note 3. The accompanying notes on pages 12 to 164 are an integral part of these financial statements.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 23 – DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Options

Although options are not accounted for as hedges, the Bank has an operational policy where the risks of options sold and purchased are matched on a one to one basis with offsetting deals conducted with counterparties of sound credit standing.

The Bank applies hedge accounting for some of its derivatives concluded in frame of Asset and Liability Management.

Cash flow hedge of interest rate risk

The aim of the cash-flow hedges designated by the Bank is to hedge changes in cash flows group of assets and liabilities related to changes in interest and foreign exchange rates. The hedging instruments are EUR and HUF interest rate swaps.

Hedging relationships are subject to prospective and retrospective effectiveness measurement. Fair value changes in hedging instruments for the effective part of the hedging relationship are recognised in other comprehensive income and are accumulated to Cash flow hedge reserve. Since the exchange revaluation result of the hedged assets and liabilities is recorded as Net gains / (losses) from financial instruments at fair value through profit or loss, the foreign exchange revaluation effect of the hedging cross currency interest rate swaps recorded in Other comprehensive income was transferred to the income statement at the same time.

The Bank recorded a HUF 3 921 million loss (HUF 276 million loss) in the other comprehensive income in 2018 resulting from the changes of the fair value of hedging derivatives. The result is recorded as Cash flow hedge - Net gain / (loss) from fair value changes in the other comprehensive income. In 2018 the Bank transferred HUF 194 million loss to the net profit due to ineffectiveness (HUF 233 million loss in 2017) recorded as Cash flow hedge – Ineffective part in the other comprehensive income. The result of the transfers were recorded as Net gains / (losses) from financial instruments at fair value through profit or loss in the income statement (see Note 7).

The fair value change used for recognising hedge ineffectiveness for the period amounted to HUF 194 million loss in 2018. The Bank recognised HUF 1 810 million gain in other comprehensive income as the effective portion at 31 December 2018. Other comprehensive income includes HUF 559 million gain reserve on discontinued cash flow hedges in 2018.

The periods when the cash flows are expected to occur are the following:

	2018		2017	
	Expected cash flows		Expected cash flows	
	Inflow MHUF	Outflow MHUF	Inflow MHUF	Outflow MHUF
< 3 months	345	(131)	174	(11)
3-6 months	736	(168)	388	14
6 months - 1 year	2 496	(513)	1 041	28
1-2 years	3 837	(2 381)	1 660	(136)
2-5 years	8 273	(10 063)	3 061	(1 353)
> 5 years	4 247	(5 045)	759	(913)
Total	19 934	(18 301)	7 083	(2 371)

Forecast transactions for which hedge accounting had previously been used but which is no longer expected to occur amounted to HUF 28 million as at 31 December 2018 (HUF 38 million as at 31 December 2017). The related transfer was presented as Cash flow hedges – Gross amount in the other comprehensive income.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 23 – DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Fair value hedge of interest rate risk

The risk to be hedged under fair value hedge of interest rate risk is interest rate risk, arising from changes in fair value of non-maturity deposits to changes in the risk-free (interest rate swap) yield curve. The hedging instruments are HUF interest rate swaps.

The accumulated fair value changes of hedged item under portfolio hedge of interest rate risk is presented separately in the statement of financial position and amounted to HUF 6 164 million loss and HUF 7 333 million gain in 2018 (HUF 12 560 million loss as at 31 December 2017). The loss recorded on the hedged item was compensated by a gain recorded on the hedging instrument in the same amount. The fair value changes of the hedged item and the hedging instrument in the current year is recorded as Net gains / (losses) from financial instruments at fair value through profit or loss in the income statement.

Fair value hedge of fixed rate available-for-sale/FVOCI bonds

The Bank defines the risk to be hedged as the interest rate risk arising from changes in fair value of available-for-sale/FVOCI bonds to changes in the risk-free (interest rate swap) yield curve. The hedging instruments are fixed rate payer-floating rate receiver (BUBOR 3M-6M) interest rate swaps.

The changes in the fair value of the available-for-sale/FVOCI government bonds and the interest rate swaps due to interest rate risk are offset in the income statement and the unhedged credit spread of the bonds remains in the other comprehensive income. The change in the fair value of the hedged instrument amounted to a gain of HUF 1 160 million in 2018 (a loss of HUF 1 504 million in 2017).

The following table presents information related to the hedged items under fair value hedge in 2018. Hedging instruments are interest rate swaps.

	<u>Micro Fair value hedge</u>		<u>Portfolio fair value hedge</u>	
	<u>Carrying amount</u>	<u>Accumulated fair value adjustments</u>	<u>Carrying amount</u>	<u>Accumulated fair value adjustments</u>
	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>
Hedged items				
Debt securities at fair value through other comprehensive income	-	-	58 750	835
Debt securities at amortised cost	19 941	(17)	135 783	6 001
Loans and advances at amortised cost	-	-	71 876	1 332
Total hedged assets	19 941	(17)	266 409	8 168
Deposits at amortised cost	-	-	468 259	6 164
Total hedged liabilities	-	-	468 259	6 164

There was no hedge ineffectiveness recognised for the period in 2018 (nor in 2017).

There is no remaining fair value adjustment recognised on any hedged item in case of discontinued hedges in the consolidated financial position in 2018 (nor in 2017).

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 24 – NON-CURRENT ASSETS HELD FOR SALE AND DISPOSAL GROUPS

Non-current assets held for sale and disposal groups include IT equipments and softwares. In 2018 the Bank decided to sell the equipments and intangible assets in a short term and reclassified it from property, plant and equipment, intangible assets to non-current assets held for sale and disposal groups. (In 2017 there was a building located in Budapest in this category which was sold in January 2018)

The assets are measured at the carrying amount since it is lower than its fair value less costs to sell.

NOTE 25 – OTHER ASSETS

	<u>2018</u>	<u>2017</u>
	<u>MHUF</u>	<u>MHUF</u>
Prepayments	471	518
Trade receivables	1 488	1 150
Receivables from bankcard service	17 120	10 832
Items in transit due to payment services	413	217
Items in transit due to trading in securities	48	20
Income accruals and cost prepayments	5 315	5 113
Inventories	637	544
Other receivables	725	547
	<u>26 217</u>	<u>18 941</u>

NOTE 25 – OTHER ASSETS (continued)

Trade receivables and receivables from bankcard and payment services are performing short term receivables without any delay. Other receivables include a HUF 232 million non-performing other claim due to retail clients (HUF 258 million as at 31 December 2017) for which a HUF 231 million impairment charge is recorded in the income statement (HUF 236 million as at 31 December 2017).

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS
NOTE 26 – DEFERRED TAX ASSETS AND DEFERRED TAX LIABILITIES

The deferred tax included in the statement of financial position and changes recorded in the income statement and equity are as follows:

For the period ended 31 December 2018:

	<u>Assets</u> MHUF	<u>Liabilities</u> MHUF	<u>Income statement</u> MHUF	<u>Equity</u> MHUF
Employee benefits	(6)	-		(2)
Losses carry forward	-	-	-	-
Tangibles and intangibles assets	458	-	1	-
Other provisions for risk and charges and credit commitments	53	-	2	-
Impairment for losses on loans and advances	-	-	-	-
Financial instruments at fair value	-	-	-	5
Fair value adjustments FVOCI	(475)	-	-	93
Cash flow hedge	(213)	-	-	383
Transition to IFRS	538	-	(541)	-
Transition to IFRS 9	-	-	(370)	1 768
Other	6	-	(60)	-
	<u>361</u>	<u>-</u>	<u>(968)</u>	<u>2 247</u>
Total	<u>361</u>	<u>-</u>	<u>(968)</u>	<u>2 247</u>

For the period ended 31 December 2017:

	<u>Assets</u> MHUF	<u>Liabilities</u> MHUF	<u>Income statement</u> MHUF	<u>Equity</u> MHUF
Employee benefits	-	4	(46)	(4)
Losses carry forward	-	-		-
Tangibles and intangibles assets	-	(457)	(68)	-
Other provisions for risk and charges and credit commitments	-	(51)	(8)	-
Impairment for losses on loans and advances	-	-	(63)	-
Financial instruments at fair value	-	5	(1 849)	(5)
Fair value adjustments AFS FVOCI	-	1 966	(29)	(479)
Cash flow hedge	-	596	(10)	17
Transition to IFRS	-	(1 079)	1 079	-
Other	-	(42)	302	-
	<u>-</u>	<u>942</u>	<u>(692)</u>	<u>(471)</u>
Total	<u>-</u>	<u>942</u>	<u>(692)</u>	<u>(471)</u>

In 2018 and 2017 income taxes were calculated on all temporary differences under the asset and liability method using a tax rate of 9% or 10.82% (9% corporate income tax and 1.82% local business tax).

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 27 – INVESTMENTS IN SUBSIDIARIES AND ASSOCIATED COMPANIES

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
K&H Autópark Kft.	410	410
K&H Csoportszolgáltató Kft.	60	60
K&H Equities Zrt.	4 584	4 757
K&H Befektetési Alapkezelő Zrt.	850	850
K&H Faktor Zrt.	450	450
K&H Ingatlanlízing Zrt.	50	50
K&H Jelzálogbank Zrt.	4 500	3 500
HAGE Zrt.	-	542
	<hr/>	<hr/>
Total	<u>10 904</u>	<u>10 619</u>

The table includes the net carrying amount of investments.

The Bank increased the capital of K&H Jelzálogbank Zrt. by HUF 1 000 million in 2018.

For more information on the subsidiaries and associated companies see Note 40.

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS**NOTE 28 – INVESTMENT PROPERTIES**

	Investment properties
	MHUF
At 31 December 2016	
Cost	1 087
Accumulated depreciation	<u>(77)</u>
Net book value	1 010
Movements in 2017	
Additions	1 031
Disposals - net	(522)
Impairment charge	(26)
Depreciation charge	<u>(17)</u>
At 31 December 2017	
Cost	1 579
Accumulated depreciation	<u>(103)</u>
Net book value	<u><u>1 476</u></u>
Movements in 2018	
Additions	1 393
Disposals - net	(1 166)
Impairment charge	1
Depreciation charge	<u>(15)</u>
At 31 December 2018	
Cost	1 804
Accumulated depreciation	<u>(115)</u>
Net book value	<u><u>1 689</u></u>

Investment properties include collaterals obtained by taking in possession. The Bank intends to sell investment properties within a reasonable time period.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 28 – INVESTMENT PROPERTIES (continued)

The following table presents the results related to investment properties.

	<u>2018</u> MHUF	<u>2017</u> MHUF
Impairment on investment property		
Additions	(4)	(29)
Reversals	<u>6</u>	<u>3</u>
Total impairment	<u>1</u>	<u>(26)</u>
Expenses from investment properties		
Acquisition cost	(160)	(171)
Maintenance expenses	(111)	(75)
Sale related cost	<u>(35)</u>	<u>(18)</u>
Total expenses	<u>(306)</u>	<u>(264)</u>

The difference between the fair value and the carrying amount of the assets is immaterial as at 31 December 2018 (and as at 31 December 2017).

The Bank believes that the carrying amount of investment properties approximates their fair value (classified as level 3 in the fair value hierarchy).

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS****NOTE 29 – PROPERTY, PLANT AND EQUIPMENT**

	<u>Land and buildings</u> MHUF	<u>IT equipment</u> MHUF	<u>Office equipment</u> MHUF	<u>Other</u> MHUF	<u>Total</u> MHUF
At 31 December 2016					
Cost	48 734	12 064	9 225	1 478	71 501
Accumulated depreciation	(17 769)	(7 846)	(7 162)	(418)	(33 195)
Net book value	30 965	4 218	2 063	1 060	38 306
Movements in 2017					
Additions (acquired separately)	2 713	3 270	77	652	6 712
Disposals - net	(60)	-	-	(19)	(79)
Transfer	(1 921)	-	-	-	(1 921)
Impairment charge	(190)	(41)	(10)	(10)	(251)
Depreciation charge	(2 612)	(1 567)	(693)	15	(4 857)
Other	-	(1)	-	-	(1)
At 31 December 2017					
Cost	46 651	14 067	8 960	2 073	71 751
Accumulated depreciation	(17 756)	(8 188)	(7 523)	(375)	(33 842)
Net book value	28 895	5 879	1 437	1 698	37 909
Movements in 2018					
Additions (acquired separately)	1 466	1 643	401	419	3 929
Disposals - net	(26)	(8)	-	(36)	(70)
Transfer	-	(1 087)	-	-	(1 087)
Impairment charge	(175)	(14)	(8)	(1)	(198)
Depreciation charge	(2 637)	(1 734)	(534)	(350)	(5 255)
Other	-	-	-	-	-
At 31 December 2018					
Cost	48 815	11 641	8 737	2 442	71 635
Accumulated depreciation	(21 292)	(6 962)	(7 441)	(712)	(36 407)
Net book value	<u>27 522</u>	<u>4 680</u>	<u>1 296</u>	<u>1 730</u>	<u>35 228</u>

The reclassification of IT equipments as Non-current assets held for sale and disposal groups is presented as transfer in the table above (see Note 22).

Expenditure on items in the course of construction amounted to HUF 10 613 million as at 31 December 2018 (HUF 5 357 million as at 31 December 2017).

Fully amortised tangible assets which were still in use amounted to HUF 16 066 million as at 31 December 2018 (HUF 12 866 million as at 31 December 2017).

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS****NOTE 30 – INTANGIBLE ASSETS**

	<u>Software MHUF</u>	<u>Other intangible assets MHUF</u>	<u>Total MHUF</u>
At 31 December 2016			
Cost	41 466	4	41 470
Accumulated depreciation	(28 997)	(4)	(29 001)
Net book value	12 469	-	12 469
Movements in 2017			
Additions (acquired separately)	6 011	37	6 048
Impairment charge	(575)	-	(575)
Depreciation charge	(3 387)	(35)	(3 422)
Other	(1)	2	1
At 31 December 2017			
Cost	46 894	45	46 939
Accumulated depreciation	(32 377)	(41)	(32 418)
Net book value	14 517	4	14 521
Movements in 2018			
Additions (acquired separately)	9 270	-	9 270
Disposals - net	(238)	-	(238)
Impairment charge	(4)	-	(4)
Depreciation charge	(3 778)	(4)	(3 782)
Other	-	-	-
At 31 December 2018			
Cost	54 508	42	54 550
Accumulated depreciation	(34 741)	(42)	(34 783)
Net book value	19 767	-	19 767

The reclassification of software as Non-current assets held for sale and disposal groups is presented as transfer in the table above (see Note 22).

Fully amortised intangible assets which were still in use amounted to HUF 27 076 million as at 31 December 2018 (HUF 24 059 million as at 31 December 2017).

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS**NOTE 31 – PROVISIONS FOR RISK AND CHARGES**

	<u>Provision for restructuring</u> MHUF	<u>Provision for tax litigation and pending legal disputes</u> MHUF	<u>Other</u> MHUF	<u>Total</u> MHUF
Balance as at 31 December 2016	10	116	74	200
Amounts allocated	-	111	-	111
Amounts used	(6)	-	-	(6)
Unused amounts reversed	(4)	(108)	(7)	(119)
Other (foreign exchange revaluation)	-	-	(1)	(1)
Balance as at 31 December 2017	-	119	66	185
Amounts allocated	-	10	2	12
Amounts used	-	-	-	-
Unused amounts reversed	-	(59)	(1)	(60)
Other (foreign exchange revaluation)	-	-	-	-
Balance as at 31 December 2018	-	70	67	137

The Bank is party to litigation and claims arising in the normal course of business, the provision of HUF 60 million from the total provision for losses from tax litigation and pending legal disputes at 31 December 2018 relates to these litigations (HUF 119 million at 31 December 2017). Management considers the provision raised for the still pending cases adequate to cover any remaining potential losses.

Provisions on credit commitments of HUF 1 655 million as at 31 December 2018 (HUF 1 097 million as at 31 December 2017) is presented in Note 22 and Note 35. The sum of HUF 137 million provision for risk and charges and HUF 1 655 million provisions for credit commitments amounts to HUF 1 792 million (HUF 1 282 million in 2017).

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 32 – OTHER LIABILITIES

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Trade creditors	4 808	6 808
Lease liabilities	23 795	23 822
Items in transit due to payment services	34 871	19 085
Items in transit due to lending activity	1 779	2 201
Liabilities from bankcard service	10 988	5 445
Other	16 977	16 330
	<u>93 218</u>	<u>73 691</u>

Other liabilities include mainly short term liabilities.

Other includes trading tax liabilities, social charges, liability from transactional levy not settled yet, liabilities due to employees (see Note 37) and other accrued charges and deferred income arising from the normal course of business recorded as general administrative expenses in the income statement.

NOTE 33 – SHARE CAPITAL

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Ordinary shares issued and outstanding	<u>140 978</u>	<u>140 978</u>

The nominal value of the ordinary shares issued and outstanding at 31 December 2018 is HUF 1 per share (31 December 2017: HUF 1).

Shareholders of the Bank:

	<u>2018</u> <u>Shareholding</u> <u>%</u>	<u>2017</u> <u>Shareholding</u> <u>%</u>
KBC Bank N. V.	<u>100.00</u>	<u>100.00</u>
	<u>100.00</u>	<u>100.00</u>

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 34 – ADDITIONAL INFORMATION TO THE CASH FLOW STATEMENT

Net debt with regard to financing activities are presented in the table below.

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Cash and cash equivalents	412 240	685 675
Subordinated liabilities (see Note 14)	(40 802)	(39 362)
Finance lease due after 1 year	-	(23 822)
Borrowing – repayable within 1 year	(10 687)	(9 506)
Borrowing – repayable after 1 year	(262 470)	(257 669)
	<hr/>	<hr/>
Net debt	<u>98 281</u>	<u>355 316</u>

K&H BANK ZRT.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 34 – ADDITIONAL INFORMATION TO THE CASH FLOW STATEMENT (continued)

The components of net debt changed as follows in 2018.

	Cash	Cash balances with central banks	Other demand deposits with credit institutions	Loans and advances to banks repayable on demand and term loans to banks < 3 months	Deposits from banks repayable on demand and redeemable at notice	Finance leases due after 1 year	Subordinated liabilities	Borrowing – repayable within 1 year	Borrowing – repayable after 1 year	Total net debt
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Net debt as at 31 December 2017	36 789	201 542	199 515	283 399	(35 570)	(23 822)	(39 362)	(9 506)	(257 669)	355 316
Cash flows	6 044	172 497	(109 141)	(232 313)	(97 833)	24 486	685	(5 441)	(13 394)	(254 410)
Foreign exchange adjustments	-	952	2 437	160	811	-	(1 448)	-	(5 295)	(2 383)
Other non-cash movements	-	(13 527)	(16 461)	44	12 895	(664)	(677)	4 260	13 888	(242)
Net debt as at 31 December 2018	<u>42 833</u>	<u>361 464</u>	<u>76 350</u>	<u>51 290</u>	<u>(119 697)</u>	<u>-</u>	<u>(40 802)</u>	<u>(10 687)</u>	<u>(262 470)</u>	<u>98 281</u>

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018
NOTES TO THE FINANCIAL STATEMENTS**

NOTE 34 – ADDITIONAL INFORMATION TO THE CASH FLOW STATEMENT (continued)

The components of net debt changed as follows in 2017.

	Cash	Cash balances with central banks	Other demand deposits with credit institutions	Loans and advances to banks repayable on demand and term loans to banks < 3 months	Deposits from banks repayable on demand and redeemable at notice	Finance leases due after 1 year	Subordinated liabilities	Borrowing – repayable within 1 year	Borrowing – repayable after 1 year	Total net debt
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Net debt as at 31 December 2016	35 457	186 562	17 767	412 676	(51 453)	(23 849)	(27 957)	(1 689)	(258 146)	289 368
Cash flows	1 398	20 840	182 265	(127 064)	12 502	743	(10 765)	(7 816)	(4 329)	67 774
Foreign exchange adjustments	(66)	-	(568)	(2 570)	211	-	145	-	3 356	508
Other non-cash movements	-	(5 860)	51	357	3 170	(716)	(785)	(1)	1 450	(2 334)
Net debt as at 31 December 2017	<u>36 789</u>	<u>201 542</u>	<u>199 515</u>	<u>283 399</u>	<u>(35 570)</u>	<u>(23 822)</u>	<u>(39 362)</u>	<u>(9 506)</u>	<u>(257 669)</u>	<u>355 316</u>

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 35 – COMMITMENTS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES

In the normal course of business, the Bank is a party to credit related financial instruments with off-statement of financial position risk. These financial instruments include commitments to extend credit, financial guarantees and commercial letters of credit. These instruments involve elements of credit risk in excess of the amounts recognized in the statement of financial position.

Credit risk for off-statement of financial position financial instruments is defined as the possibility of sustaining a loss because any other party to a financial instrument fails to perform in accordance with the terms of the contract. The Bank uses the same credit policies in making commitments and conditional obligations as it does for financial instruments in the statement of financial position through established credit approvals, risk control limits and monitoring procedures.

Commitments are contractual agreements to extend credit which generally have fixed expiration dates or other termination requirements and may require payment of a fee. The potential credit loss is less than the total unused commitments since most commitments to extend credit are contingent upon customers maintaining specific standards. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Financial guarantees are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing guarantees is essentially the same as that involved in extending credit facilities to other customers. The Bank applies similar principles as those applied in assessing the required allowance for losses under other credit facilities when assessing the likelihood of loss under the guarantee.

Letters of credit represent a financing transaction by a Bank to its customer where the customer is usually the buyer/importer of goods and the beneficiary is typically the seller/exporter. Credit risk is limited as the merchandise shipped serves as collateral for the transaction.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 35 – COMMITMENTS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (continued)

The Bank has the following commitments, contingent assets and liabilities:

	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Credit commitments – undrawn amount		
Received	3 569	10 707
Given		
Irrevocable	292 077	288 309
Revocable	341 929	297 824
Total given	<u>634 006</u>	<u>586 133</u>
Collaterals		
Given	<u>239 724</u>	<u>214 240</u>
Guarantees received/collateral		
For impaired and past due assets		
Non-financial assets	77 538	125 873
Financial assets	5 991	6 772
For assets that are not impaired or past due		
Non-financial assets	1 493 354	1 243 521
Financial assets	305 373	325 041
Total guarantees received/collateral	<u>1 882 256</u>	<u>1 701 207</u>
Other commitments given – irrevocable	<u>12 028</u>	<u>16 227</u>

The amount of the received guarantees and collaterals includes the indexed or reviewed collateral value.

The following table presents the nominal value and the provision for loan commitments and guarantees at 31 December 2018.

K&H BANK ZRT.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 35 – COMMITMENTS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (continued)

The following table presents the nominal value and the provision for loan commitments and guarantees at 31 December 2018.

	<u>Nominal amount</u>			<u>Provision</u>			<u>Total MHUF</u>
	<u>Performing</u>		<u>Non- performing</u>	<u>Performing</u>		<u>Non- performing</u>	
	<u>Stage 1 MHUF</u>	<u>Stage 2 MHUF</u>	<u>Stage 3 MHUF</u>	<u>Stage 1 MHUF</u>	<u>Stage 2 MHUF</u>	<u>Stage 3 MHUF</u>	
Loan commitments	553 655	79 083	1 268	(251)	(168)	(110)	633 477
Financial guarantees	214 457	23 252	2 015	(9)	(13)	(1 035)	238 667
Other commitments	10 852	631	545	(1)	-	(68)	11 959
Total	778 964	102 966	3 828	(261)	(181)	(1 213)	884 103

For evaluation of provision on commitments and contingent liabilities in 2018 see Note 22.

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS**NOTE 35 – COMMITMENTS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (continued)**

The following table presents the nominal value and the provision for loan commitments and guarantees at 31 December 2017.

	<u>Nominal amount</u>		<u>Provision</u>		<u>Total</u>
	<u>Performing MHUF</u>	<u>Non- performing MHUF</u>	<u>Performing MHUF</u>	<u>Non- performing MHUF</u>	
Loan commitments	585 149	984	(237)	(228)	585 668
Financial guarantees	213 232	1 008	(52)	(782)	213 406
Other commitments	15 968	259	(7)	(68)	16 152
Total	<u>814 349</u>	<u>2 251</u>	<u>(296)</u>	<u>(1 078)</u>	<u>815 226</u>

For evaluation of provision on commitments and contingent liabilities in 2017 see Note 22.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS**

NOTE 35 – COMMITMENTS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (continued)

The table below presents the nominal amount of stage 1 commitments and contingent liabilities by internal risk grade categories in 2018.

	Commitments and contingent liabilities
	MHUF
High grade	318 642
Standard grade	278 252
Sub-standard grade	182 070
	<hr/>
Total carrying value	778 964

Legal claims

Litigation is a common occurrence in the banking industry due to the nature of the business. The Bank has an established protocol of dealing with such legal claims. Once professional advice has been obtained and the amount of damages reasonably estimated, the Bank makes adjustments to account for any adverse effects which the claims may have on its financial standing. At year-end the Bank had several unresolved legal claims in the amount of HUF 1 340 million (HUF 1 180 million as at 31 December 2017) where the Bank has been advised by its legal advisor that it is possible, but not probable, that the action will succeed. Accordingly no provision for these claims has been made in these financial statements.

NOTE 36 – FINANCE AND OPERATING LEASES***Lessor position***

The Bank operates in the domestic leasing market and provides both finance and operating lease products to customers. Certain lease contracts designated as operating lease under Hungarian Accounting Standards are designated as finance lease according to the IFRS terminology.

The assets leased out by the Bank are predominantly cars and trucks. In finance lease, the lessee selects an asset and the Bank purchases that asset and gives it to the lessee. In this way the Bank acts as a financier of the assets borrowed by the lessee. The lessee will have to use the asset during the lease period and will have to pay for the cost of repairs, maintenance and insurance of the asset. The Bank is the legal owner of the asset during the period of lease and recovers a major part of the cost of the asset plus interest earned from lease payment by the lessee. The lessee assumes some risks of the ownership and enjoys some of the benefits. The lessee or the third party has the option to acquire ownership of the asset by paying a nominal price which is the repurchase price.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 36 – FINANCE AND OPERATING LEASES (continued)

The following tables indicate the key amounts of the Bank's lease activity:

	<u>2018</u>	<u>2017</u>
	<u>MHUF</u>	<u>MHUF</u>
Finance lease receivables		
Total of gross investment in the lease, receivable:		
less than one year	22 093	17 955
one to five years	45 527	40 646
more than five years	<u>2 295</u>	<u>2 468</u>
	<u>69 915</u>	<u>61 069</u>
The present value of minimum lease payments receivables*:		
less than one year	20 704	16 953
one to five years	43 401	37 783
more than five years	<u>2 250</u>	<u>2 368</u>
	<u>66 355</u>	<u>57 104</u>
Unearned finance income	3 561	3 965
Contingent rents recognized as income - gross	1 402	1 351
Non-guaranteed residual values	12 525	9 902

*Net of impairment.

The total impairment recorded on finance lease receivables amounted to HUF 341 million as at 31 December 2018 (HUF 573 million as at 31 December 2017).

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 36 – FINANCE AND OPERATING LEASES (continued)

Lessee position

Operative lease

The Bank has entered into property lease agreements which are accounted for as operating leases. The Bank has the following commitments for the remaining term of the contracts:

	<u>2018</u> MHUF	<u>2017</u> MHUF
Total of future minimum lease payments under non-cancellable operating leases:		
less than one year	897	1 066
one to five years	6 515	6 742
more than five years	1 245	426
	<u>8 657</u>	<u>8 234</u>

	<u>2018</u> MHUF	<u>2017</u> MHUF
Minimum lease payments recognized as expense	3 328	3 313

The Bank doesn't expect sublease payments in the future.

From the total future minimum lease payments HUF 576 million results from the renewable agreement related to a part of the headquarter building in 2018, which part is not owned by the Bank (HUF 711 million in 2017).

Finance lease

A part of the headquarter building of the Bank is owned by a third party is object of finance lease. The tables below present the minimum lease payments and the present value of the lease liability.

	<u>2018</u> MHUF	<u>Reclassified</u> <u>2017</u> MHUF
Net carrying amount of leased assets in the Statement of financial position	15 446	16 619
The present value of finance lease liabilities may be analysed		
less than one year	27	25
one to five years	151	137
more than five years	23 617	23 660
The present value of finance lease liabilities may be analysed	<u>23 795</u>	<u>23 822</u>
less than one year	763	676
one to five year	3 047	2 696
more than five years	47 402	43 829
Finance lease liabilities-minimum lease payments	<u>51 212</u>	<u>47 201</u>

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 37 – RELATED PARTY TRANSACTIONS

For the purposes of these financial statements, related parties include all enterprises that directly or indirectly through one or more intermediaries, control or are controlled by, or are under common control with the Bank (this includes parents, subsidiaries and fellow subsidiaries), key management and associated companies.

Parent:

KBC Bank N.V. owns 100.00% of the ordinary shares in K&H Bank (2017: 100.00%). The ultimate parent of the Bank is KBC Group N.V.

Subsidiaries:

See list of subsidiaries in Note 40.

Associates:

See list of associates in Note 40.

Members of KBC Bank and other related parties:

CBC Banque SA
Československa Obchodni Banka a.s.
Československa Obchodna Banka a.s.
KBC Bank Ireland Plc.
KBC Asset Management SA
KBC Asset Management N.V.
KBC Credit Investments N.V.
KBC Fund Management Limited
KBC Groep N.V.
KBC Securities N.V.
K&H Biztosító Zrt.
Omnia N.V.

Other related parties through key management

If the Bank's key management has direct or indirect authority and responsibility for planning, directing and controlling the activity of a company outside of KBC Group, the companies are presented as other related parties through key management.

The banking transactions entered into with related parties in the normal course of business including loans and deposits were carried out on normal commercial terms and conditions and at market rates. All loans and advances to related parties are performing and are free of any provision for possible loan losses.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018 NOTES TO THE FINANCIAL STATEMENTS

NOTE 37 - RELATED PARTY TRANSACTIONS (continued)

The year-end balances and the income and expenses in respect of related parties included in the financial statements are as follows:

	Parent MHUF	Subsi- diaries MHUF	Other related parties (KBC Group) MHUF	Other related parties (through key management) MHUF	Total MHUF
As at 31 December 2018					
Assets					
Other demand deposit	54 518	-	220	-	54 738
Loans and advances	121 363	37 698	263 783	4 017	426 861
Current accounts	-	11 630	145	334	12 109
Term loans	121 363	26 068	263 638	3 683	414 752
Finance leases	-	-	-	-	-
Other receivables	27	365	940	-	1 332
Total assets	175 908	38 063	264 943	4 017	482 931
Liabilities					
Deposits	19 500	116 303	37 311	954	174 068
Current accounts	8 752	12 994	37 275	954	59 975
Term deposits (with agreed maturity)	10 748	103 309	36	-	114 093
Subordinated liabilities	40 802	-	-	-	40 802
Non-convertible bonds	-	-	-	-	-
Other liabilities	81	23 935	1 081	-	25 097
Total liabilities	60 383	140 238	38 392	954	239 967
Income statement					
Net interest and similar income	(1 146)	(1 298)	(682)	82	(3 044)
Interest and similar income	900	519	19	82	1 520
Interest and similar expense	(2 046)	(1 817)	(701)	-	(4 564)
Net fee and commission income	223	(279)	2 548	58	2 550
Fee and commission income	501	24	3 114	64	3 703
Fee and commission expense	(278)	(303)	(566)	(6)	(1 153)
Other income	15	281	746	-	1 042
Other expense	(393)	(897)	(2 792)	-	(4 082)
Total income statement	(1 301)	(2 193)	(1 80)	140	(3 534)
Off-statement of financial position items					
Commitments and contingent liabilities	194 602	19 344	5 060	10	219 016
Guarantees received	2 539	-	-	-	2 539
Notional amount of derivatives	4 360 495	-	414 054	-	4 774 549

The table excludes the fair value of derivatives.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018 NOTES TO THE FINANCIAL STATEMENTS

NOTE 37 - RELATED PARTY TRANSACTIONS (continued)

	<u>Parent</u> <u>MHUF</u>	<u>Subsi- diaries</u> <u>MHUF</u>	<u>Associ- ates</u> <u>MHUF</u>	<u>Other related parties (KBC Group)</u> <u>MHUF</u>	<u>Other related parties (through key management)</u> <u>MHUF</u>	<u>Total</u> <u>MHUF</u>
As at 31 December 2017						
Assets						
Other demand deposit	193 418	-	-	78	-	193 496
Loans and advances	216 030	40 006	90	186 157	2 313	444 596
Current accounts	-	11 900	-	72	7	11 979
Term loans	216 030	28 106	90	186 085	2 306	432 617
Finance leases	-	-	-	-	-	-
Other receivables	77	320	-	582	-	979
Total assets	409 525	40 326	90	186 817	2 313	639 071
Liabilities						
Deposits	16 238	87 769	82	31 569	1 052	136 710
Current accounts	15 381	14 756	82	31 239	1 052	62 510
Term deposits (with agreed maturity)	857	73 013	-	330	-	74 200
Subordinated liabilities	39 362	-	-	-	-	39 362
Non-convertible bonds	-	-	-	-	-	-
Other liabilities	149	23 905	-	930	-	24 984
Total liabilities	55 749	111 674	82	32 499	1 052	201 056
Income statement						
Net interest and similar income	(485)	(759)	4	(144)	53	(1 331)
Interest and similar income	1 429	567	4	8	53	2 061
Interest and similar expense	(1 914)	(1 326)	-	(152)	-	(3 392)
Net fee and commission income	(187)	(174)	4	2 195	41	1 879
Fee and commission income	359	22	4	2 561	46	2 992
Fee and commission expense	(546)	(196)	-	(366)	(5)	(1 113)
Other income	(22)	247	-	93	-	318
Other expense	54	(929)	-	(2 617)	-	(3 492)
Total income statement	(640)	(1 615)	8	(473)	94	(2 626)
Off-statement of financial position items						
Commitments and contingent liabilities	104 193	19 102	-	5 001	10	128 306
Guarantees received	2 563	-	-	-	-	2 563
Notional amount of derivatives	1 394 871	-	-	24 914	-	1 419 785

The table excludes the fair value of derivatives.

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 37 - RELATED PARTY TRANSACTIONS (continued)

The interest rate of other demand deposits and loans and advances from related parties varied in a range of -0.21 and 2.72 percent in 2018 (-0.35 and 2.98 percent in 2017). Deposits due to related parties bear a minimum interest rates of 0 and a maximum interest rate of 2.73 percent in 2018 (0 and 2.76 in 2017). For interest rate conditions of subordinated liabilities see Note 14.

Transactions with key management

The Bank's key management includes the members of the executive committee, senior executive directors and executive directors.

Loans

In accordance with the Bank's internal policy, all employees of the Bank, including key management may apply for interest-free loans or for loans with favourable conditions. Interest-free loans are only provided in line with relevant local laws (i.e. for housing, if the claimant and the property fit pre-defined requirements). Favourable conditions include a waiver of handling fees and lower than market interest rates.

The major part of the total of HUF 421 million outstanding amount of loans of key management at 31 December 2018 was housing loan (HUF 411 million at 31 December 2017), with the long-term maturity obligations ranging from 15-20 years.

Deposits

In accordance with the Bank's internal policy, all the employees of the Bank, including key management staff are entitled to have a bank account and a securities/bond account with condition of K&H 4000+ account package offered for companies with number of employees over 4 000. According to this package the interest paid on deposit is the basic interest rate of the Hungarian National Bank less 3.25% but if it is negative, then the interest rate for the K&H Demand Deposit Account.

At 31 December 2018 the outstanding amount of deposits was HUF 665 million (HUF 557 million at 31 December 2017). In 2018 the Bank didn't pay interest on these deposits.

Staff expenses

The following amounts have been recorded related to key management personnel:

Type of benefit	<u>2018</u>	<u>2017</u>
	MHUF	MHUF
Short-term employee benefits	2 226	2 268
Other long-term benefits	15	29
Termination benefits	63	-
Share based payment (cash settled)	68	103
	<hr/>	<hr/>
Total benefits	<u>2 372</u>	<u>2 400</u>

The liability of HUF 137 million (HUF 172 million in 2017) resulting from the carrying amount of share based payment is recorded as other liability in the statement of financial position.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 37 - RELATED PARTY TRANSACTIONS (continued)

Share based payment

The Bank applies specific rules for Key Identified Staff (KIS). The performance-based remuneration of Key Identified Staff is awarded in a manner which promotes sound risk management and does not induce excessive risk-taking. This is ensured by specific rules, which are applicable to the variable remuneration of Key Identified Staff:

- At least 40% of variable remuneration awarded to Key Identified Staff may not be paid straightaway and its payment is spread over a period of three to five years;
- Half of the total amount of variable remuneration for Key Identified Staff is awarded in the form of non-cash instruments (phantom shares) with a one-year retention period;
- No advance payments may be made in relation to the variable component and claw-back/holdback is put in place (evidence of misconduct or serious error; significant deterioration in the financial performance of the Bank; major shortcomings in risk management; significant changes in the economic or regulatory capital base of the Bank).

Key Identified Staff who are allocated variable compensation of less than the amount stated in the Remuneration Policy are considered exempt Key Identified Staff. (In this case, variable remuneration is not subject to three years' deferral and payment in non-cash instruments, but 100% of the variable remuneration is settled upfront in cash.) The employees whose variable remuneration is subject to deferral and payment in non-cash instruments are called material Key Identified Staff.

Structure for 2018 variable compensation of material Key Identified Staff

	Individual variable remuneration awarded for 2018 performance year			
	Upfront part		Deferred part	
In case of KBC Senior General Managers	(40% of award)		(60% of award)	
In case of all KIS whose variable compensation is below the limit prescribed in the Remuneration Policy	(60% of award)		(40% of award)	
In case of all KIS whose variable compensation is equal to or exceeds the limit prescribed in the Remuneration Policy	(40% of award)		(60% of award)	
	Cash (50% of Upfront)	Non-cash instrument (50% of Upfront)	Cash (50% of Deferred)	Non-cash instrument (50% of Deferred)
Vesting schedule	fully vested at grant	fully vested at grant	3/5-year equal vesting tranches	3/5-year equal vesting tranches
Retention period		retention period ends April 2020		retention period ends one year after vesting

The cash is payable following vesting. The non-cash instrument is payable following the retention period.

The number of phantom shares to which each Key Identified Staff is entitled is calculated based on the average price of the KBC share during the first three months of the year following the year to which the variable remuneration relates. Phantom shares are converted into cash on the basis of the average price of the KBC share during the first three months of the pay-out year.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 37 - RELATED PARTY TRANSACTIONS (continued)

	2018		2017	
	number of shares	weighted average share price* HUF/share	number of shares	weighted average share price* HUF/share
Outstanding as at the beginning of the period	6 452	16 823	11 232	13 924
Granted	2 960	23 103	2 101	18 692
Exercised	(3 563)	16 358	(5 956)	13 084
Transferred**	(186)	16 358	(925)	13 084
Outstanding as at the end of the period	5 663	21 107	6 452	16 823

*Share prices as at the grant date weighted by the number of shares granted at that date.

**Shares granted to employees moving between KBC entities during the year may increase/decrease the number of shares to be exercised or paid off by the Bank. These changes are presented as transferred shares. Transferred shares also include no longer payable deferred amounts due to employment termination.

The value of the phantom shares outstanding as at 31 December 2018 based on the year-end closing price of KBC shares was 19 926 HUF/share (22 074 HUF/share as at 31 December 2017).

There were no shares exercisable as at 31 December 2018 (and as at 31 December 2017).

The weighted average share price of shares converted to cash as at the date of the exercise was 23 103 HUF/share in 2018 (18 692 HUF/share in 2017).

The weighted average remaining contractual life of phantom shares outstanding as at 31 December 2018 is 18 months (14 months as at 31 December 2017).

The Bank applied the share based payment plan for the 2018 performance as well.

As at 31 December 2018 the information related to the number of phantom shares for the 2018 performance is not available, since the first grant date is in April 2019.

From the grant date phantom shares are valued based on the quoted market prices of KBC shares. No intrinsic value is recorded.

A part of the Bank's employees are entitled to participate in defined benefit plan founded by the Bank. The amount of benefits to be provided depends on the employee's length of service in a certain past period and the level of reference interest rate. The future payments regarding to the plan have no significant effect on the Bank's cash flow.

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 38 – DEFINED BENEFIT PLAN

The table below presents the reconciliation of defined benefit obligations recorded as other liabilities.

	<u>2018</u> MHUF	<u>2017</u> MHUF
Defined benefit obligations at the beginning of the period	431	516
Interest cost	12	16
Actuarial gains and losses arising from changes in financial assumptions	(20)	(45)
Benefits paid	(21)	(20)
Past service cost, including gains and losses arising from settlements	(37)	(36)
Defined benefit obligation at end of the period	<u>365</u>	<u>431</u>

Interest cost on defined retirement benefit plans are recorded as interest expense in the income statement (see Note 4). Current service cost, benefits paid and past service includes the effect of the renegotiation of defined benefit plans. Current service costs are recorded as staff expenses in the income statement (see Note 12). Actuarial gains and losses arising from changes in financial assumptions are accounted directly in other comprehensive income.

NOTE 39 – AUDITOR'S REMUNERATION

	<u>2018</u> MHUF	<u>Reclassified</u> <u>2017</u> MHUF
Fees for the statutory audit services	190	171
Fees related to permitted non-audit services provided by the statutory auditor	57	45
Fee related to services provided by other audit Firms	1 099	390
Total fees paid to audit firms	<u>1 346</u>	<u>606</u>

The amounts in the table above include VAT.

The Bank is provided with statutory audit services by PricewaterhouseCoopers Könyvvizsgáló Korlátolt Felelősségű Társaság.

Non-audit services provided by the statutory auditor includes professional education and audit reports on special lending activity.

HUF 1 099 million fee was paid to other audit firms for consultancy, for feasibility study of implementing a new core system, tax advisory services and audit activity related to properties in 2018 (HUF 390 million for the feasibility study of a new online lending solution and audit activity related to properties in 2017).

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 40 – SUBSIDIARIES AND ASSOCIATES

	<u>Address of headquarter</u>	<u>Principal activities</u>	<u>Capital 2018</u>	<u>Effective Shareholding 2018</u>	<u>Effective Shareholding 2017</u>
Fully consolidated subsidiaries			MHUF	%	%
K&H Jelzálogbank Zrt.	1095 Budapest, Lechner Ödön fasor 9.	Other credit granting services	3 100	100	100
K&H Autópark Kft.	1095 Budapest, Lechner Ödön fasor 9.	Operating lease	11	100	100
K&H Ingatlanlízing Zrt.	1095 Budapest, Lechner Ödön fasor 9.	Finance lease	50	100	100
K&H Befektetési Alapkezelő Zrt.	1095 Budapest, Lechner Ödön fasor 9.	Fund manager	850	100	100
K&H Csoportszolgáltató Kft.	1095 Budapest, Lechner Ödön fasor 9.	Group service center	60	100	100
K&H Equities Zrt.	1095 Budapest, Lechner Ödön fasor 9.	Business and management consultancy	38	100	100
K&H Faktor Zrt.	1095 Budapest, Lechner Ödön fasor 9.	Other financial services	51	100	100
Not consolidated investments under control					
HAGE Zrt.	4181 Nádudvar, Kossuth u. 2.	Meat processing	-	-	25
Not consolidated investments under control					
K&H csúcstámadás zártkörű alap	1095 Budapest, Lechner Ödön fasor 9.	Securities investment fund	250	92	91
Subsidiaries in voluntary liquidation					
K&H Eszközlízing Kft.	1095 Budapest, Lechner Ödön fasor 9.	Operative lease	5	100	100

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 40 – SUBSIDIARIES AND ASSOCIATES (continued)

The Bank sold its investment in HAGE Zrt. in 2018 . The result realised on the sale was HUF 282 million gain and was recorded as Other income in the income statement.

The Bank owns 92 % of the equity instruments in K&H csúcstámadás zártkörű alap. The investment fund is managed by K&H Befektetési Alapkezelő Zrt., one of the Bank's subsidiaries therefore the Bank has control over the fund. The fund is recorded as held-for-trading equity instrument in the financial statements and is valued at fair value. The Bank does not consolidate the fund considering that changing the valuation (consolidation versus valuation at fair value) would have an immaterial impact on the financial figures presented in the financial statements.

The principal place of business of the companies mentioned in the table is Hungary.

NOTE 41 – SUBSEQUENT EVENTS

There were no subsequent events to be reported till the approval of the Financial Statement.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT

42.1 General

The Bank is not only a universal commercial bank and a major player in the Hungarian market but also part of the KBC Group. As such the activities of the Bank cover a wide range including the retail, corporate and the professional money market segments. In its role as a financial intermediary, the Bank faces different uncertainties presenting both risk and opportunity at the same time. The challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value.

Risk management makes it possible for management to effectively deal with this uncertainty and the risks and opportunities linked to it, enhancing the capacity to build value. Therefore at both KBC Group and K&H Bank value and risk management is based on the following fundamental principles:

- Value, risk and capital management are inextricably linked to one another.
- Risk management is approached from a comprehensive, enterprise- wide angle, taking into account all the risks a company is exposed to and all the activities it engages in.
- Primary responsibility for value and risk management lies with line management, while within Capital and Risk Oversight (CRO) Services Division separate Value and Risk Management departments – operating independently of line management – perform advisory, supporting and supervisory role.
- Every material subsidiary is required to adhere to the same risk governance model as the parent company.

The Bank risk management activity is primarily based on the on-going Internal Capital Adequacy Assessment Process (ICAAP) that is aligned with international standards and KBC Group principles. The ICAAP is subject of annual Supervisory Review and Evaluation Process (SREP) conducted by the local supervisor in the frame of Joint Capital Decision of home and host supervisors.

The Bank has Recovery Plan prepared according to the guidelines set out by KBC Group and the local supervisor. The Recovery Plan of the Bank is integrated into the Recovery Plan of KBC Group.

Risk management governance model

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

- Overarching company and risk committees are the Board of Directors (BoD), the Audit Board (AB), Risk and Compliance Committee (RCC), 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), 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 relevant Value and Risk Management departments.
- Line management and activity-specific committees have primary responsibility for value and risk management on the operational level. Whereas Value and Risk Management departments measure risks, economic capital and value creation for all relevant business entities and reports their findings directly to line management and the relevant activity-specific committees.
- Within CRO Services Division the Risk Integration and Support Directorate is dedicated to overarch the three existing risk centres of competence (Credit Risk, Market and Liquidity Risk and Non-financial Risks), enhance coordination and report to Management regarding value creation, risk and capital.

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 – quarterly risk reports, yearly overview of the remuneration policy and the risk based pricing policy - ensures that there is an ample flow of information to the relevant members of the Board over the course of the year. Moreover, through the involvement of the entire 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 Bank and on the adequacy of the risk management structure.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Risk measurement and – monitoring

Risk measurement and monitoring in general includes the following sub-processes:

- Identification of risks is a process of discovering and defining material risks, namely those risks that could have a positive or negative impact on the financial position of the Bank. Identification of risks is further ensured with setting up New and Active Products Process (NAPPs) in all business domains.
- Measurement of risks; qualitative and quantitative assessment of exposure to risk. The Bank uses amongst others the following risk measures for the following most significant risk types:
 - Credit default and migration risks: nominal positions (outstanding/exposure), PD (probability of default), LGD/EL (loss given default/expected loss), credit concentration ratios, loan delinquency ratios, renegotiated loan ratios, credit loss ratios, RWA, stress test results;
 - Trading risk: BPV (basis point value), historic VaR (value at risk), and stress test results;
 - ALM (asset-liability management) risk: BPV, results of stress test on interest income, parametric VaR;
 - Operational risk: KRI (key risk indicator), results of risk self-assessment, level of compliance with Group Standards, availability of crisis management plans;
 - Liquidity risk: liquidity gaps, loan-to-deposit ratio, liquidity coverage ratio (LCR), net stable funding ratio (NSFR), liquidity concentration ratios, stress test results.
- Risk appetite and setting limits; is a way of authorizing specific forms of risk taking. A limit indicates how much risk the Bank considers being 'an acceptable maximum' for a portfolio or a segment of a portfolio. They reflect the general risk appetite, set by the Board of Directors. This general risk appetite cascades down in specific risk limits or tolerances that reflect the degree of acceptable variation to the achievement of objectives. Risk appetite and limits are agreed upon by the Board of Directors.
- Reporting; delivery of risk measurement results and compliance with the limits (comparison of risk exposure with the risk limit) to the decision makers (relevant risk committees) in a structured format. The main types of reports used in the Bank:
 - exposures to key risk types,
 - key risk indicators,
 - limit breaches,
 - losses,
 - advice from risk management department regarding the risk response.

A dual reporting system by the local value and risk departments exists: hierarchical reporting to the local Executive Committee via the local risk committees, and functional reporting via the KBC Group Value and Risk Management to the group risk committees and on to the KBC Group Executive Committee.

- Monitoring and response to shortcomings; the purpose of responding to risks is to constrain threats and take advantage of the opportunities. Management (or respective decision makers) need to come up with a response to risk and define, implement and execute controls instruments that help to achieve a residual risk level aligned with the Bank's risk limits.

The following paragraphs deal with each of the material risk types in more detail.

42.2 Liquidity risk and funding management

Liquidity is the ability of the Bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. The fundamental role of the Bank in the maturity transformation of short-term deposits into long-term loans makes the Bank inherently vulnerable to liquidity risk both of an institution-specific nature and that which affects markets as a whole. Liquidity risk management is of paramount importance because a liquidity shortfall at a single institution can have system-wide repercussions. Financial market developments in the past decade have increased the complexity of liquidity risk and its management.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The objective of the liquidity risk management framework is to limit liquidity risks by taking into account an adequate level of funding, the potential growth of the Bank, and in considering liquidity shocks to guarantee the availability of sufficient cash flow to meet all of the Bank's financial commitments:

- in a normal business environment;
- under extreme circumstances (shocks);
- and on different time horizons (short, medium and long term).

The Bank assesses the following liquidity risk aspects:

- Short-term liquidity risk represents the risk that the Bank will not be able to meet its payment obligations in full or in time. Short-term liquidity risk is measured up to 30-90 working days.
- Long-term liquidity risk represents the risk that additional refinancing funds will be available only at higher market interest rates. Long-term liquidity risk is measured from 1 year onwards.
- Concentration liquidity risk occurs when the Bank has an excessive level of exposure to individual depositor, type of deposit instrument, market segment or currency of denomination, mainly on the liabilities' side. However, concentration liquidity risk can be also due to concentration in a particular on- or off-statement of financial position instrument, which could significantly alter expected cash flows.
- Marketable asset risk represents the risk that the Bank will not be able to liquidate assets on the market only at a discount.

The core collateral pool (liquidity buffer or liquidity reserve) is considered as the liquidity resource of the Bank. The Bank maintains adequate liquidity resources at all times, both as to amount, maturity and quality, to ensure that the Bank can continue to meet its liabilities as they fall due, both in normal and stressed times.

The structure of the core collateral pool reflects the Bank's market position, and advantages resulting from the composition of shareholders and various internal and external prudential expectations such as:

- Attracting significant client funds (both corporate and retail);
- Having (indirect) access to international capital markets, funds provided by KBC Group (parent company);
- Keeping the cost of funding to a minimum, while maintaining competitiveness (prices should be in line with the rates of other key players in the market);
- Avoiding as much as possible reliance on volatile deposits;
- Offering full service to clients with the widest possible array of financial products.

The Bank maintains adequate balances on its accounts with the National Bank of Hungary and foreign correspondents to continuously meet its obligations.

K&H BANK ZRT.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The following table shows a breakdown of the financial assets and financial liabilities by expected maturity at 31 December 2018:

	<u><=1 year MHUF</u>	<u>1-5 year MHUF</u>	<u>>5 year MHUF</u>	<u>Without maturity MHUF</u>	<u>Total MHUF</u>
Financial assets					
Cash balances with central banks and other demand deposits with credit institutions	437 814	-	-	-	437 814
Held for trading	7 873	40 184	21 760	-	69 817
Mandatorily at fair value through profit or loss	2 683	9 157	8 226	-	20 066
Fair value through other comprehensive income	26 905	52 859	13 382	2 216	95 362
Amortised cost	825 573	852 300	763 415	-	2 441 288
Fair value changes of hedged item under portfolio hedge of interest rate risk	7 333	-	-	-	7 333
Hedging derivatives	-	2 526	14 739	-	17 265
	<u>1 308 181</u>	<u>957 026</u>	<u>821 522</u>	<u>2 216</u>	<u>3 088 945</u>
Financial liabilities					
Held for trading	5 471	32 055	16 862	-	54 388
Designated at fair value through profit or loss	39 801	48 989	-	-	88 790
Hedging derivatives	-	3 576	9 990	-	13 566
Measured at amortised cost	2 364 037	237 943	66 551	-	2 668 531
Fair value changes of hedged item under portfolio hedge of interest rate risk	6 164	-	-	-	6 164
	<u>2 415 473</u>	<u>322 563</u>	<u>93 403</u>	<u>-</u>	<u>2 831 439</u>
Commitments and contingent liabilities	881 523	-	-	-	881 523
	<u>3 296 996</u>	<u>322 563</u>	<u>93 403</u>	<u>-</u>	<u>3 712 962</u>

Financial assets and liabilities repayable on demand are included in the <=1 year category.

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018****NOTES TO THE FINANCIAL STATEMENTS****NOTE 42 – RISK MANAGEMENT (continued)**

The following table shows a breakdown of the financial assets and financial liabilities by expected maturity at 31 December 2017 :

	<u><=1 year MHUF</u>	<u>1-5 year MHUF</u>	<u>>5 year MHUF</u>	<u>Without maturity MHUF</u>	<u>Total MHUF</u>
Financial assets					
Cash balances with central banks and other demand deposits with credit institutions	401 057	-	-	-	401 057
Held for trading	35 086	53 822	8 782	504	98 194
Available for sale	8 615	64 312	119 425	1 857	194 209
Loans and receivables	794 199	556 664	425 621	-	1 776 484
Held to maturity	34 906	189 253	199 341	-	423 500
Hedging derivatives	1 658	14 242	7 164	-	23 064
	<u>1 275 521</u>	<u>878 293</u>	<u>760 333</u>	<u>2 361</u>	<u>2 916 508</u>
Total financial assets and cash balances with central banks and other demand deposits with credit institutions					
	<u>1 275 521</u>	<u>878 293</u>	<u>760 333</u>	<u>2 361</u>	<u>2 916 508</u>
	<u><=1 year MHUF</u>	<u>1-5 year MHUF</u>	<u>>5 year MHUF</u>	<u>Without maturity MHUF</u>	<u>Total MHUF</u>
Financial liabilities					
Held for trading	14 589	21 381	504	-	36 474
Designated at fair value through profit or loss	41 362	79 147	-	-	120 509
Hedging derivatives	9	429	3 665	-	4 103
Measured at amortised cost	2 220 211	220 290	84 954	-	2 525 455
Fair value changes of hedged item under portfolio hedge of interest rate risk	12 560	-	-	-	12 560
	<u>2 288 731</u>	<u>321 247</u>	<u>89 123</u>	<u>-</u>	<u>2 699 101</u>
Total financial liabilities	<u>2 288 731</u>	<u>321 247</u>	<u>89 123</u>	<u>-</u>	<u>2 699 101</u>
Commitments and contingent liabilities	812 680	-	-	-	812 680
	<u>812 680</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>812 680</u>
Total financial liabilities, commitments and contingent liabilities	<u>3 101 411</u>	<u>321 247</u>	<u>89 123</u>	<u>-</u>	<u>3 511 781</u>

Financial assets and liabilities repayable on demand are included in the <=1 year category.

K&H BANK ZRT.**FINANCIAL STATEMENTS
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The remaining maturity of non-financial assets and liabilities held as at 31 December 2018 is presented in the table below.

	<u>< 1 year</u> <u>MHUF</u>	<u>> 1 year</u> <u>MHUF</u>	<u>Total</u> <u>MHUF</u>
Tax assets	1 975	361	2 336
Investments in associated companies	-	10 904	10 904
Investment property	-	1 689	1 689
Property, plant and equipment	-	35 228	35 228
Intangible assets	-	19 767	19 767
Non-current assets held for sale and disposal groups	1 325	-	1 325
Other assets	26 217	-	26 217
Total assets	29 517	67 949	97 466
Provisions for risks and charges	1 725	67	1 792
Other liabilities	93 218	-	93 218
Total liabilities	94 943	67	95 010

The remaining maturity of non-financial assets and liabilities held as at 31 December 2017 is presented in the table below.

	<u>< 1 year</u> <u>MHUF</u>	<u>> 1 year</u> <u>MHUF</u>	<u>Total</u> <u>MHUF</u>
Tax assets	2 633	-	2 633
Investments in associated companies	-	10 619	10 619
Investment property	-	1 476	1 476
Property, plant and equipment	-	37 909	37 909
Intangible assets	-	14 521	14 521
Non-current assets held for sale and disposal groups	1 921	-	1 921
Other assets	18 941	-	18 941
Total assets	23 495	64 525	88 020
Tax liabilities	-	942	942
Provisions for risks and charges	1 443	116	1 559
Other liabilities	73 691	-	73 691
Total liabilities	75 134	1 058	76 192

The expected remaining maturity breakdown above represents the current and non-current classification of non-financial assets and liabilities.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The following tables present the future undiscounted cash flows of financial liabilities and commitments and contingent liabilities by remaining contractual maturity as at 31 December 2018. For held-for-trading derivatives nominal values are disclosed in the table.

	Cash balances with central banks and other demand deposits with credit institutions	Held for trading derivatives	Mandatory fair value through profit or loss	Fair value through other comprehensive income	Amortised cost	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial assets							
On demand and less than three months	437 810	1 340 351	1 115	2 106	534 196	474 498	2 790 076
More than three months but not more than one year	-	463 308	1 886	19 288	307 412	3 674	795 568
More than one but not more than five years	-	1 442 295	9 147	51 539	868 617	538 592	2 910 190
More than five years	-	1 669 708	8 225	24 147	769 898	271 493	2 743 471
Total	437 810	4 915 662	20 373	97 080	2 480 123	1 288 257	9 239 305

	Held for trading derivatives	Designated fair value through profit or loss	Amortised cost	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF
Financial liabilities					
On demand and less than three months	1 339 737	12 434	2 292 367	475 222	4 119 760
More than three months but not more than one year	459 628	25 130	64 085	3 674	552 517
More than one but not more than five years	1 442 268	46 074	268 273	540 312	2 296 927
More than five years	1 670 084	-	48 149	271 493	1 989 726
Total	4 911 717	83 638	2 672 874	1 290 701	8 958 930

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

	Commitments to extend credit	Guarantees	Letters of credit	Total
	MHUF	MHUF	MHUF	MHUF
Commitments and contingent liabilities				
On demand and less than three months	630 031	239 724	12 028	881 783
More than three months but not more than one year	-	-	-	-
More than one but not more than five years	-	-	-	-
More than five years	-	-	-	-
Total	<u>630 031</u>	<u>239 724</u>	<u>12 028</u>	<u>881 783</u>

The tables below present the future undiscounted cash flows of financial liabilities and commitments and contingent liabilities by remaining contractual maturity as at 31 December 2017. For held-for-trading derivatives fair nominal values are disclosed in the table.

	Cash balances with central banks and other demand deposits with credit institutions	Held for trading derivatives	Held to maturity	Available for sale	Loans and receivables	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial assets							
On demand and less than three months	400 435	432 162	10 391	5 118	591 847	14 051	1 454 004
More than three months but not more than one year	1	368 850	28 634	6 214	229 529	86	633 314
More than one but not more than five years	1	935 117	191 211	63 571	593 806	38 063	1 821 769
More than five years	-	961 108	183 950	105 677	427 241	21 235	1 699 211
Total	<u>400 437</u>	<u>2 697 237</u>	<u>414 186</u>	<u>180 580</u>	<u>1 842 423</u>	<u>73 435</u>	<u>5 608 298</u>

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

	Held for trading derivatives	Held to maturity	Amortised cost	Hedging derivatives	Total	
	MHUF	MHUF	MHUF	MHUF	MHUF	
Financial liabilities						
On demand and less than three months	430 214	9 843	2 161 006	14 051	2 615 114	
More than three months but not more than one year	347 143	29 458	64 357	86	441 044	
More than one but not more than five years	912 456	75 559	260 017	37 934	1 285 966	
More than five years	953 112	0	46 938	21 235	1 021 285	
Total	<u>2 642 925</u>	<u>114 860</u>	<u>2 532 318</u>	<u>73 306</u>	<u>5 363 409</u>	
			Commitments to extend credit	Guarantees	Letters of credit	Total
			MHUF	MHUF	MHUF	MHUF
Commitments and contingent liabilities						
On demand and less than three months		586 133	214 240	16 227		816 600
Less than three months		-	-	-		-
More than three months but not more than one year		-	-	-		-
More than one but not more than five years		-	-	-		-
More than five years		-	-	-		-
Total		<u>586 133</u>	<u>214 240</u>	<u>16 227</u>		<u>816 600</u>

The Bank's exposure to the risk arising from the outflows of cash or other financial asset which can occur significantly earlier or can be for significantly different amounts from the data presented in the tables above is immaterial.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The Bank uses different ratios to measure and limit liquidity risk that arises from financial intermediation. The operational liquidity is monitored via limits on the unsecured liquidity gap, stress tests and “Basel III” and local regulatory liquidity indicators. From a structural liquidity point of view a group wide net stable funding ratio is used. The Bank is also analysing liquidity stress test results.

Operational liquidity is measured by the unsecured liquidity gap limit. The operational liquidity gap is the difference between the cash in and outflows in different time horizons (5 days, 30 days) and an internal limit was set for the gap to be covered by National Bank of Hungary eligible collaterals. The Bank had sufficient liquidity gap surplus in 2018 and 2017, having increasing reliance on sight deposits.

Liquidity stress tests

Contingency liquidity risk is assessed in the Bank on the basis of several liquidity stress scenarios. The aim of the stress tests is to measure how the liquidity buffer of the Bank evolves under stressed scenarios. For each scenario the evolution of the liquidity buffer is calculated: this is the amount of excess liquidity per time bucket. Excess liquidity is the amount of cash that is available which is not required to cover immediately maturing liabilities. The simulated liquidity buffer is the sum of two components: the expected cash evolution under stressed scenarios and the expected liquidity increasing actions under stressed scenarios. In essence, there are four different types of stress tests: K&H specific empirical scenario, 2013’s Cyprus banking crisis inspired empirical scenario, Combined general market turmoil and Central Europe specific scenarios, and a reverse stress scenario. Under all scenarios the Bank would achieve the internally set survival period of one month and also the time to wall period is indicated which is sufficiently remote in each stress test.

Basel III and regulatory ratios

LCR and NSFR ratios prescribed in regulation from Basel III origin on liquidity measurement are calculated and reported regularly as key liquidity risk measure. Effective LCR threshold is 100% since 1 October 2015, the Bank’s LCR ratio stood at 142% at the end of 2018 and at 141% at the end of 2017 meeting all time the regulatory minimum requirement. NSFR’s 100% regulatory compliance is postponed from beginning of 2018, but that does not restraint the Bank from monitoring it. The Bank stood at 145% at the end of 2018 and at 144% at the end of 2017.

42.3 Market Risk

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as interest rates and foreign exchange rates. The Bank classifies exposures to market risk into either trading or non-trading portfolios.

Market risk – trading

The Bank is exposed to market risk via the trading books of the Bank’s dealing room and via the FX exposure of the subsidiaries. The Bank has set limits on the level of market risk that may be accepted. The Bank applies VaR methodology to assess the market risk positions held and to estimate the potential economic loss based on a number of parameters and assumptions for various changes in market conditions. VaR is defined as an estimate of the amount of money that can be lost on a given portfolio due to market risk, over a defined holding period, to a given confidence level. The measure only considers the market risk of the current portfolio and does not attempt to capture possible losses due to further trading or hedging, counterparty default or operational losses.

In practice the actual trading results will differ from the VaR calculation and in particular, the calculation does not provide a meaningful indication of profits and losses in stressed market conditions. To determine the reliability of the VaR models, actual outcomes are monitored regularly to test the validity of the assumptions. Market risk positions are also subject to regular stress tests to assess if the Bank would withstand market shocks.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

There are a number of different approaches used in the industry to generate VaR, with each having a varying level of suitability for different sizes and types of portfolios. The Bank has chosen to use the historical VaR methodology to measure and manage market risks in the trading book.

The hVaR approach uses the actual historic market performance to simulate possible future market evolutions. The hVaR methodology does not rely on assumptions regarding the distribution of price fluctuations or correlations, but is based on patterns of experience over the previous two years (500 scenario dates). The hVaR that the Bank applies is an estimate - using a confidence level of 99% and ten-day holding period. The use of the 99% confidence level means that, within a one day horizon, losses exceeding the VaR figure should occur, on average, once every hundred days. However, the VaR method will not tell us how much we will lose on that day, only that it is expected to exceed a certain amount. HVaR has rapidly become the standard VaR approach in large, internationally active banks. Moreover, hVaR provides a much better fit with the increased emphasis on scenario-based risk management, which includes stress testing.

Beside the hVaR calculations and stress-test risk concentrations are also monitored via secondary limits: FX concentration limits to limit FX risk stemming from a particular foreign currency position, and basis-point-value (BPV) limits for interest rate risk. BPV limits are set per currency and per time bucket.

VaR results can be presented as follows:

	<u>Foreign exchange</u> MHUF	<u>Interest rate</u> MHUF	<u>Total VAR</u> MHUF
2018 – 31 December	51	12	52
2018 – Average daily	53	40	78
2018 – Highest	190	282	275
2018 – Lowest	7	3	15
2017 – 31 December	52	156	150
2017 – Average daily	71	162	189
2017 – Highest	250	374	372
2017 – Lowest	11	87	92

The Bank's average limit utilization was well below the hVaR limit.

Trading risk taking was stable at around 25% of the available VaR limit. There was no limit overrun in the examined period. In March 2018 trading positions were migrated to KBC (phase 1: interest rate positions), during 2019 FX positions will be migrated also (phase 2).

The Bank does not have exposure to direct equity risk. Trading portfolio buy back notes in closed and open-end capital protected funds from K&H Asset Management Funds so as to assure secondary market for these notes. Typically all funds are made of deposit and different option structures. The trading risk is managed with a EUR 5 million net nominal limit on these notes and above one year maturity all components are fully hedged. The structure of notes which are kept in trading book is dismantled and the option part is hedged back-to-back within the limits.

Market risk – Non-trading

The Capital and Risk Oversight Committee (CROC) is responsible for controlling the value creation, the maturity transformation and the market risks of the banking book. Risk tolerance levels are allocated by KBC Group and approved by the K&H Board of Directors.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Majority of the Bank's ALM risks are interest rate related risks; consequently the tolerance level is limited in BPV terms (10-basispoint upward parallel yield curve shift impact on net present value). The interest rate risk is also measured with scenario analyses (including stressed environment). ALM-Capital Model determines the amount of capital that is required in view of the ALM risk profile in the banking book. ALM-CM measures the impact of very severe events on the Available Capital under Pillar I. Banking book's inherent risks are interest rate risk, inflation, real estate and equity risk that are measured and monitored according to the Bank approach. Foreign currency risk is not inherent in the banking book.

The BPV tables below present the results of reasonable possible changes of the fair value of the financial instruments held at fair value on 31 December 2018 and 2017. Possible alternatives were calculated based on the scenarios of 10, 100, and 200 basis point parallel shifts in yield curves. The banking book is limited in BPV by an internally set limit. The results contain the impact of derivative exposures too.

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NOTES TO THE FINANCIAL STATEMENTS
NOTE 42 – RISK MANAGEMENT (continued)

UP Scenarios, 31 December 2018	denomination	Sensitivity of equity	Sensitivity of profit or loss	Total sensitivity
		MHUF	MHUF	MHUF
10 bp parallel up	CHF	-	-	-
	EUR	(95)	186	91
	HUF	(215)	(39)	(254)
	USD	-	(6)	(6)
10 bp parallel up total		(310)	141	(169)
100 bp parallel up	CHF	-	-	-
	EUR	(931)	1 034	103
	HUF	(2 121)	(2 910)	(5 031)
	USD	-	(75)	(75)
100 bp parallel up total		(3 052)	(1 951)	(5 003)
200 bp parallel up	CHF	-	-	-
	EUR	(1 823)	1 919	96
	HUF	(4 472)	(6 237)	(10 709)
	USD	-	(116)	(116)
200 bp parallel up total		(6 295)	(4 434)	(10 729)
DOWN Scenarios, 31 December 2018				
	denomination	Sensitivity of equity MHUF	Sensitivity of profit or loss MHUF	Total sensitivity MHUF
10 bp parallel down	CHF	-	-	-
	EUR	95	(187)	(92)
	HUF	214	39	253
	USD	-	6	6
10 bp parallel down Total		309	(142)	167
100 bp parallel down	CHF	0	-	-
	EUR	973	(942)	31
	HUF	2 163	3 652	5 815
	USD	0	42	42
100 bp parallel down total		3 136	2 752	5 888
200 bp parallel down	CHF	0	-	-
	EUR	1 989	(2 056)	(67)
	HUF	4 019	6 850	10 869
	USD	-	123	123
200 bp parallel down total		6 008	4 917	10 925

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

UP Scenarios, 31 December 2017	denomination	Sensitivity of equity	Sensitivity of profit or loss	Total sensitivity
		MHUF	MHUF	MHUF
10 bp parallel up	CHF	-	-	-
	EUR	(28)	(198)	(226)
	HUF	(749)	(1 275)	(2 024)
	USD	-	(1)	(1)
10 bp parallel up total		(777)	(1 474)	(2 251)
100 bp parallel up	CHF	-	-	-
	EUR	(274)	(1 936)	(2 210)
	HUF	(7 259)	(12 445)	(19 704)
	USD	-	(11)	(11)
100 bp parallel up total		(7 533)	(14 392)	(21 925)
200 bp parallel up	CHF	-	-	-
	EUR	(542)	(3 777)	(4 319)
	HUF	(14 026)	(24 235)	(38 261)
	USD	-	(21)	(21)
200 bp parallel up total		(14 568)	(28 033)	(42 601)
DOWN Scenarios, 31 December 2017	denomination	Sensitivity of equity	Sensitivity of profit or loss	Total sensitivity
		MHUF	MHUF	MHUF
10 bp parallel down	CHF	-	-	-
	EUR	28	199	227
	HUF	755	1 282	2 037
	USD	-	1	1
10 bp parallel down Total		783	1 482	2 265
100 bp parallel down	CHF	-	-	-
	EUR	282	2 036	2 318
	HUF	7 793	13 151	20 944
	USD	-	10	10
100 bp parallel down total		8 075	15 197	23 272
200 bp parallel down	CHF	-	-	-
	EUR	572	4 177	4 749
	HUF	16 167	27 063	43 230
	USD	-	21	21
200 bp parallel down total		16 739	31 261	48 000

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Currency risk

Currency or foreign exchange (FX) risk basically arises from mismatches in the currency structure of the Bank's assets and liabilities. Positions are monitored on a daily basis and the hedging strategy of the Bank is to close all material FX positions in the bank's banking book, thus currency risk is managed exclusively within the trading book. Trading FX exposure is managed within the trading limit, and the global hVaR limit of the Bank. For details see the market risk-trading section above.

Fair valuation

One of the building blocks of a sound market risk management is also the prudent valuation of positions valued at Fair Value. This applies to *HFT instruments*: Held For Trading (adjustments impact P&L), *FIFV instruments*: financial instruments designated at fair value through profit or loss (adjustments impact P&L) and *AFS/FVOCI instruments*: Available for Sale/Fair value through other comprehensive income (adjustments impact equity).

The Bank's overall Valuation Framework stipulates that, when available, published independent price quotations from well-established active markets are used to determine Fair Value. In case of non-active markets, other valuation techniques (i.e. mark-to-model) are used in order to arrive at realistic estimates of Fair Value.

Consequently a daily independent valuation of front-office positions is performed by the Treasury Middle Office. Market-observed prices used in the valuation are regularly validated by the Market and Liquidity Risk Department via a formal parameter review process. Apart from market parameters, valuation techniques/models are also subject of independent review by the Market and Liquidity Risk Department.

42.4 Credit risk

Credit risk is the potential shortfall relative to the value expected consequent on non-payment or non-performance by an obligor (a borrower, guarantor, counterparty to an inter-professional transaction or issuer of a debt instrument), due to that party's insolvency or lack of willingness to pay, or to events or measures taken by the political or monetary authorities of a particular country. The latter risk is also referred to as 'country risk'.

Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values, as recorded in the statement of financial position. The Bank makes available to its customers guarantees which may require that the Bank makes payment on their behalf. Such payments are collected from customers based on the terms of the credit contracts. They expose the Bank to similar risks to loans and these are mitigated by the same control processes and policies.

Credit risk is managed at both transactional and portfolio level. Managing credit risk at the transactional level means that there are sound procedures, processes and applications in place to estimate the risks before and after accepting individual credit exposures. Managing the risk at portfolio level encompasses periodic reporting on (parts of) the loan portfolio, monitoring limit discipline and the specific portfolio management function.

Expected credit loss (ECL)

Expected credit losses are modelled over instrument's *lifetime period*. The *lifetime period* is equal to the remaining contractual period to maturity of debt instruments, adjusted for expected prepayments, if any. For loan commitments and financial guarantee contracts, it is the contractual period over which an entity has a present contractual obligation to extend credit. The exception from determining the lifetime exposure based on contractual maturity, for credit cards and overdrafts, the lifetime exposure is measured over a period that is based on expected life of the credit card contracts, based on internal statistics it is set to 30 years.

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Management models *Lifetime ECL*, that is, losses that result from all possible default events over the remaining lifetime period of the financial instrument is based on various models developed both locally and centrally depending on the sub-portfolio. The *12-month ECL*, represents a portion of lifetime ECLs that result from default events on a financial instrument that are possible within 12 months after the reporting period, or remaining *lifetime period* of the financial instrument if it is less than a year.

It is important to note that the ECLs estimated for the purposes of these financial statements are point-in-time estimates, rather than through-the-cycle estimates that are commonly used for regulatory purposes. The estimates consider *forward looking information*, that is, ECLs reflect probability weighted development of key macroeconomic variables (e.g. unemployment, GDP evolution) that have an impact on credit risk.

The ECL modelling does not differ for Purchased or Originated Credit Impaired (“POCI”) financial assets, except that (a) gross carrying value and discount rate are based on cash flows that were recoverable at initial recognition of the asset, rather than based on contractual cash flows, and (b) the ECL is always a lifetime ECL. POCI assets are financial assets that are credit-impaired upon initial recognition, such as loans affected by settlement of CHF mortgage loans which were NPL at the time of settlement. (On 16 June 2014, the Hungarian Supreme Court rendered its decision regarding the legal assessment of foreign currency based loans (“FX loans”) for consumers under Hungarian civil law. In accordance with the Conversion Act the Bank was required to convert foreign currency and foreign currency-based consumer mortgage loan contracts into Hungarian Forints with the effect date of 1 February 2015.)

For purposes of measuring PD, the Bank defines default as described in the Accounting policy – Definition of default chapter.

An instrument is considered to be no longer in default (i.e. to have cured) when it no longer meets any of the default criteria for a consecutive period of three months. This period of three months has been determined based on an analysis that considers the likelihood of a financial instrument returning to default status after curing by using the definition of cures.

Although the default/non-default flag is conceptually conceived on client level, a different treatment is allowed in case of retail exposures. For these exposures, the definition of default can be applied at the level of a particular facility, rather than at the level of the obligor. As a consequence, a default of a client on one retail exposure does not require to treat all other retail exposure of this client as defaulted as well.

The assessment whether or not there has been a significant increase in credit risk (“SICR”) since initial recognition is performed on an individual basis and on a portfolio basis. On loans issued to corporate entities, interbank loans and debt securities at AC or at FVOCI, SICR is assessed on an individual basis by monitoring the triggers stated below. For loans issued to individuals and other financial assets, SICR is assessed either on a portfolio basis or an individual basis, depending on the existence of scoring models. The criteria used to identify an SICR are monitored and reviewed periodically for appropriateness by the Bank’s Risk Management Department. The presumption, being that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has not been rebutted.

The Bank considers a financial instrument to have experienced an SICR when one or more of the following quantitative, qualitative or backstop criteria have been met.

For interbank operations and bonds issued by banks or government:

- 30 days past due;
- award of risk grade “Special monitoring”;
- SICR based on relative threshold based either on external ratings or internal ratings, which corresponds to an approximate increase of PD by 4.0 times.

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

For loans issued to legal entities and bonds issued by corporate customers:

- 30 days past due;
- award of risk grade “Special monitoring”;
- SICR based on relative threshold based either on external ratings or internal ratings. The following thresholds are used for external ratings: decrease of rating by 2 notches, for internal ratings by 5 notches, which corresponds to approximate increase of PD by 2.5 times;
- inclusion of loan into a watch list according to the internal credit risk monitoring process.

For loans to Individuals:

- 30 days past due;
- Relative threshold defined on the basis of a portfolio for products without existing scoring models: the Bank regularly monitors segments with increased credit risk (regions of higher credit risk, failed products, products on which issuing was stopped) and considers such portfolios to have a SICR; / Relative threshold defined on individual basis for products with existing scoring models: increase of the remaining lifetime PD compared to remaining lifetime PD estimated as of the date of initial recognition by 2.5 times.

The level of ECL that is recognised in these financial statements depends on whether the credit risk of the borrower has increased significantly since initial recognition. This is a three-stage model for ECL measurement. A financial instrument that is not credit-impaired on initial recognition and its credit risk has not increased significantly since initial recognition has a credit loss allowance based on 12-month ECLs (Stage 1). If a SICR since initial recognition is identified, the financial instrument is moved to Stage 2 but is not yet deemed to be credit-impaired and the loss allowance is based on lifetime ECLs. If a financial instrument is credit-impaired, the financial instrument is moved to Stage 3 and loss allowance is based on lifetime ECLs. The consequence of an asset being in Stage 3 is that the entity ceases to recognise interest income based on gross carrying value and applies the asset’s effective interest rate to the carrying amount, net of ECL, when calculating interest income.

If there is evidence that the SICR criteria are no longer met, the instrument is transferred back to Stage 1. If an exposure has been transferred to Stage 2 based on a qualitative indicator, the Bank monitors whether that indicator continues to exist or has changed. The monitoring is done in an automated way in the engine which calculates ECL.

ECL for POCI financial assets is always measured on a lifetime basis. The Bank therefore only recognises the cumulative changes in lifetime expected credit losses.

The Bank has two approaches for ECL measurement: (i) assessment on an individual basis; (ii) assessment on a portfolio basis: internal ratings are estimated on an individual basis but the same credit risk parameters (e.g. PD, LGD) will be applied during the process of ECL calculations for the same credit risk ratings and homogeneous segments of the loan portfolio. The Bank performs an assessment on an individual basis for non-retail clients above HUF 300mln exposure. The Bank performs an assessment on a portfolio basis for the following types of loans: retail loans and non-retail loans where exposure is below HUF 300mln when no borrower-specific information is available.

ECL assessment on an individual basis is performed by weighting the estimates of credit losses for different possible outcomes against the probabilities of each outcome. The Bank defines at least two possible outcomes for each assessed loan, one of which leads to a credit loss even if the probability of such a scenario may be very low. Individual assessment is primarily based on the expert judgement of experienced officers from the Credit Management Department. Expert judgements are regularly tested in order to decrease the difference between estimates and actual losses.

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

When assessment is performed on a portfolio basis, the Bank determines the staging of the exposures and measures the loss allowance on a collective basis. The Bank analyses its exposures by segments determined on the basis of shared credit risk characteristics, such that exposures within a group have homogeneous or similar risks. The different segments also reflect differences in credit risk parameters such as PD and LGD. The appropriateness of groupings/models is monitored and reviewed on yearly periodic basis by the Modelling Department and validated by Credit Risk Department locally or centrally depending on the specific model.

In general, ECL is the sum of the multiplications of the following credit risk parameters: EAD, PD and LGD, that are defined as explained below, and discounted to present value using the instrument's effective interest rate. The ECL is determined by predicting credit risk parameters (EAD, PD and LGD) for each future year during the lifetime period for each individual exposure or collective segment. These three components are multiplied together and adjusted for the likelihood of survival (i.e. the exposure has been repaid). This effectively calculates an ECL for each future period, that is then discounted back to the reporting date and summed up. The discount rate used in the ECL calculation is the original effective interest rate or an approximation thereof.

EADs are determined based on the expected payment profile, that varies by product type. EAD is based on the contractual repayments owed by the borrower over a 12-month or lifetime basis for amortising products and bullet repayment loans. This will also be adjusted for any expected overpayments made by a borrower. Early repayment or refinancing assumptions are also incorporated into the calculation. For revolving products, the EAD is predicted by taking the current drawn balance and adding a "credit conversion factor" that accounts for the expected drawdown of the remaining limit by the time of default. These assumptions vary by product type, current limit utilisation and other borrower-specific behavioural characteristics.

PDs are used for calculating ECLs: The Bank uses different statistical approaches depending on the segment and product type to calculate lifetime ECLs, such as the extrapolation of 12-month ECLs based on migration matrixes, developing lifetime ECL curves based on the historical default data, hazard rate.

LGD represents the Bank's expectation of the extent of loss on a defaulted exposure. LGD varies by the type of counterparty, type and seniority of the claim, and the availability of collateral or other credit support. LGDs are determined based on the factors that impact the expected recoveries after a default event. The approach to LGD measurement can be divided into three possible approaches:

- measurement of LGD based on the specific characteristics of the collateral;
- calculation of LGD on a portfolio basis based on recovery statistics; or
- individually defined LGD depending on different factors and scenarios.

The Bank calculates LGD based on specific characteristics of the collateral, such as projected collateral values, historical discounts on sales and other factors for loans secured by real estate, cash and liquid securities. LGD is calculated on a collective basis based on the latest available recovery statistics for the remainder of the corporate loan portfolio and for retail secured and unsecured products.

ECL measurement for financial guarantees and loan commitments. The ECL measurement for these instruments includes the same steps as described above for on-balance sheet exposures and differs with respect to EAD calculation. The EAD is a product of credit conversion factor ("CCF") and amount of the commitment ("*ExOff*"). CCF for undrawn credit lines of corporate customers, credit cards and overdrafts issued to both individuals and non-retail entities, and for financial guarantees is defined based on statistical analysis of past exposures at default.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Forward-looking information incorporated in the ECL models. The assessment of SICR and the calculation of ECLs both incorporate supportable forward-looking information. The Bank identified certain key economic variables that correlate with developments in credit risk and ECLs. Forecasts of economic variables (the "base economic scenario") are provided by the Bank's Chief Economist and provide the best estimate of the expected macro-economic development over the next five years. After five years, a mean reversion approach is used, which means that economic variables tend to revert to either a long run average rate (e.g. for unemployment) or a long run average growth rate (e.g. GDP). The impact of the relevant economic variables on the PD, EAD and LGD has been determined by performing statistical regression analysis to understand the impact that the changes in these variables historically had on the default rates and on the components of LGD and EAD.

In addition to the base economic scenario, the Bank's Credit Risk Department also provides other possible scenarios (e.g. stress tests) along with scenario weightings. The number of other scenarios used is set based on the analysis of each major product type to ensure that non-linearities are captured. The number of scenarios and their attributes are reassessed at each reporting date. The scenario weightings are determined by a combination of statistical analysis and expert credit judgement, taking into account the range of possible outcomes of which each chosen scenario is representative. The assessment of SICR is performed using the 12 month PD as a proxy for Lifetime PD under each of the bases and the other scenarios, multiplied by the associated scenario weighting, along with qualitative and backstop indicators. This determines whether the whole financial instrument is in Stage 1, Stage 2, or Stage 3 and hence whether a 12-month or lifetime ECL should be recorded. Following this assessment, the Bank measures ECL as either a probability-weighted 12 month ECL (Stage 1), or a probability weighted lifetime ECL (Stages 2 and 3). These probability-weighted ECLs are determined by running each scenario through the relevant ECL model and multiplying it by the appropriate scenario weighting (as opposed to weighting the inputs).

As with any economic forecast, the projections and likelihoods of occurrence are subject to a high degree of inherent uncertainty, and therefore the actual outcomes may be significantly different to those projected. The Bank considers these forecasts to represent its best estimate of the possible outcomes and has analysed the non-linearities and asymmetries within the Bank's different portfolios to establish that the chosen scenarios are appropriately representative of the range of possible scenarios.

The Bank regularly reviews its methodology (back testing) and assumptions to reduce any difference between the estimates and the actual loss of credit. Such back testing is performed semi-annually.

The results of backtesting the ECL measurement methodology are communicated to Bank Management and further steps for tuning models and assumptions are defined after discussions between authorised persons.

Accounting judgements and estimates related to ECL

The Bank considers three different forward looking macro-economic scenarios with different weights in the calculation of ECL. A sensitivity analysis on the impact of these multiple economic scenarios on IFRS 9 collectively calculated ECL, by calculating the delta between the probability weighted outcome (which is booked) and the base case scenario, shows a higher probability weighted ECL for year-end 2018 of 0,2% versus the base case scenario ECL. Singling out only the portfolios for which there are statistical macroeconomic dependencies, the amount increases to 2,3%.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The Bank used supportable forward looking information for measurement of ECL, primarily an outcome of its own macro-economic forecasting model. The most significant forward looking assumptions that correlate with ECL level and their assigned weights were as follows at 31 December 2018:

Variable	Scenario	Assigned weight	Assumption for:				
			2019	2020	2021	2022	2023
Unemployment rate	Base	60%	3.5%	3.6%	3.7%	3.8%	4.0%
	Upside	20%	2.9%	2.3%	1.7%	2.2%	2.7%
	Downside	20%	3.8%	4.2%	4.8%	4.8%	4.7%
Real GDP Growth rate	Base	60%	3.3%	2.6%	2.4%	2.3%	2.2%
	Upside	20%	4.4%	4.3%	4.0%	3.6%	3.2%
	Downside	20%	2.2%	0.8%	0.7%	0.9%	1.0%

The assumptions and assigned weights were as follows at 1 January 2018:

Variable	Scenario	Assigned weight	Assumption for:				
			2018	2019	2020	2021	2022
Unemployment rate	Base	60%	3.8%	3.6%	3.8%	3.9%	4.0%
	Upside	20%	3.4%	3.4%	3.6%	3.7%	3.9%
	Downside	20%	4.0%	4.3%	4.7%	4.7%	4.6%
Real GDP Growth rate	Base	60%	3.5%	3.0%	2.5%	2.3%	2.1%
	Upside	20%	4.1%	4.1%	3.8%	3.4%	3.0%
	Downside	20%	2.6%	1.8%	1.0%	1.0%	1.1%

Two variables are used during ECL calculation: the unemployment rate and the real GDP growth rate. Macroeconomic assumptions are updated on a quarterly basis. There were no changes regarding the assigned weights during 2018.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The industry breakdown of loans and advances is presented in the table below:

<u>Industry sector</u>	<u>2018</u> <u>MHUF</u>	<u>2017</u> <u>MHUF</u>
Agriculture, forestry and fishing	80 126	72 350
Mining and quarrying	941	1 091
Manufacturing	215 128	201 225
Electricity, gas, steam and air conditioning supply	17 467	5 399
Water supply	10 791	10 094
Construction	27 727	25 879
Wholesale and retail trade	116 670	115 327
Transport and storage	67 789	60 516
Accommodation and food service activities	13 339	18 042
Information and communication	2 960	3 071
Financial and insurance activities	79 983	45 068
Real estate activities	113 281	104 150
Professional, scientific and technical activities	30 400	38 589
Administrative and support service activities	10 582	8 273
Public administration and defence, compulsory social security	35	43
Education	1 592	876
Human health services and social work activities	7 191	5 828
Arts, entertainment and recreation	787	892
Central bank	361 470	208 445
Individuals	620 015	581 948
Central governments	7 908	34 522
Municipalities	20 343	14 581
Credit institutions	496 432	623 949
Other services	19 328	16 565
Gross loans and advances	<u>2 322 285</u>	<u>2 196 723</u>
Total impairment on loans and advances (see Note 22)	<u>(41 428)</u>	<u>(33 330)</u>
Total loans and advances	<u><u>2 280 857</u></u>	<u><u>2 163 393</u></u>

The table includes the net carrying amount of loans and advances mandatorily at fair value through profit or loss and at amortised cost (loans and receivables in 2017), cash and cash balances with central banks and other demand deposits to credit institutions.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Collateral and other credit enhancements

In compliance with its business policy the Bank does not grant collateral-based financing (i.e. financing that is not based on the loan repayment capacity of the client), however, there is one exception to this rule in case of a special credit type when the loan is collateralized with cash deposit. The borrower's cash flow represents the primary – direct – source of loan repayment to the Bank.

The inclusion of any type of collateral is subject to the assessment of the credit solvency of the client/guarantor, in the course of which the assets in question must be evaluated in compliance with the concerning internal regulations.

The main types of collateral applied are as follows:

- for retail lending, mortgages over residential real estate,
- for commercial lending, mortgage on real estate properties (both commercial and residential), state and institutional guarantees, and pledge on inventory and trade receivables,
- for securities lending cash deposits or security pledges.

The Bank also obtains guarantees from parent companies for loans to their subsidiaries.

In case of corporate clients relationship-managers monitor the market value of collaterals, regularly request for a review of the concerning collateral or requests additional collateral behind the deal if necessary. For defaulted counterparties, collaterals are assessed thoroughly to estimate expected recovery in order to set necessary level of impairments. For retail clients the regularly updated indexed market values are used.

The carrying amount of investment properties and other assets, which were obtained by the Bank by taking possession during 2018 amounted to HUF 914 million (HUF 859 million in 2017).

The Bank sells its assets obtained as collateral instead of using them for its operation.

The following tables present un-, under- and full or over collateralised loans and advances, The tables include the fair value of collaterals maximized to the net carrying amount of loans and advances, loan commitments, guarantees and other commitments given.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

	Under collateralised loans		Full and over collateralised loans		Uncollateralised loans	Total carrying amount of loans	Total fair value of collateral
	Carrying amount of loans	Fair value of collateral	Carrying amount of loans	Fair value of collateral			
	MHUF	MHUF	MHUF	MHUF			
Loans and advances at 31 December 2018							
Central bank and credit institutions	31 955	31 179	-	-	825 933	857 888	31 179
General government	24 937	21 168	151	151	2 783	27 871	21 319
Corporate	544 351	273 229	93 107	93 107	165 341	802 799	366 336
of which: Small and Medium enterprises	374 288	189 235	66 200	66 200	52 798	493 286	225 435
Households	45 854	31 455	453 877	453 881	92 569	592 300	485 336
Consumer credit	15 623	11 417	30 449	30 449	814	46 886	41 866
Credit card	-	-	-	-	6 009	6 009	-
Current account	5 163	3 567	58	58	7 724	12 945	3 625
Finance lease	219	170	1 259	1 259	888	2 366	1 429
Mortgage loan	14 754	10 904	411 816	411 820	76 608	503 178	422 724
Term loan	10 095	5 397	10 295	10 295	525	20 915	15 692
Trade receivables	-	-	-	-	-	-	-
Total	647 097	357 031	547 134	547 139	1 086 625	2 280 857	904 170
Loan commitments and guarantees at 31 December 2018							
Loan commitments	173 836	67 851	1 330	1 330	458 836	634 002	69 181
Financial guarantees	128 926	69 839	22	22	110 775	239 723	69 861
Other commitments	4 136	1 058	-	-	7 893	12 029	1 058
Total	306 898	138 748	1 352	1 352	577 504	885 754	140 100

The table includes the net carrying amount of loans and advances mandatorily at fair value through profit or loss and at amortised cost, cash and cash balances with central banks and other demand deposits to credit institutions. The fair value of collaterals is maximised to the net carrying amount of the loans and loan commitments.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

	<u>Under collateralised loans</u>		<u>Full and over collateralised loans</u>		<u>Uncollateralised loans</u>	<u>Total carrying amount of loans</u>	<u>Total fair value of collateral</u>
	<u>Carrying amount of loans</u>	<u>Fair value of collateral</u>	<u>Carrying amount of loans</u>	<u>Fair value of collateral</u>			
	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>			
Loans and advances at 31 December 2017							
Central bank and credit institutions	14 514	14 432	-	-	817 871	832 385	14 432
General government	20 759	17 450	22 080	22 127	6 257	49 096	39 577
Corporate	566 389	302 717	35 677	35 871	119 054	721 120	338 588
of which: Small and Medium enterprises	390 637	212 005	19 859	19 972	36 821	447 317	231 977
Households	451 477	440 018	37 687	37 724	71 628	560 792	477 742
Consumer credit	643	572	10	12	34 523	35 176	584
Credit card	-	-	-	-	5 848	5 848	-
Current account	4 566	3 318	48	50	8 323	12 937	3 368
Finance lease	2 403	2 282	68	71	131	2 602	2 353
Mortgage loan	423 752	418 948	36 722	36 749	22 349	482 823	455 697
Term loan	20 113	14 898	839	842	454	21 406	15 740
Trade receivables	-	-	-	-	-	-	-
Total	1 053 139	774 617	95 444	95 722	1 014 809	2 163 392	870 339
Loan commitments and guarantees at 31 December 2017							
Loan commitments	154 401	59 018	11 635	11 635	430 799	596 835	70 653
Financial guarantees	98 868	50 502	13 569	13 569	101 802	214 239	64 071
Other commitments	5 156	1 310	-	-	11 072	16 228	1 310
Total	258 425	110 830	25 204	25 204	543 673	827 302	136 034

The table includes the net carrying amount of loans and advances mandatorily at fair value through profit or loss and at amortised cost, cash and cash balances with central banks and other demand deposits to credit institutions. The fair value of collaterals is maximised to the net carrying amount of the loans and loan commitments.

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The breakdown of loans and advances* by the type of collateral is presented below.

	Collateralised by								Total carrying amount of loans	Total fair value of collateral
	residential immovable property		commercial immovable property		debt securities		other			
	Carrying amount of loans	Fair value of collateral	Carrying amount of loans	Fair value of collateral	Carrying amount of loans	Fair value of collateral	Carrying amount of loans	Fair value of collateral		
MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	
Loans and advances* at 31 December 2018										
Central bank and credit institutions	-	-	-	-	-	-	31 955	31 179	31 955	31 179
General government	-	-	4 150	1 050	11	11	20 927	20 258	25 088	21 319
Corporate	-	-	418 163	227 876	7 854	7 014	211 438	131 447	637 455	366 337
of which: Small and Medium enterprises	-	-	306 566	176 518	7 568	6 796	126 350	72 121	440 484	255 435
Households	472 641	464 589	11 951	7 473	431	402	14 711	12 871	499 734	485 335
Consumer credit	46 072	41 865	-	-	-	-	-	-	46 072	41 865
Credit card	-	-	-	-	-	-	-	-	-	-
Current account	-	-	3 772	2 814	6	6	1 444	805	5 222	3 625
Finance lease	-	-	-	-	-	-	1 478	1 429	1 478	1 429
Mortgage loan	426 569	422 724	-	-	-	-	-	-	426 569	422 724
Term loan	-	-	8 179	4 659	425	396	11 789	10 637	20 393	15 692
Trade receivables	-	-	-	-	-	-	-	-	-	-
Total	472 641	464 589	434 264	236 399	8 296	7 427	279 031	195 755	1 194 232	904 170
Unsecured exposures	77 423	-	2 441	-	-	-	1 006 761	-	1 086 625	-
Total carrying value loans and advances to customers at amortised cost (amount representing exposure to credit risk for each class of loans at amortised cost)	550 064	464 589	436 705	236 399	8 296	7 427	1 285 792	195 755	2 280 857	904 170

*The table includes the net carrying amount of loans and advances mandatorily at fair value through profit or loss and at amortised cost, cash and cash balances with central banks and other demand deposits to credit institutions

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

	Collateralised by								Total carrying amount of loans	Total fair value of collateral
	residential immovable property		commercial immovable property		debt securities		other			
	Carrying amount of loans MHUF	Fair value of collateral MHUF	Carrying amount of loans MHUF	Fair value of collateral MHUF	Carrying amount of loans MHUF	Fair value of collateral MHUF	Carrying amount of loans MHUF	Fair value of collateral MHUF		
Loans and advances* at 31 December 2017										
Central bank and credit institutions	-	-	-	-	-	-	14 514	14 432	14 514	14 432
General government	-	-	3 355	934	93	82	39 391	38 560	42 839	39 576
Corporate	-	-	379 618	202 732	15 899	9 403	208 440	126 421	602 030	338 556
of which: Small and Medium enterprises	-	-	266 116	146 665	15 685	9 216	130 409	75 895	410 283	231 776
Households	461 131	456 284	12 010	7 359	349	325	15 710	13 807	489 200	477 775
Consumer credit	653	584	-	-	-	-	-	-	653	584
Credit card	-	-	-	-	-	-	-	-	-	-
Current account	-	-	3 430	2 656	3	3	1 181	708	4 614	3 367
Finance lease	-	-	-	-	-	-	2 503	2 384	2 503	2 384
Mortgage loan	460 478	455 700	-	-	-	-	-	-	460 478	455 700
Term loan	-	-	8 580	4 703	346	322	12 026	10 715	20 952	15 740
Trade receivables	-	-	-	-	-	-	-	-	-	-
Total	<u>461 131</u>	<u>456 284</u>	<u>394 983</u>	<u>211 025</u>	<u>16 341</u>	<u>9 810</u>	<u>278 055</u>	<u>193 220</u>	<u>1 148 583</u>	<u>870 339</u>
Unsecured exposures	<u>56 868</u>	<u>-</u>	<u>1 154</u>	<u>-</u>	<u>1</u>	<u>-</u>	<u>954 859</u>	<u>-</u>	<u>1 014 809</u>	<u>-</u>
Total carrying value loans and advances to customers at amortised cost (amount representing exposure to credit risk for each class of loans at amortised cost)	<u>517 999</u>	<u>456 284</u>	<u>396 137</u>	<u>211 025</u>	<u>16 342</u>	<u>9 810</u>	<u>1 232 914</u>	<u>193 220</u>	<u>2 163 392</u>	<u>870 339</u>

*The table includes the net carrying amount of loans and advances in the loans and receivables portfolio, cash and cash balances with central banks and other demand deposits to credit institutions.

Collaterals behind non performing or past due financial assets amounted to HUF 70 781 million as at 31 December 2018 (HUF 92 334 million as at 31 December 2017). The amount of the collaterals includes the indexed or reviewed collateral value limited to the carrying amount of the related asset.

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The following tables present the quality of loans and advances by stage categories.

	Loans and advances at amortised cost						Total net carrying amount MHUF
	Gross carrying amount			Accumulated impairment			
	Stage 1 MHUF	Stage 2 MHUF	Stage 3 MHUF	Stage 1 MHUF	Stage 2 MHUF	Stage 3 MHUF	
Loans and advances* at 31 December 2018							
Central bank and credit institutions	809 327	48 566	10	(15)	-	-	857 888
General government	27 765	10	381	(16)	-	(364)	27 776
Corporate	733 418	62 204	16 033	(1 403)	(893)	(11 020)	798 339
of which: Small and Medium enterprises	450 257	39 579	14 770	(1 100)	(675)	(9 819)	493 012
Households	421 147	137 809	45 009	(851)	(4 052)	(22 274)	576 788
of which: purchased or originated credit impaired	-	3 316	26 112	-	-	(10 581)	18 847
Consumer credit	45 183	2 533	729	(591)	(365)	(603)	46 886
Credit card	5 681	437	59	(50)	(79)	(39)	6 009
Current account	7 595	4 861	1 520	(45)	(286)	(700)	12 945
Finance lease	1 977	406	105	(9)	(8)	(105)	2 366
Mortgage loan	344 080	125 287	42 522	(124)	(3 302)	(20 790)	487 673
Term loan	16 631	4 285	74	(32)	(12)	(37)	20 909
Trade receivables	-	-	-	-	-	-	-
Total	1 991 657	248 589	61 433	(2 285)	(4 945)	(33 658)	2 260 791

*Including cash balance with central banks and other demand deposits to credit institutions.

As of 2018, the financial information is prepared in accordance with IFRS 9. For more information on the impact of the transition see Note 3. The accompanying notes on pages 12 to 164 are an integral part of these financial statements.

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The table below presents the gross carrying amount of stage 1 loans and advances by internal risk grade categories in 2018.

	Loans and advances at amortised cost*
	<hr/>
	MHUF
High grade	486 705
Standard grade	944 491
Sub-standard grade	560 461
	<hr/>
Total carrying value	<hr/> 1 991 657 <hr/>

*Including cash balance with central banks and other demand deposits to credit institutions

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FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The credit quality of unimpaired and not past due assets as at 31 December 2017 is presented in the table below:

	Cash balances with central banks and other demand deposits with credit institutions	Held for trading	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
High grade	198 077	86 492	192 353	617 003	423 500	23 064	1 540 489
Standard grade	202 980	9 531	1 856	511 043	-	-	725 410
Sub-standard grade	-	1 980	-	578 128	-	-	580 108
Non-performing	-	-	-	664	-	-	664
Total carrying value	<u>401 057</u>	<u>98 003</u>	<u>194 209</u>	<u>1 706 838</u>	<u>423 500</u>	<u>23 064</u>	<u>2 846 671</u>

K&H BANK ZRT.**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS**NOTE 42 – RISK MANAGEMENT (continued)****Credit risk exposure for each internal risk rating**

The table below includes outstanding exposure of loans and loan commitments to customers and banks (without any money market position). Past due assets are distributed to the internal risk rating classes.

	Historical default rates* 2018	Average unsecured share of exposure 2018	Total 2018	Historical default rates* 2017	Average unsecured share of exposure 2017	Total 2017
	%	%	MHUF	%	%	MHUF
High grade	0.00	84.50	172 591	0.00	50.77	198 149
Standard grade	0.03	59.86	951 019	0.20	57.83	660 766
Sub-standard grade	1.43	57.22	848 840	3.41	38.77	553 153
Impaired	100.00	31.36	<u>76 759</u>	100.00	21.38	<u>107 879</u>
Total			<u>2 049 209</u>			<u>1 519 947</u>

* Impaired portfolio per credit grades compared to last year's total non-impaired portfolio.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

42.5 Credit risk – forborne loans

The policy on forbearance is based on the directive of the European Banking Authorities (EBA) harmonizing the definitions of forbearance and non-performing loans within the EU from 30/09/2014 on and on Regulation 39/2016 issued by the National Bank of Hungary.

Forbearance is similar to distressed renegotiations, whereby the bank agrees to renegotiate the existing contracts and obligations for a borrower with financial difficulties in order to avoid default (e.g. in order to avoid overdue interest, rent, capital and/or fees).

Forbearance measures consist of concessions towards a debtor facing or about to face difficulties in meeting its financial commitments.

A concession refers to either of the following actions:

- a) a modification of the terms and conditions of an existing contract because the debtor is considered unable to comply with the terms and conditions of the contract due to its financial difficulties and whereby the modification in principle would not have been granted in case the debtor would not have been in financial difficulties;
- b) a total or partial refinancing of a troubled debt contract because the debtor is considered unable to comply with the terms and conditions of the troubled debt due to its financial difficulties and whereby the partial refinancing in principle would not have been granted in case the debtor would not have been in financial difficulties.

The above means that an exposure should be perceived as forborne in case that two conditions are met:

- a) The bank granted concessions towards the borrower
- b) due to the fact that the borrower has financial difficulties.

The forbearance classification is discontinued when all the following conditions are met:

- a minimum 2 year probation period has passed from the date the forborne exposure was considered as performing;
- the contract is considered as performing, including if it has been reclassified from the non-performing category after an analysis of the financial condition of the debtor showed it no longer met the conditions to be considered as non-performing;
- regular payments of more than an insignificant aggregate amount of principal or interest have been made during at least half of the probation period;
- none of the exposures to the debtor is more than 30 days past-due at the end of the probation period.

A non-performing exposure for which forbearance measurement has been applied cannot be considered as performing for at least one year after the forbearance measurement.

The rating category of the debtor does not improve due to the forbearance measurement. The Bank classify borrowers with forborne exposures to at least PD9. In the following cases forborne borrowers are classified to a default status (i.e. at least PD 10):

- a second forbearance during the probation period;
- in case of 30 days past due for an amount exceeding the default materiality threshold of 2% of the exposure or HUF 250 000 during the probation period;
- partial and/or full debt forgiveness.

Forbearance measurement is applied on facility level (not on entire exposure).

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**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The following tables presents forborne loans, loan commitments and guarantees.

	Mandatorily at fair value through profit or loss			At amortised cost		
	Gross carrying amount	Accumulated negative changes in fair value due to credit risk	Total	Gross carrying amount	Accumulated impairment	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Loans and advances at 31 December 2018						
Central bank and credit institutions	-	-	-	-	-	-
General government	-	-	-	367	(356)	11
Corporate	-	-	-	9 030	(4 108)	4 922
of which: Small and Medium enterprises	-	-	-	9 030	(4 108)	4 922
Households	3	(2)	1	20 618	(5 454)	15 164
Consumer credit	-	-	-	93	(71)	22
Credit card	-	-	-	-	-	-
Current account	-	-	-	-	-	-
Finance lease	-	-	-	28	(28)	-
Mortgage loan	3	(2)	1	20 497	(5 355)	15 142
Term loan	-	-	-	-	-	-
Trade receivables	-	-	-	-	-	-
Total	<u>3</u>	<u>(2)</u>	<u>1</u>	<u>30 015</u>	<u>(9 918)</u>	<u>20 097</u>

Forborne loans mandatorily measured at fair value through profit or loss are non-performing loans.

K&H BANK ZRT.**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018
NOTES TO THE FINANCIAL STATEMENTS****NOTE 42 – RISK MANAGEMENT (continued)**

The following table presents forborne loans.

	<u>At amortised cost</u>		
	<u>Gross carrying amount</u>	<u>Accumulated impairment</u>	<u>Total</u>
	<u>MHUF</u>	<u>MHUF</u>	<u>MHUF</u>
Loans and advances at 31 December 2017			
Corporate	6 905	(3 987)	2 918
of which: Small and Medium enterprises	6 897	(3 980)	2 917
Households	28 689	(7 125)	21 564
Consumer credit	333	(242)	91
Credit card	-	-	-
Current account	-	-	-
Finance lease	149	(116)	33
Mortgage loan	28 191	(6 767)	21 424
Term loan	16	-	16
Trade receivables	-	-	-
Total	<u>35 594</u>	<u>(11 112)</u>	<u>24 482</u>

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

There were no forbore commitments and guarantees in 2018 and 2017.

The following table explains the change of forbore loans.

	<u>2018</u>	<u>2017</u>
	<u>MHUF</u>	<u>MHUF</u>
Balance as at the beginning of the period	24 482	33 082
IFRS 9 FTA	10 695	-
Loans which have become forbore	5 593	1 132
Loans which are no longer considered to be forbore	(3 318)	(4 377)
Repayments	(14 544)	(15 856)
Change in the impairment of forbore loans	(5 932)	(1 091)
Other	3 122	11 592
	<u>20 098</u>	<u>24 482</u>

The Bank recorded HUF 907 million interest income on forbore loans in the income statement in 2018 (HUF 1 092 million in 2017).

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**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Aging analysis quality of forborne loans and advances as at 31 December 2018 is as follows:

	Loans and advances*							Total MHUF
	Performing				Non-performing			
	Not past due MHUF	Past due <= 30 days MHUF	Past due > 30 days <= 90 days MHUF	Past due > 90 days MHUF	Past due <= 30 days MHUF	Past due > 30 days <= 90 days MHUF	Past due > 90 days MHUF	
Loans and advances at 31 December 2018								
Central bank and credit institutions	-	-	-	-	-	-	-	-
General government	-	-	-	-	11	-	-	11
Corporate	3 399	-	-	-	1 458	-	65	4 922
of which: Small and Medium enterprises	3 399	-	-	-	1 458	-	65	4 922
Households	4 717	928	1	-	2 598	923	5 998	15 165
Consumer credit	11	-	-	-	7	2	2	22
Credit card	-	-	-	-	-	-	-	-
Current account	-	-	-	-	-	-	-	-
Finance lease	-	-	-	-	-	-	-	-
Mortgage loan	4 706	928	1	-	2 591	921	5 996	15 143
Term loan	-	-	-	-	-	-	-	-
Trade receivables	-	-	-	-	-	-	-	-
Total	8 116	928	1	-	4 067	923	6 063	20 098

*The table includes the net carrying amount of loans and advances mandatorily at fair value through profit or loss and at amortised cost, cash and cash balances with central banks and other demand deposits to credit institutions.

K&H BANK ZRT.

**FINANCIAL STATEMENTS
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NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Aging analysis quality of forborne loans and advances as at 31 December 2017 is as follows:

	Loans and advances*							Total MHUF
	Performing				Non-performing			
	Not past due MHUF	Past due <= 30 days MHUF	Past due > 30 days <= 90 days MHUF	Past due > 90 days MHUF	Past due <= 30 days MHUF	Past due > 30 days <= 90 days MHUF	Past due > 90 days MHUF	
Loans and advances at 31 December 2017								
Central bank and credit institutions	-	-	-	-	-	-	-	-
General government	-	-	-	-	-	-	-	-
Corporate	1 124	-	5	-	1 461	-	328	2 918
of which: Small and Medium enterprises	1 124	-	4	-	1 461	-	328	2 917
Households	5 462	1 083	2	-	4 878	1 488	8 652	21 564
Consumer credit	50	7	2	-	9	3	20	91
Credit card	-	-	-	-	-	-	-	-
Current account	-	-	-	-	-	-	-	-
Finance lease	21	3	-	-	1	1	8	33
Mortgage loan	5 387	1 073	-	-	4 868	1 484	8 612	21 424
Term loan	4	-	-	-	-	-	12	16
Trade receivables	-	-	-	-	-	-	-	-
Total	6 586	1 083	7	-	6 338	1 488	8 980	24 482

*The table includes the net carrying amount of loans and advances in the loans and receivables portfolio, cash and cash balances with central banks and other demand deposits to credit institutions.

K&H BANK ZRT.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

Staging of forborne loans and advances are presented as follows.

	Loans and advances at amortised cost*						Total MHUF
	Gross carrying amount			Accumulated impairment			
	Stage 1 MHUF	Stage 2 MHUF	Stage 3 MHUF	Stage 1 MHUF	Stage 2 MHUF	Stage 3 MHUF	
Loans and advances* at 31 December 2018							
Central bank and credit institutions	-	-	-	-	-	-	-
General government	-	-	367	-	-	(356)	11
Corporate	284	3 329	5 417	(2)	(212)	(3 894)	4 922
of which: Small and Medium enterprises	284	3 329	5 417	(2)	(212)	(3 894)	4 922
Households	-	5 869	14 749	-	(223)	(5 231)	15 164
of which: purchased or originated credit impaired	-	2 594	9 794	-	-	(2 480)	9 908
Consumer credit	-	11	82	-	-	(71)	22
Credit card	-	-	-	-	-	-	-
Current account	-	-	-	-	-	-	-
Finance lease	-	-	28	-	-	(28)	-
Mortgage loan	-	5 858	14 639	-	(223)	(5 132)	15 142
Term loan	-	-	-	-	-	-	-
Trade receivables	-	-	-	-	-	-	-
Total	284	9 198	20 533	(2)	(435)	(9 481)	20 097

Also including Cash and cash balances with central banks and other demand deposits to credit institutions.

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

The industrial breakdown of forborne loans is included in the table below.

	<u>2018</u>	<u>2017</u>
<u>Industry sector</u>	<u>MHUF</u>	<u>MHUF</u>
Agriculture, forestry and fishing		642
Manufacturing	5 711	2 437
Electricity, gas, steam and air conditioning supply	243	370
Wholesale and retail trade	227	149
Transport and storage	1	2
Accommodation and food service activities	20	1 850
Information and communication	-	2
Financial and insurance activities	-	1 450
Real estate activities	2 703	2
Professional, scientific and technical activities	125	1
Individuals	20 621	28 688
Non-credit institutions	367	-
	<hr/>	<hr/>
Forborne loans and advances - gross	30 018	35 593
	<hr/>	<hr/>
Accumulated impairment	(9 918)	(148)
Accumulated negative changes in fair value due to credit risk	(2)	(10 963)
	<hr/>	<hr/>
Total forborne loans and advances	<u>20 098</u>	<u>24 482</u>

For comparative information to the total loan portfolio see Note 42 – Credit risk.

All forborne loans are granted to domestic clients in 2018 and 2017.

The table includes the net carrying amount of loans and advances mandatorily at fair value through profit or loss and at amortised cost (loans and receivables in 2017), cash and cash balances with central banks and other demand deposits to credit institutions.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2018**

NOTES TO THE FINANCIAL STATEMENTS

NOTE 42 – RISK MANAGEMENT (continued)

42.6 Operational risk

In line with KBC Group, the Bank applies the official Basel definition of Operational Risk and Operational Risk Management. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people or systems and from external events. It includes legal and tax risks, but excludes strategic and systemic risks. The Bank takes reputation risk into account to a certain level. When controls fail to adequately perform, operational risks can result in financial loss, damage to reputation, have legal or regulatory consequences. The operational risks cannot be completely eliminated; but using sound control framework these risks can be mitigated to an acceptable level.

Processes and risk event types together are used as common and universal/uniform framework of reference for reporting purposes. The Bank implemented the use of a uniform set of processes, risk event types, risk mitigating/measuring processes and a toolkit for operational risk management.

The first element of the toolkit is the use of *Group-wide Control requirements (Group Key Controls)* which are the key controls, defined by a centre of competence intended to control or mitigate major inherent risks. All KBC Group entities must implement these Key Controls. The compliance with the Group Key Controls is monitored via a benchmarking (assessment) exercise, assessments which are used to determine the gap between the group-wide requirements and the local practice. The derived action plans are continuously monitored and reported to the Capital and Risk Oversight Committee and Operational Risk Councils. The Local line management is responsible for translating the Group Key Controls into local procedures as well as for the timely and proper implementation of action plans.

Risk Self-Assessments aim to identify and assess the operational risk inherent in all material products, activities, processes and systems by the line management with the involvement of other concerned parties.

A '*Case Study Assessment*' is the process of testing the level of the protection of the current control environment against severe operational risk events that have actually happened in the banking and insurance industry by detecting gaps in subsequent control layers.

In line with the guidelines of KBC, the Bank collects the *operational loss events* in a unified and integrated database which is also used for analysis and reporting purposes.

The method and framework of *Key Risk Indicators* were implemented in 2009. These are measurable metrics or indicators which help the organization with monitoring the inherent and / or residual exposure to certain key risks, and combine the measurement of risk with the actual management of risk. Changes in the risk exposure versus the risk tolerance of the Bank are measured by warning and alert thresholds that are set for each Key risk indicator.

Risk scans for operational, and business and reputation risks were performed there by the main business lines, Information security and ICT (Information and Communication Technology), to assess the most important non-financial risks using a top-down approach.

In order to assure the continuity of its critical business services, the Bank has an extensive business continuity framework in place, that includes business continuity plans for material activities, the testing of such plans in order to be prepared for potential crisis situations.

K&H BANK ZRT.

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

NOTES TO THE FINANCIAL STATEMENTS

NOTE 43 – SOLVENCY AND CAPITAL

Based on the Hungarian Law (Act C of 2000, no. 114 / B. §)

	<u>2018</u>	<u>2017</u>
	<u>MHUF</u>	<u>MHUF</u>
Share capital in accordance with IFRS	140 978	140 978
Capital reserve	48 775	48 775
Tied-up reserve	23 335	17 631
Revaluation reserve	6 135	21 984
Accumulated profit	26 522	(5 012)
Profit for the year	57 050	41 669
Total equity	<u>302 795</u>	<u>266 024</u>
<i>from this</i>		
Registered capital by the Registry Court	140 978	140 978
Distributable reserves available for dividend payment	83 572	36 657

In accordance with Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises (banking law) and the EU Regulation No 575/2013 on prudential requirements for credit institutions and investment firms (CRR), the Bank must have a minimum capital in place. The Bank reports its level of capital adequacy situation to the National Bank of Hungary (MNB) on a quarterly basis and also forecasts are prepared to the Capital and Risk Oversight Committee (CROC) of the Bank on a regular basis. When needed, the Bank's Executive Committee decides and proposes to KBC Group any necessary steps that the Committee believes need to be taken (such as capital increase, subordinated debt increase, dividend payment etc.).

	<u>2018</u>	<u>2017</u>
	<u>MHUF</u>	<u>MHUF</u>
Tier 1 capital elements	273 861	243 706
Adjustments due to prudential filters	(2 519)	(6 663)
Other transitional adjustments	-	-
Tier 1 total	<u>271 342</u>	<u>237 043</u>
Tier 2 capital elements	40 832	39 388
Other transitional adjustments	-	-
Tier 2 total	<u>40 832</u>	<u>39 388</u>
Own funds	<u>312 174</u>	<u>276 431</u>

The Bank fulfilled the capital requirements set by MNB continuously during years 2018 and 2017 and at 31 December 2018 (and at 31 December 2017). The Bank is required to set aside 10% of its profit calculated as a statutory reserve for use against future losses. The balance of this reserve as at 31 December 2018 was HUF 23 335 million (HUF 17 630 million as at 31 December 2017). The Bank had distributable reserves of HUF 83 572 million as at 31 December 2018 (HUF 36 657 million as at 31 December 2017).

Proposed dividend for 2018 is HUF 3 000 million (no dividend was proposed for 2017).

Approved by the Board of Directors on 15 April 2019.

David Moucheron
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board



K&H Bank Zrt.
Management Report

31 December 2018

Below we summarise the business operations, the operating conditions and the financial results of K&H Bank Zrt. (hereunder "Bank") in 2018.

1. Economic environment

The pace of the economic growth in Hungary accelerated to 4.6% in 2018 after the 4.1% growth in 2017. Household consumption and investments were the main drivers of the growth in 2018, the latter was supported by the accelerated use of EU subsidies, the low interest rate environment, the intensive public investments and the tight labor market. Regarding the sectorial performance, construction grew the fastest again, but the service and industry sectors increased also substantially.

The internal and external balance positions of the economy deteriorated further (accelerated consumption and investments resulted in faster growing import), but the current account balance remained in positive territory. The external debt was decreasing further and its currency composition also improved further, contributing to the more positive risk assessment/perception of the country. The borrowing willingness increased substantially in both the household and corporate segment. None of the rating agencies has changed Hungary's rating in 2018 although two of them were maintaining positive outlook for the country, which considered as a prelude of further potential upgrades during 2019 (which ultimately happened in early 2019).

	2017 actual	2018 preliminary
GDP growth	+4.1%	+4.6%
CPI (average)	2.4%	2.8%
Households' consumption	+4.1%	+4.8%
Investments	+24.8%	+17.0%
Unemployment rate	3.8%	3.6%
Budget deficit (ESA) (in % of GDP)	-2.2%	-2.0%
Debt/GDP rate	73.3%	71.9%
Balance of payments (in % of GDP)	+3.2%	+1.7%

Source: MNB, KSH, K&H

During 2018 the European Central Bank continued its asset purchasing program, but it was finished at the end of the year. The FED, which plays the role of the US central bank, raised its base rate four times during the year due to the strong economic figures and it continued to consolidate its balance sheet. The National Bank of Hungary (MNB) left the base rate unchanged at 0.9% in 2018 and further unconventional monetary policy tools were applied with the aim of keeping the interbank and government bond yields at a lower level (pumping extra HUF liquidity into the market via FX swaps, mortgage bond purchase and the MIRS program). Parallel with the increase of inflation MNB started to open towards monetary tightening in its communication, although no concrete measure was taken. The 3-month deposit, the MIRS program and the mortgage bond purchasing were abolished at the end of the year, but a new MNB funding for growth (NHP fix) program for SMEs was introduced from the beginning of 2019.

2. Key balance sheet and performance data

2.1. Balance sheet

HUF Bln	1 Jan 2018 (IFRS9)	31 Dec 2018 (IFRS9)	Variance
Total assets	3,025	3,229	+6.7%
Central Banks and credit institutions	832	858	+3.1%
Loans and advances to customers	1,327	1,423	+7.2%
Deposits from customers	2,293	2,391	+4.3%
Equity	251	303	+20.8%

Total assets of K&H Bank amounted to 3,229 bln on 31 Dec 2018 (+6.7% growth in 2018)¹.

- *Loans and advances to customers* increased by 7.2% in 2018: both corporate and retail loan portfolio continued to increase during the period.

Market share	31 Dec 2017	31 Dec 2018 *
Corporate loans	10.5%	10.1%
Retail loans	10.5%	10.2%
Corporate deposits	12.9%	12.0%
Retail deposits+mutual funds	11.4%	11.3%

* preliminary figures
source: MNB, K&H

- *Deposits from customers* increased by 4.3% during the year mainly driven by retail and SME deposits.
- *Shareholders' equity* increased by 52.2 bln (+21%) compared to 1 Jan 2018 as profit 2018 (+57.1 bln) was partially counterbalanced by lower cash flow reserve (-3.8 bln) and revaluation reserve of securities (-1.0 bln). Based on a shareholders' resolution the Group will pay 3.0 bln dividend from the net result of 2018. The capital adequacy ratio was 16.7% at 31 December 2018 which fulfilled the capital requirements set by MNB.

2.2. Profit

HUF bln	2017	2018
Profit after taxation	41.7	57.1

In 2018 the Bank's net result amounted to 57.1 bln (2017: 41.7 bln).

- In comparison with previous year *net interest income* increased by 3.0% (2018: 74.2 bln; 2017: 72.0 bln) due to the growing loan and deposit volumes compensating the negative impact of low interest environment.
- The 11.2% increase in *net fee and commission income* (2018: 57.2 bln, 2017: 51.5 bln) is primarily driven by the increased transactional and investment services income.
- The higher *net gains from financial instruments at fair value* (2018: 27.2 bln, 2017: 18.3 bln) is attributable primarily to favourable Treasury related income. 0.7 bln income was accounted for in 2018 due to the lending activity related interest rate swap deals (HIRS) linked to the Hungarian National Bank's Market Lending Scheme (PHP). The initial positive net present value on MIRS (Monetary Interest Rate Swap) deals with MNB resulted in 6.2 bln income in 2018.
- *Operating expenses* amounted to 101.7 bln in 2018 (2017: 98.3 bln), disregarding banktax and financial transaction levy there is a 2.0% growth compared to the previous year (higher ICT expenditure due to investment in digitalization, higher regulatory fees).
- *Impairment on financial assets at amortised cost* amounted to +3.0 bln release in 2018. Portfolio quality remained stable in all segments, NPL rates decreased further.

¹ On 1 Jan 2018 the new accounting standard of IFRS9 became effective impacting both the classification and measurement of financial instruments:

- the full impact of first time application is recorded in the equity as at 1 Jan 2018 (-15.458 mln). The Bank will not make use of any transitional arrangements with regard to the impact of IFRS 9 on capital, as it wants to provide full transparency.
- the 2018 annual report (standalone statement of financial position) includes comparative information for IFRS9 at the date of initial application (the detailed description of IFRS9 and its implications is available in the Bank's standalone financial statements 2018, note 3). The analysis on the balance sheet is based on comparable basis of IFRS9.

3. Risk Management

Banks are exposed to several types of risks due to their operations. K&H Bank has a system in place for the 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 organisational set-up.

3.1 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), 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 – amongst others the quarterly risk reports, annual review of remuneration and risk based pricing policies – 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 appetite and 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.

3.2 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 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. This work is continuously ongoing to have up to date information on various portfolios. Based on MNB permission, the Bank shifted to IRB Advanced methodology for regulatory capital calculation from 30 September 2015.

The Bank made the transition to IFRS 9 based provision calculation in 2018 but this had no significant effect on credit risk related issues.

Management reports were further fine-tuned during 2018, and amended with additional information. The main conclusions for 2018 are:

- Corporate and SME portfolio quality remained stable with some improvements in risk indicators in the period. Furthermore the performing portfolio continued to increase in 2018, while non-performing portfolio remained stable with no material new defaults during the year.
- Retail portfolio continued to improve during 2018 driven by the decreasing NPL volume and also the substantial amount of new production. It should also be noted that cures from NPL also contributed to the improving risk metrics, although to a lesser degree.

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.

The Bank's large risk portfolio is stable, no significant change can be observed in the past years (the total volume of clients with large risk is at 13% of the total legal lending limit). Evolution of large risk is monitored monthly, and the internal processes of the Bank are created in a way so that no breach of the legal lending limit can be made.

- **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 stable interest rate risk taking, at full sovereign limit utilization. During Q3 2018 sovereign limit has been increased by KBC, which was not fully utilized until the end of year 2018.

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 25% of the available VaR limit. There was no limit overrun in the examined period. In March 2018 trading positions were migrated to KBC (phase 1: interest rate positions), during 2019 FX positions will be migrated also (phase 2).

- **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 and by liquidity stress tests and liquidity early warning signals. The department prepares regular reports to the K&H Bank Capital and Risk Oversight Committee on the various liquidity indicators and limits.

	31 Dec 2017	31 Dec 2018	Regulatory requirement
NSFR (%)	143.9	158.0	n.a*
LCR (%)	165.6	141.9	100
FFAR (DMM) (%)	101.2	125.9	100

* Regulatory limit will be introduced in 2019

- 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).

4. Operating Conditions of the Bank

Capital investments in the branch network:

- In 2018 the set-up, full or partial reconstruction of 32 branches was started or completed.
- Premium-banking offices were installed in 6 branches.
- By the end of 2018 altogether 466 ATMs were serving our customers (incl. 212 cash-in ATMs).

The number of branches at year-end 2018 was 206.

The most important IT development projects in 2018 were the followings:

- Several project size developments were initiated or completed to align with legal regulations such as: MNB Custody reporting, Value based segmentation, Szép Card, Personal Data Protection, MIFID2, Domestic HUF Instant Payment, New AML legislation, Regulatory Reporting, PSD2, HitReg.
- For corporate clients the Electra thin client application roll out with VICA client authentication via Mobil phone related developments were executed.
- The “Time to yes 48” project launched by retail lending department aiming to support decision making within 48 hours was finished.
- Within the Digitalization programme the following developments were delivered in 2018:
 - Credit Card e-statement
 - Impresto: K&H new online E2E cash loan application platform went live
 - Multibank app: preparation of connections channels to the API sandbox recently available on the market was delivered
 - website: the online loan calculator for SME clients went live
 - Mobilbank/MobilePayment: message sending function related developments were delivered
 - Biometric Signature: the roll out of the already productive Biometric Signature function was done for the entire branch network

5. Non-financial statement

K&H sustainability strategy

Sustainability is embedded in the four pillars of the corporate reference strategy (bank-insurance, sustainable profitable growth, client centricity, role in society) and our day-to-day business activities. Sustainability is only possible if we also maintain the trust of the society in which we operate.

We aim to achieve this by acting as a responsible company: being aware at all times of the impact of our operations on society, and responding to society’s needs and expectations in a balanced, relevant and transparent way.

The core of K&H Group sustainability strategy

5.1

K&H follows strict policies for our activities regarding business ethics and socially sensitive issues, human rights, and reducing our environmental and ecological footprint.

Related policies at K&H

Business ethics:

Code of Conduct (2010 March)

Code of Ethics (2010 February)

Socially sensitive issues:

Retail Credit Risk regulations (2013 July)

Personal bankruptcy (2015 September)

Corporate Credit Policy (part of Corporate Decisions regulations)

Accessibility Policy (2016 November) based on Equal access strategy

Human Rights:

Collective Agreement (6A and 6B §)

Environment:

Environmental Policy (2016 September)

Energy Policy (2016 September)

5.2

We strive to increase our positive impact on society, which includes four focus domains close to our core business: financial literacy, environmental responsibility, stimulating entrepreneurship and health.

Financial literacy domain

Our financial education program & contest for primary school children of “K&H Ready, Steady, Money!” was organised for the seventh time in the 2017-2018 school year to encourage children to learn the basics of everyday household finance, thus helping them make smart financial decisions later.

Branch mentor program for schools was also organised with the involvement of branch managers.

Results: in 8 years 608 settlements, 1100 schools, 9250 teams and more than 38 000 students participated.

Environmental responsibility domain and K&H ecological footprint

Beside helping our clients make smart decisions, we are also responsible for the community and the environment in which we, our private individual and enterprise clients as well as our employees operate. Through our financial intermediary role we have a great influence on the environment our society lives in. Hence, we aim to respond to the environmental needs of the society and contribute to the ability of the members of the society to live a full life today as well as tomorrow. We are engaged to build a sustainable agriculture supporting young agricultural scientists, who design new procedures and may thus change both the future and the general image of the profession. The award is intended to financially support those students in pursuing their studies and research who at the same time wish to focus on the long-term, healthy and sustainable development of the agricultural sector. Results: 207 participants, 29 awards, from 15 universities.

Besides its financial activities, K&H Group lays special emphasis on improving the efficiency of its energy use as part of its sustainable operations. At the end of 2016 K&H Group successfully obtained certification for its integrated environmental and energy management system, becoming the first Hungarian financial institution to operate audited and certified ISO 14001 and ISO 50001 systems.

Completed in 2011, K&H's headquarters was the first office building in Central Europe to earn LEED Gold environmental protection certification for the entire project. The state-of-the-art environmentally friendly technological solutions used in the headquarters building have enabled K&H Group to reduce its per-capita carbon emissions by 47% between 2015 and 2018. In addition, the Group now uses 26% less drinking water, 16% less energy annually, and it produces 6% less waste than in 2015.

Stimulating entrepreneurship domain

In Hungary, about 70% of the companies are family-owned small and medium enterprises which produce more than half of the country's GDP and provide jobs to half of the Hungarian employees.

- K&H “gap in the market” program provides a free-of charge market research for sme companies about local needs, www.uzletetide.hu website can show what products and services are needed and where by local people. Business development support tools for entrepreneurs are provided by K&H. Results: Total page views: 579 352, business ideas: 19 094, votes: 56 160, sme lead: 10 593.
- K&H Family-Owned Business (FOB) Excellence Award provides substantial media coverage for the winners in order to promote and recognize their family-owned businesses’ contribution to the Hungarian economy and employer market as well as commitment to the local society. The three award periods concluded 65 applications.
- K&H Family-Owned Business events: we organize these to reach family-owned businesses’ owners and succeeding family members to help them in the future growth and sustainability of the company.
- FOB Clubs: events for customers structured to inspire and facilitate peer networking (14 events were organized with 400-500 participating clients).
- Next Generation (NextGen) roundtables are organized to inspire and provide insight into business management. The program was launched in 2015 (51 participants so far).
- K&H NextGen alumni: events for all NextGens (5 events were held so far).

Start it @K&H:

- leading corporate incubator programme, currently working with 22 start-ups; incubation period: 12 or 18 months
- the previous wave exceeded all expectations: the 13 teams won a total of 10 awards, Hungarian and international, and attracted combined capital investment of more than 500 mln
- community office in downtown Budapest
- experienced professional mentoring team, with more than 30 mentors representing different industries

Health domain

Research shows that the Hungarian society deems healthcare as one of the most important areas in the country needing support beyond state financing. Our 15 years old K&H MediMagic program has been a committed supporter of child healthcare. We purchase paediatric equipment for hospitals from funding by K&H. We also operate K&H MediMagic story-telling doctors’ volunteer program in hospitals and on youtube, which help kids’ recovery with mental support. A total of 390 institutions benefited with equipment worth 652 mln in 15 years. 50 000 registered volunteer storytellers, 17 000 stories in 40 hospitals. 733 videos uploaded, 95 400 views.

5.3.

Actions against corruption and bribery, respect for human rights

The Bank Group’s Anti-Corruption Program focuses on the following two main objectives:

- defining the criteria and principles that enable the Group’s employees and associated persons to avoid conflicts of interest
- developing a group-wide solution for compliance with all the legal requirements arising from regulations

The Program is managed and coordinated by the Bank’s Compliance Directorate. Local implementation and compliance is the shared responsibility of all the stakeholders.

Regarding the human rights our company considers the general provisions of internal regulations.

Social responsibility

In appreciation of its exemplary operations as a family-friendly employer, which proliferates family-friendly workplace practices in Hungary and which helps its employees strike a healthy balance between private life and work while giving them an opportunity to build a fulfilling career, K&H has been granted the ‘Family-Friendly Company Mentor Organisation 2018’ award by the Three Princes, Three Princesses Movement, an NGO. The Bank runs an HR project dedicated to atypical employment in an effort to put even more emphasis on part-time work and flexible hours. Flexible hours allow employees to adjust their working days to their family obligations, providing more room for family life. Currently, some 600 employees work in such arrangements in accordance with their

employment contracts. In 2018, we worked extensively on a technological and policy background to allow employees – the nature of their jobs permitting – to work from home, at least partially. To that end we carried out a major infrastructure development project, as working from home requires secure IT channels, and provided an opportunity for all our colleagues to replace their desktop PCs with laptops. We also spent an unprecedented amount on assisting employees in sending their children to summer camps. 318 kids benefited. With its wide-ranging efforts to create opportunities for employees to live up to their personal preferences K&H won the ‘Reliable Employer Award 2018’, awarded by the German-Hungarian Chamber of Industry and Commerce.

K&H Bank was selected as one of the TOP10 Diverse and Family-Friendly Workplaces in 2017. In both 2014 and 2016, the Bank was awarded a prize in the Large Corporate category of the Family-Friendly Workplace competition, which is judged by the Government. In 2017 we introduced our Senior Program for employees aged over 55 years because we are confident that developing and operating such a program may help them achieve an improved work/life balance and contribute to an increase in the number of healthy and well-functioning families.

At the moment we have 340 employees older than 55 and this will rise by a further 200 in the next 3 years. Our Group provides welfare aid to its employees in need and to its pensioners. In 2018 the Bank spent 45 mln on welfare aid; so far, around 888 employees and retired bank employees have received such aid.

Besides helping out in difficult welfare situations, subsidising loan repayments, topping up salaries lost due to illness and paying for certain expenses, we continued in 2018 to provide financial assistance to our employees requesting us to help finance their IVF (In vitro fertilisation) treatment.

Our “Welcome back” program is helping women to reintegrate into the labour market – from our 4000 employees, we have 2000 female colleagues in the age group where they might be planning for a new family or more children in the near future. We believe it is important to keep them informed about recent events at K&H Group and also wish to help them return to work in increasing numbers after child-care leave. 30% of mothers returning to work do so part-time; this is an exceptionally high proportion under Hungarian employment conditions.

Budapest, 26 April 2019

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer