Kereskedelmi és Hitelbank Zrt.

CONSOLIDATED SEMI-ANNUAL REPORT

30 June 2019

Budapest, 30 August 2019

CONTENT

Statement of the Issuer

K&H Bank Zrt., as the Issuer (represented by David Moucheron, CEO and Attila Gombás, CFO) based on 2th attachment 2.4. point of 24/2008. (VIII.15.) PM decree about the rules of the information obligation regarding publicly traded securitiy hereby declare that K&H Bank Zrt.'s consolidated 2019 Semi-annual Report has been prepared in compliance with the applicable accounting laws and regulations, to the best of the Issuer's knowledge, and that the financial details contained therein reflect a true and reliable status of the assets, liabilities, financial position and profit of K&H Bank Zrt. and of the companies involved in the consolidation, and that the consolidated management report shows a true and fair picture of the position, development and performance of K&H Bank Zrt. and the companies involved in the consolidation, also including the major risks and uncertainties pertaining to the remaining six months of the financial year.

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

Budapest, 30 August 2019

David Moucheron	*Attila Gombás*
Chief Executive Officer	*Chief Financial Officer*

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Not audited 30 June 2019	Reclassified 31 December 2018
	MHUF	MHUF
ASSETS		
Cash and cash balances with central banks	328 785	480 648
Cash	42 960	42 834
Cash balances with central banks	46 978	361 464
Other demand deposit with credit institutions	238 847	76 350
Financial assets	2 759 854	2 623 813
Held for trading	82 985	69 814
Mandatorily fair value through profit or loss	21 132	20 066
Fair value through other comprehensive income	88 421	95 161
of witch pledged as collateral	-	9 359
At amortised cost	2 542 086	2 421 507
of witch pledged as collateral	223 915	239 188
Hedging derivatives	25 230	17 265
Fair value changes of hedged item under portfolio hedge of interest rate risk	15 205	7 333
Tax assets	1 510	2 586
Current tax assets	1 478	2 070
Deferred tax assets	32	516
Investments in associated companies	-	-
Investment property	1 857	1 689
Property and equipment	46 149	35 563
Intangible assets	21 742	20 008
Other assets	23 537	27 087
Total assets	3 198 639	3 198 727
LIABILITIES AND EQUITY		
Financial liabilities	2 807 575	2 813 553
Held for trading	60 682	54 388
Designated at fair value through profit or loss	78 611	88 790
Measured at amortised cost	2 649 255	2 656 809
Hedging derivatives	19 027	13 566
FV changes of hedged item under portfolio hedge of interest rate risk	13 219	6 164
Tax liabilities	191	-
Current tax liabilities	159	-
Deferred tax liabilities	32	-
Provisions for risks and charges	1 554	1 785
Other liabilities	43 756	72 007
Total liabilities	2 866 295	2 893 509
Share capital	140 978	140 978
Share premium	48 775	48 775
Accumulated profit	108 574	85 977
Other reserves	34 017	29 488
Total equity	332 344	305 218
Total liabilities and equity	3 198 639	3 198 727

Budapest, 30 August 2019

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Share capital MHUF	Share premium MHUF	Statutory risk reserve MHUF	Revaluation reserve of securities MHUF	Revaluation reserve - Cash flow hedge MHUF	Revaluation reserves – other MHUF	Retained earnings MHUF	Total equity MHUF
Balance as at 1 January 2018	140 978	48 775	17 630	15 961	5 936	87	38 479	267 846
Early adoption of IFRS 9	-	-	-	(11 016)	-	-	(4 690)	(15 706)
Balance at the beginning of the period after transition to IFRS 9	140 978	48 775	17 630	4 945	5 936	87	33 789	252 140
Net profit for the year	-	-	-	-	-	-	57 912	57 912
Other comprehensive income for the period	-	-	-	(1 026)	(3 780)	(28)	-	(4 834)
Total comprehensive income	-	-	-	(1 026)	(3 780)	(28)	57 912	53 078
Realised result of investments	-	-	-	(5)	-	-	5	-
Transfer from retained earnings to statutory risk reserve	-	-	5 729	-	-	-	(5 729)	-
Total change	-	-	5 729	(12 047)	(3 780)	(28)	47 498	37 372
Balance as at 31 December 2018	140 978	48 775	23 359	3 914	2 156	59	85 977	305 218
of which								
revaluation reserve for shares	-	-	-	656	-	-	-	656
revaluation reserve for bonds	-	-	-	3 258	-	-	-	3 258
Balance as at 1 January 2019	140 978	48 775	23 359	3 914	2 156	59	85 977	305 218
Net profit for the year	-	-	-	-	-	-	22 597	22 597
Other comprehensive income for the period	-	-	-	1 260	3 273	(4)	-	4 529
Total comprehensive income	-	-	-	1 260	3 273	(4)	22 597	27 126
Total change	-	-	-	1 260	3 273	(4)	22 597	27 126
Balance as at 30 June 2019	140 978	48 775	23 359	5 174	5 429	55	108 574	332 344
of which								
revaluation reserve for shares	-	-	-	1 148	-	-	-	1 148
revaluation reserve for bonds	-	-	-	4 026	-	-	-	4 026

Budapest, 30 August 2019

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED INCOME STATEMENT

	Not audited 1st half of year 2019	Reclassified not audited 1st half of year 2018
	MHUF	MHUF
Interest income	48 807	42 927
Interest Income calculated using the effective interest method	41 256	36 576
Other similar income	7 551	6 351
Interest expense	(9 749)	(6 053)
Net interest income	39 058	36 874
Fee and commission income	42 166	38 885
Fee and commission expense	(10 510)	(9 583)
Net fee and commission income	31 656	29 302
Net gains / (losses) from financial instruments at fair value through profit or loss and foreign exchange differences	9 833	13 887
Dividend income	12	6
Other income	1 020	4 907
Other expense	(390)	(427)
Total income	81 189	84 549
Operating expenses	(55 182)	(54 275)
Staff expenses	(16 662)	(16 606)
General administrative expenses	(27 546)	(27 466)
Depreciation and amortisation of tangible and intangible assets	(5 352)	(4 381)
Bank tax	(5 622)	(5 822)
Impairment:	1 021	2 235
Financial assets at amortised cost	1 031	2 256
Other	26	(18)
Share in results of associated companies	(36)	(3)
Profit before tax	27 028	32 509
Income tax expense	(4 431)	(4 749)
Profit after tax	22 597	27 760

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Not audited 1st half of year 2019 MHUF	Not audited 1st half of year 2018 MHUF
Profit after tax	22 597	27 760
Other comprehensive income		
Items that may be reclassified to the profit or loss under IFRS 9		
Revaluation reserve of debt instruments		
Net gain / (loss) from fair value changes	886	(2 044)
Deferred tax impact on fair value changes	(96)	221
Transfer from available for sale reserve to net profit:		
(Losses)/gains on impairment	(26)	18
(Losses)/ gains on disposal	1	-
Deferred income tax	3	(2)
Cash flow hedge		
Net gain / (loss) from fair value changes	3 783	(10 344)
Deferred tax impact on fair value changes	(340)	931
Transfer from cash flow hedge reserve to net profit:		
Ineffective part	82	102
Gross amount	(269)	(227)
Deferred income tax	17	11
Items that will not be reclassified to the profit or loss under IFRS 9		
Available-for-sale equity instruments		
Net gain / (loss) from fair value changes	552	348
Deferred tax impact on fair value changes	(60)	(38)
Own credit risk adjustments	1	(50)
Deferred income tax	-	5
Actuarial result on defined benefit plans	(6)	18
Deferred income tax	1	(2)
Total other comprehensive income	4 529	(11 053)
Total comprehensive income	27 126	16 707

Budapest, 30 August 2019

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Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CASH FLOWS

	Not audited 1st half of year 2019 MHUF	Not audited 1st half of year 2018 MHUF
OPERATING ACTIVITIES		
Profit before tax	27 028	32 509
Adjustments for:		
Interest income	(48 087)	(42 927)
Interest expense	9 749	6 053
Net transfer from revaluation reserve	26	18
Net transfer from cash flow hedge reserve	(187)	(125)
Depreciation and impairment of property, plant and equipment, intangible assets, financial assets at fair value through other comprehensive income and other assets	5 184	4 364
(Profit)/Loss on the disposal of property and equipment	(95)	(49)
(Profit)/Loss on the disposal of investment property	(210)	(111)
Change in impairment on assets valued at amortised cost	(1 217)	(2 256)
Change in other provisions	(49)	(48)
Unrealised valuation differences	(2 889)	62 262
Cash flows from operating profit before tax and before changes in operating assets and liabilities	(11 467)	59 690
Changes in financial assets held for trading	(17 595)	(3 356)
Changes in financial assets mandatorily valued at fair value through profit or loss	2 061	-
Changes in financial assets at fair value through other comprehensive income	9 191	(32 776)
Changes in financial assets at amortised cost	(123 789)	(296 801)
Changes in other assets	(14 378)	(493)
Changes in operating assets	(144 510)	(333 426)
Changes in financial liabilities held for trading	7 872	25 764
Changes in financial liabilities designated at fair value through profit or loss	(11 000)	(12 976)
Changes in financial liabilities measured at amortised cost	(14 895)	50 229
Changes in other liabilities	(15 970)	(21 178)
Changes in operating liabilities	(33 993)	41 839
Income taxes paid	(4 393)	(4 745)
Interest received	43 776	44 329
Interest paid	(8 844)	(6 697)
Net cash from/(used in) operating activities	(159 431)	(199 010)

* Including also provisions on loan commitments.

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2019 MHUF	Not audited 1st half of year 2018 MHUF
INVESTING ACTIVITIES		
Purchase of securities at amortised cost	(110 647)	(23 672)
Proceeds from the repayment of securities at amortised cost at maturity	68 337	8 707
Proceeds from the sale of securities at amortised cost	441	44 918
Proceeds from the disposal of a subsidiary or business unit, net of cash disposed	-	548
Dividends received from associated companies	12	2
Purchase of intangible fixed assets	(3 438)	(2 294)
Purchase of property, plant and equipment	(1 601)	(1 370)
Proceeds from the sale of property, plant and equipment	14	59
Proceeds from the sale of non-current assets held for sale and disposal groups	-	4 177
Purchase of investment property	(524)	(686)
Proceeds from the sale of investment property	-	536
Net cash from/(used in) investing activities	(47 406)	30 925
FINANCING ACTIVITIES		
Dividend paid	-	-
Net cash from/(used in) financing activities	-	-
CHANGE IN CASH AND CASH EQUIVALENTS		
Net increase/(decrease) in cash and cash equivalents	(206 837)	(168 085)
Net foreign exchange difference	498	(14 525)
Cash and cash equivalents at beginning of the period	419 395	689 900
Cash and cash equivalents at end of the period	213 056	507 290

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2019 MHUF	Not audited 1st half of year 2018 MHUF
OPERATING CASH FLOWS FROM DIVIDENDS		
Dividends received	12	2
COMPONENTS OF CASH AND CASH EQUIVALENTS		
Cash and cash balances with central banks	89 938	248 036
Loans and advances to banks repayable on demand and term loans to banks < 3 months	242 965	417 083
Deposits from banks repayable on demand and redeemable at notice	(119 847)	(157 829)
Total cash and cash equivalents	213 056	507 290

Loans and advances to banks repayable on demand are presented as Cash and cash balances with central banks and other demand deposits with credit institutions in the consolidated statement of financial position. Term loans to banks < 3 months are included in financial assets at amortised cost. Deposits from banks repayable on demand and redeemable at notice are presented as financial liabilities measured at amortised cost.

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

Budapest, 30 August 2019

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

Consolidated Management Report

On 30 June 2019, the consolidated total assets of K&H Bank Group (hereunder “the Group”) stood at 3,199 billion. As a financial institution which offers banking and insurance products alike and has a nation-wide branch network of 206 branches, the Group offers the full range of financial services to its clients.

1. Economic environment

The Hungarian economy had a very strong first six months in this year (GDP grew by 5.2% in H1 yoy, which is one of the highest in Europe) driven mainly by domestic components (construction, industrial production and retail sales). This dynamic economic growth looks challenging to maintain in medium term: the construction may slow down (the stock of orders started to decrease in some segments and it is running close to its full capacity) and there are still concerns about the effect of the trade war, so a remarkable global slowdown is still in the cards.
State budget remains under control: the deficit of the first six months amounted to HUF 390 billion (which is 39% of the planned deficit). The deficit target of 1.8% to GDP for the whole of the year continues to remain realistic and achievable, while the sovereign debt may decrease further. As a combination of sustained strong households consumption and weaker outlook for the European conjuncture the current account balance (and within that the balance of trade) may deteriorate further in the coming quarters.

	2018 actual	2019 forecast*
GDP growth	+4.9%	+4.7%
CPI (average)	+2.9%	+3.4%
Investments	+16.5%	+15.0%
Unemployment rate	3.6%	3.5%
Balance of state budget (in % of GDP)	-2.2%	-1.8%
Balance of payments (in % of GDP)	+0.5%	-0.1%

**source: K&H Bank Zrt*

Financial market expectations are shifting more and more towards additional monetary policy stimulus by the major central banks. In line with its dovish communication Fed has already delivered a 25bps base rate cut in July, while also from ECB steps towards active monetary policy intervention are expected in the 2nd half of the year to prevent a major slowdown of the European economy. The National Bank of Hungary (MNB) increased its O/N deposit rate by 10bps in March to keep its credibility amidst increasing local inflation environment, but kept the base rate unchanged at 0.9% in the first half of the year. The demand for the new retail bonds dried out the HUF liquidity from the market temporary pushing the implied yields above the base rate. Both the ÁKK and MNB reacted via pushing additional HUF liquidity to the market, lowering the short yields back to the low-end of interest rate channel. The dovish stance of the central banks in the world pushed the HUF long yields further down in H1, so the curve has flattened.

2. The Strategic Objectives of the Group

K&H Bank Group is a universal bank-insurer, providing banking, leasing, asset management and insurance services for individuals and corporate (focusing on SME and Mid-cap) customers.

In order to fulfil our mandate by our shareholder and our clients:

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

We want to be the reference in bank-insurance.

Customer strategy:

We help our clients realise their dreams and protect them.

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

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

Product strategy:

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

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

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

Strategy on distribution channels:

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

Key differentiators of the Bank Group:
- being close to our clients: easy access both physically (via our large branch network) and digitally (via remote channels)
- K&H Group acts as a full service provider for our clients in banking and insurance (universal financial institution)
- expertise and advice in the whole spectrum of financial services
- we continuously adopt to the changes in client behaviour and in the environment by taking actions in these 4 areas: Simplification, Digitalisation, Distribution and Fast Execution.

3. The Group's consolidated activities

3.1 Balance sheet

The Group's total assets amounted to 3,199 bln at 30 June 2019.

HUF Bln	31 Dec 2018	30 Jun 2019	Variance
Total assets	3,199	3,199	0%
Loans and advances to customers	1,403	1,471	+4.8%
Deposits from customers	2,388	2,360	-1.1%
Equity	305	332	+8.9%

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

- *Loans and advances to customers* increased by 4.8% in H1 2019: similarly to the banking sector, loan demand has strengthened further and both corporate and retail loan portfolio continued to increase during the period. K&H has managed to increase its market share in new production in both retail and corporate segments. Within retail K&H's growth rate in new production exceeded the market growth in mortgage loans as well as in cash loans.
- *Deposits from customers* decreased by 1% in the first half of 2019: the outflow from retail savings at K&H (primarily attributable to the implementation of new retail government bond, MÁP+) was quite limited compared to the total market, and the bank's market position is further strengthened in retail savings during the period.
- *Shareholders' equity* increased by 27 bln (+8.9%) compared to 31 Dec 2018 as a result of profit of 1H19 (+22.6 bln), higher cash flow hedge reserves (+3.3 bln) and available for sales reserves (+1.3 bln).

	31 Dec 2018	30 Jun 2019
Guarantee capital (bln HUF)	314	336
Capital adequacy ratio (%)	17.1	17.0

3.2 Profit & loss

HUF Bln	2018 H1	2019 H1
Profit after tax	27.8	22.6

The Bank Group's profit for the first half of 2019 amounted to 22.6 bln lagging behind the reported figures in the corresponding period of 2018 (27.8 bln). On underlying basis (excluding the exceptional gains from property and financial instruments transactions from 2018)[1] net result shows a yoy increase of 9% in 2019.

The evolution of the main P&L items in the first half of 2019:

- *Net interest income* went up by 5.9% (1H18: 36.9 bln, 1H19: 39.1 bln), as the negative impact of lower interest rate environment and decreasing commercial margins were compensated by the increasing customer loan and deposit volumes.
- The 8.0% increase in *net fee and commission income* (1H18: 29.3 bln, 1H19: 31.7 bln) is primarily driven by transactional services.
- *Net gains from financial instruments at fair value through profit or loss* went down (1H18: 13.9 bln, 1H19: 9.8 bln) primarily attributable to lower Treasury related income and exceptional revalution gains on financial instruments in the reference period.
- The *operating expenses* of the Group for the first half of 2019 amounted to 55.2 bln (1H18: 54.3 bln), the increase compared to previous year is primarily driven by higher IT costs (significant digitalization and regulatory investments) and regulatory fees.
- There was a 1.0 bln positive P&L impact from release of *impairment* on financial assets at amortised cost. Portfolio quality remained stable in all segments, NPL rates in retail decreased further (in Corporate segment the otherwise record low ratio slightly increased due to a few problematic files).

[1] Recorded as part of other income and net gains from financial instruments at fair value.

Non-performing loans ratio	31 Dec 2018	30 June 2019
Retail	11.2%	9.1%
Corporate & SME	1.8%	2.3%
Total	**5.8%**	**5.1%**

The financial performance of the Bank Group is illustrated by the following indicators:

	2018 H1	**2019 H1**	**variance**
Cost / income	64.2%	68.0%	+3.8%
Cost / income *	63.4%	61.0%	-2.4%
Non-interest type income/ total income	56.4%	51.9%	-4.5%
Fee and commission income / total income	34.7%	39.0%	+4.3%
Operating income * / average headcount	21.3	23.0	+8.0%
Operating costs * / average headcount	13.5	14.0	+4.0%
Operating profit * / average headcount	7.8	9.0	+15.0%
Credit cost ratio	-0.3%	-0.1%	+0.2%
Non-performing loans	7.1%	5.1%	-2.0%
Loan / deposit ratio	62.7%	65.4%	+2.7%
Capital **/total liabilities	9.5%	10.4%	+0.9%
Capital adequacy ratio (consolidated)	16.6%	17.0%	+0.4%
LCR	162%	154%	-8%
NSFR	144%	154%	+10%
ROE (based on average balance of equity)	21.1%	14.3%	-6.8%
ROE (based on average balance of equity) ***	15.4%	14.3%	-1.1%
ROA (based on average balance sheet total)	1.8%	1.4%	-0.4%
ROA (based on average balance sheet total) ***	1.4%	1.4%	0%

* excluding bank tax and exceptional gains from property and financial instruments transactions
** in addition to equity it also includes subordinated debt capital
*** excluding exceptional gains from property and financial instruments transactions

On comparable basis, the financial performance of the Group shows considerable improvement in 1H19. Next to the profitability and efficiency also in terms of risk, liquidity and capital adequacy ratios K&H Bank (as the 2nd largest bank based on total assets and customer–deposit volumes) is considered as one of the banks with the most favourable financial position in the banking sector.

4. Introduction of the important subsidiaries

Leasing operation

At the end of June 2019 the Leasing operation consisted of two legal entities next to the leasing operations performed by the bank (three entities were merged with K&H Bank Zrt. in previous years).

Name	Main profile
K&H Autópark Kft.	Operative leasing, fleet management
K&H Ingatlanlízing Zrt.	Financial leasing (real-estate)

On 30 June 2019 the **Group's leasing** portfolio stood at 76.8 bln, which represents a 12% increase compared to the end of the previous year. Discontinued retail car financing portfolio ran off by the end of December 2018, while the actively managed portfolio (truck, real estate, machinery & equipment and fleet portfolio altogether) increased by 8.5 bln (by 12%) compared to the end of 2018.

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

K&H Fund Management Plc. is fully owned by K&H Bank. The assets managed in investment funds (excl. double counting) increased from 763 bln in Dec 2018 to 806 bln in June 2019 (meanwhile the total assets managed increased from 846 bln to 891 bln in this period).
Based on market share in total assets managed K&H Fund Management is ranking nr. 3 in the Hungarian Fund Management market.
In the first half of 2019 three derivative closed-end funds were launched.

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

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

The company takes out service level agreements and contracts with individual group members for each individual services.

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

The K&H Factoring Zrt's main activity is factoring (purchase of receivables, financing, discounting). The company's business activities have started in 2010, (factoring) turnover has been increasing since then (2019 1H: 76.8 bln HUF, +5% yoy). The amount of trade receivables towards debtors was 13.7 bln on 30 June 2019.

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

As from April 1st 2017 MNB implemented a new indicator (Mortgage Financing Adequacy Ratio) to constrain the banking sector level systemic risk of maturity transformation related to the long term HUF retail mortgage loan portfolio. According to the current rules, at least 20% of the retail HUF mortgage loan portfolio is to be financed by long-term sources with maturity of at least 2 years (be it mortgage bonds or refinancing loans taken out from mortgage credit institutions). K&H Mortgage Bank was established in 2016.
The core business activity of the Mortgage Bank (refinancing of retail mortgage loan portfolios of K&H Bank Zrt. and mortgage bond issuance) started in Q1 2017.
The current outstanding mortgage bond volume is 101.5 bln, from which 100 bln is publicly issued fixed mortgage bond and 1.5 bln is privately issued floater mortgage bond.

5. Risk Management

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

5.1 Risk management governance model

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

- Overarching company and risk committees are the Board of Directors (BoD), the Risk and Compliance Committee (RCC), the Audit Board (AB), the Supervisory Board (SB), the Executive Committee (ExCo), the Country Team (CT) and the Capital and Risk Oversight Committee (CROC). These committees concentrate on overarching risk management and on monitoring value creation.
- Specialised risk councils (Credit Risk Council (CRC), 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.

5.2 Risk types

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

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

  In the subsequent years, the bank paid special attention to the enhancement of the applied risk management methodology, with special regard to the analyses of the various stress scenarios affecting the credit portfolio (macro-economic indicators, foreign exchange rate changes and the changes in real estate values). An additional instrumental component of the further development of the risk management methodology was the revision of the management reports to better highlight the various quantitative risk indicators in order to allow the continuous monitoring of the credit portfolio. Based on MNB permission, the Bank shifted to IRB Advanced methodology for regulatory capital calculation from 30 September 2015.
  The main conclusions for 2019 are:
  - The Corporate portfolio volume continued to increase in the first half of 2019, while a slight deterioration in portfolio quality could be observed partially due to technical impacts /late review of large clients/ and default of some larger clients. Meanwhile the quality of SME portfolio shows stable risk indicators (both NPL ratio and delinquencies). No further deterioration is expected in the coming quarters.

- The quality of the loan portfolio disbursed in the MNB's funding for growth program is better than the existing portfolio and remains stable.
- Retail portfolio showed significant increase in both mortgage and cash loan book. The overall portfolio continued to improve during the first half of 2019. This was in one part due to the decreasing NPL volume and also the high amount of new disbursements. Quality of New book remains good, with very low entries into default. No further deterioration is expected in the coming quarters.

The economic conditions, especially the evolution of unemployment 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 largest client with large risk is at 35% of the large risk limit, and the total volume of clients with large risk is at 11% 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 June 2019 due to some bigger volume matured in government bonds.
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.

	30 Jun 2018	30 Jun 2019	Regulatory requirement
NSFR (%)	144	154	n.a*
LCR (%)	162	154	100
FFAR (DMM) (%)	100	137	100

* Regulatory limit is expected to be introduced in 2020.

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

6. Operating Conditions of the Bank

Capital investments in the branch network:

- During the first half of 2019 the set-up, full or partial reconstruction of 17 branches was started or completed.
- Premium-banking offices were installed in 11 branches.
- By mid 2019, altogether 468 ATMs (+2 in 1H) were serving our customers (incl. 214 cash-in ATMs).

The number of branches at the end of June 2019 was 206.

The most important IT development projects in 2019 were the followings:

- Several project size developments were initiated or completed to align with legal regulations such as: Personal Data Protection, MIFID2, Domestic HUF Instant Payment, New AML, Regulatory Reporting, PSD2, HitReg.
- Domestic HUF Instant Payment: K&H successfully joined to the first and second phase of the country test.
- Planning and developments started for the paperless and tellerless branch operation.
- Within the Digitalization programme the following developments were delivered in the first half of 2019:
    - Digi – Impresto (online cash loan): further risk assessment engine and credit flow related developments were delivered on the K&H Bank online loan platform
    - Digi – Multibank application: development and integration of connection channels to the API sandboxes recently available on the market was prepared
    - Digi – Cash loan E2E digital application: in July went live regarding automatic pre-approved and non-pre-approved cases of cash loan for eBank and Mobilbank users
    - Digi – Text and video chat: K&H Bank has launched a business pilot of text and video chat service on selected pages of K&H website.

Budapest, 30 August 2019

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer