Kereskedelmi és Hitelbank Zrt.

CONSOLIDATED SEMI-ANNUAL REPORT

30 June 2020

Budapest, 26 August 2020

CONTENT

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 2020 Consolidated Semi-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 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, 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, 26 August 2020

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

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Not audited 30 June 2020	Audited 31 December 2019
	MHUF	MHUF
ASSETS		
Cash and cash balances with central banks	263 789	413 803
Cash	49 528	54 227
Cash balances with central banks	66 830	272 000
Other demand deposit with credit institutions	147 431	87 576
Financial assets	3 455 705	2 984 190
Held for trading	93 995	77 021
Mandatorily fair value through profit or loss	97 540	67 016
At Fair value through other comprehensive income	113 004	92 830
of witch pledged as collateral	22 099	21 599
At amortised cost	3 121 121	2 717 816
of witch pledged as collateral	325 041	276 072
Hedging derivatives	30 045	29 507
Fair value changes of hedged item under portfolio hedge of interest rate risk	26 317	19 042
Tax assets	3 684	2 638
Current tax assets	3 644	2 595
Deferred tax assets	40	43
Investment property	1 647	1 874
Property and equipment	46 863	48 107
Intangible assets	33 051	30 424
Non-current assets held for sale and disposal groups	1 719	1 720
Other assets	25 445	20 356
Total assets	3 858 220	3 522 154
LIABILITIES AND EQUITY		
Financial liabilities	3 431 339	3 105 358
Held for trading	84 137	61 193
Designated at fair value through profit or loss	47 597	52 614
Measured at amortised cost	3 263 168	2 966 530
Hedging derivatives	36 437	25 021
FV changes of hedged item under portfolio hedge of interest rate risk	16 819	15 827
Tax liabilities	776	1 127
Current tax liabilities	164	406
Deferred tax liabilities	612	721
Provisions for risks and charges	2 978	1 843
Other liabilities	43 730	38 212
Total liabilities	3 495 642	3 162 367
Share capital	140 978	140 978
Share premium	48 775	48 775
Accumulated profit	131 982	128 791
Other reserves	40 843	41 243
Total equity	362 578	359 787
Total liabilities and equity	3 858 220	3 522 154

Budapest, 26 August 2020

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	Other Revaluation reserves MHUF	Retained earnings MHUF	Total equity MHUF
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
Balance as at 1 January 2020	140 978	48 775	28 422	6 707	6 048	66	128 791	359 787
Net profit for the year	-	-	-	-	-	-	3 191	3 191
Other comprehensive income for the period	-	-	-	(1 501)	1 102	(1)	-	(400)
Total comprehensive income	-	-	-	(1 501)	1 102	(1)	3 191	2 791
Total change	-	-	-	(1 501)	1 102	(1)	3 191	2 791
Balance as at 30 June 2020	140 978	48 775	28 422	5 206	7 150	65	131 982	362 578
of which								
revaluation reserve for shares	-	-	-	1 661	-	-	-	1 661
revaluation reserve for bonds	-	-	-	3 545	-	-	-	3 545

Budapest, 26 August 2020

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Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED INCOME STATEMENT

	Not audited 1st half of year 2020	Reclassified not audited 1st half of year 2019
	MHUF	MHUF
Interest income	53 891	49 182
Interest Income calculated using the effective interest method	45 637	41 631
Other similar income	8 254	7 551
Interest expense	(11 258)	(9 749)
Net interest income	42 633	39 433
Fee and commission income	43 164	41 791
Fee and commission expense	(10 912)	(10 510)
Net fee and commission income	32 252	31 281
Net gains / (losses) from financial instruments at fair value through profit or loss	(7 321)	5 663
Foreign exchange differences	15 455	4 170
Net realised gains/ (losses) from financial assets at fair value through other comprehensive income	156	0
Dividend income	10	12
Gains on the disposal of assets at amortised cost	1 843	1 094
Other income	1 223	1 020
Other expense	(398)	(390)
Total income	85 853	82 283
Operating expenses	(55 456)	(55 182)
Staff expenses	(15 497)	(16 662)
General administrative expenses	(28 154)	(27 546)
Depreciation and amortisation of tangible and intangible assets	(6 168)	(5 352)
Bank tax	(5 637)	(5 622)
Impairment on assets	(20 985)	(73)
At amortised cost	(20 434)	(63)
At fair value through other comprehensive income	(12)	26
Other	(539)	(36)
Modification result on financial assets at amortized cost	(3 600)	0
Profit before tax	5 812	27 028
Income tax expense	(2 621)	(4 431)
Profit after tax	3 191	22 597

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Not audited 1st half of year 2020 MHUF	Not audited 1st half of year 2019 MHUF
Profit after tax	3 191	22 597
Other comprehensive income		
Items that may be reclassified to the profit or loss		
Revaluation reserve of debt instruments		
Net gain / (loss) from fair value changes	(1 813)	886
Deferred tax impact on fair value changes	196	(96)
Transfer from available for sale reserve to net profit:		
(Losses)/gains on impairment	12	(26)
(Losses)/ gains on disposal	(156)	1
Deferred income tax	16	3
Cash flow hedge		
Net gain / (loss) from fair value changes	1 407	3 783
Deferred tax impact on fair value changes	(127)	(340)
Transfer from cash flow hedge reserve to net profit:		
Ineffective part	63	82
Gross amount	(259)	(269)
Deferred income tax	18	17
Items that will not be reclassified to the profit or loss		
Revaluation reserve of equity instruments		
Net gain / (loss) from fair value changes	274	552
Deferred tax impact on fair value changes	(30)	(60)
Own credit risk adjustments	-	1
Deferred income tax	-	-
Actuarial result on defined benefit plans	(1)	(6)
Deferred income tax	-	1
Total other comprehensive income	(400)	4 529
Total comprehensive income	2 791	27 126

Budapest, 26 August 2020

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Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CASH FLOWS

	Not audited 1st half of year 2020 MHUF	Reclassified Not audited 1st half of year 2019 MHUF
OPERATING ACTIVITIES		
Profit before tax	5 811	27 028
Adjustments for:		
Interest and similar income	(53 891)	(49 182)
Interest and similar expense	11 258	9 749
Net transfer from revaluation reserve of securities	144	26
Net transfer from cash flow hedge reserve	196	(187)
Depreciation and impairment of property, plant and equipment, intangible assets, financial assets at fair value through other comprehensive income and other assets	6 726	5 184
(Profit)/Loss on the disposal of property and equipment	(1)	(95)
(Profit)/Loss on the disposal of investment property	(220)	(210)
Change of modification result on financial assets at amortized cost	3 600	0
Change in impairment on assets valued at amortised cost*	20 434	(1 217)
Change in other provisions	(1)	(49)
Unrealised valuation differences	(74 238)	(2 889)
Cash flows from operating profit before tax and before changes in operating assets and liabilities	(80 182)	(11 842)
Changes in financial assets held for trading	7 811	(17 595)
Changes in financial assets mandatorily valued at fair value through profit or loss	(20 789)	2 061
Changes in financial assets at fair value through other comprehensive income	(20 164)	9 191
Changes in financial assets at amortised cost	55 659	(123 789)
Changes in other assets	(4 685)	(14 378)
Changes in operating assets	17 832	(144 510)
Changes in financial liabilities held for trading	(5 349)	7 872
Changes in financial liabilities designated at fair value through profit or loss	5 284	(11 000)
Changes in financial liabilities measured at amortised cost	249 373	(13 648)
Changes in other liabilities	5 607	(15 970)
Changes in operating liabilities	254 915	(32 746)
Income taxes paid	(2 653)	(4 393)
Interest received	40 125	44 151
Interest paid	(1 751)	(8 844)
Net cash from/(used in) operating activities	228 286	(158 184)

* Including also provisions on loan commitments.

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2020 MHUF	Reclassified Not audited 1st half of year 2019 MHUF
INVESTING ACTIVITIES		
Purchase of securities at amortised cost	(142 585)	(110 647)
Proceeds from the repayment of securities at amortised cost at maturity	-	68 337
Proceeds from the sale of securities at amortised cost	9 010	441
Dividends received from associated companies	10	12
Purchase of intangible fixed assets	(5 833)	(3 438)
Purchase of property, plant and equipment	(2 337)	(1 601)
Proceeds from the sale of property, plant and equipment	68	14
Proceeds from the sale of non-current assets held for sale and disposal groups	-	-
Purchase of investment property	(144)	(524)
Proceeds from the sale of investment property	606	-
Net cash from/(used in) investing activities	(141 205)	(47 406)
FINANCING ACTIVITIES		
Repayment of principal of lease liabilities	(1 379)	(1 247)
Dividend paid	-	-
Net cash from/(used in) financing activities	(1 379)	(1 247)
CHANGE IN CASH AND CASH EQUIVALENTS		
Net increase/(decrease) in cash and cash equivalents	85 702	(206 837)
Net foreign exchange difference	69 238	498
Cash and cash equivalents at beginning of the period	295 735	419 395
Cash and cash equivalents at end of the period	450 675	213 056

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2020 MHUF	Reclassified Not audited 1st half of year 2019 MHUF
OPERATING CASH FLOWS FROM DIVIDENDS		
Dividends received	10	12
COMPONENTS OF CASH AND CASH EQUIVALENTS		
Cash and cash balances with central banks and other demand deposits with credit institutions	263 789	89 938
Loans and advances to banks repayable on demand and term loans to banks < 3 months	347 218	242 965
Deposits from banks repayable on demand and redeemable at notice	(160 332)	(119 847)
Total cash and cash equivalents	450 675	213 056

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

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

Budapest, 26 August 2020

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

Consolidated Management Report

On 30 June 2020, the consolidated total assets of K&H Bank Group (hereunder “the Group”) stood at 3,858 billion. As a financial institution which offers banking and insurance products alike and has a nation-wide branch network of 208 branches, the Group offers the full range of financial services to its clients.

1. Economic environment

The spread of coronavirus resulted in an unprecedented economic shock worldwide and drastically reshaped the performance of the real economy also in Hungary: although the economy started the year with a dynamic expansion, the virus and the related containment measures caused a substantial economic shock impacting negatively both the supply and demand sides of the Hungarian economy. The contraction of the economy is expected to bottom out in the second quarter (with 13.5% yoy decrease in Q2) but the recession looks to be unavoidable for this year – the only questions are the deepness of the recession and the pace (or shape) of the recovery.
There was a steep increase in the state budget deficit in the first six months of the year due to the spending of defense against the pandemic, including fiscal programs and missing tax revenues – as a result the deficit of the state budget is expected to reach 7-9 percent of GDP in 2020. Also the decreasing trend of the public debt may stop this year, and according to the forecasts it will increase back above 70 percent of the GDP at the end of the year. The falling external demand may deteriorate the trade balance and the current account deficit is expected to widen further.

	2019 actual	2020 forecast*
GDP growth	+4.9%	-6.2%
CPI (average)	+3.4%	+3.5%
Investments	+13.9%	-12.0%
Unemployment rate	3.3%	6.1%
Balance of state budget (in % of GDP)	-2.0%	-8.0%
Balance of payments (in % of GDP)	-0.8%	-1.9%

**source: K&H Bank Zrt*

Similarly to the major central banks, also the Hungarian National Bank (MNB) has implemented several conventional and unconventional measures to preserve the stability of the banking system and support the economic recovery in the first half of 2020. Regarding financial stability, next to the financial moratorium for debt repayment (see more details and its expected impact on K&H Bank on page 13) more flexible forebearance and NPL rules were announced, while the capital buffer requirements were also eased for the banks. A new monetary policy tool was launched (1 week deposit) with the aim of supporting the short-end of the yield curve (and as a consequence the forint exchange rate), and several new tools (for instance more accommodative repo collateral rules) were introduced to boost the banking sector’s liquidity position. Also a new Funding for Growth program was announced (NHP Hajrá) and the conditions of the existing Bond Funding for Growth Scheme were adjusted. With two consecutive cuts of 15-15 bps in June and July the base rate was reduced to 0.60% by the end of July (before that the base rate stood unchanged at 0.90% since May 2016).

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 with a strong emphasis on introducing innovative solutions.

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:

Omni-channel distribution approach – best fit combination of:

- e-bank, mobile bank
- extensive branch network with high level of cash automation and focus on advisory
- TeleCenter, remote advisory
- 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
- innovation: we continuously adopt to the changes in client behaviour and in the environment, aiming at being the best innovator in the market.

During 2019, the Bank reviewed its strategy and decided that we continue to pursue our strategic aims while also speed up digitalisation transformation in each business line. Therefore, we speed up activities aiming at developing our mobile banking app so that it will be capable not just to manage accounts and bankcards, but also to fulfil sales functions. As a first sign of that, and also as a sign of our continuous and close cooperation with K&H Insurance, we are the first and only bank in the Hungarian market to introduce the sale of certain insurance products in the mobile banking application. Furthermore, we take steps in order to serve our clients beyond banking via their mobile phones.

3. The Group's consolidated activities

3.1 Balance sheet

The Group's total assets amounted to 3,858 bln at 30 June 2020.

HUF Bln	31 Dec 2019	30 Jun 2020	Variance
Total assets	3,522	3,858	+9.5%
Loans and advances to customers	1,534	1,665	+8.5%
Deposits from customers	2,608	2,859	+9.6%
Equity	360	363	+0.8%

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

- *Loans and advances to customers* increased by 8.5% in H1 2020: the growth rate of loan portfolio exceeded the growth rate of the banking sector both in retail and in corporate segments and as a result K&H has strengthened its market share in lending in both segments. Under these special circumstances digital solutions gaining more and more attention in retail lending: the share of E2E cash loan service in mobile bank & e-bank continuously increased in K&H Bank (from 39% in 2019, to 56% of the new production in H1 2020) and contributed to the market share improvement in cash loans new production (10.4% in H1 vs 8.0% in FY 2019). K&H participates in the newly introduced MNB subsidized loan program (NHP Hajrá) and its share in the contracted volumes exceeded 20% in the period until June.
- *Deposits from customers* increased by 9.6% in the first half of 2020: the Bank's market share improved further in corporate deposits and in retail savings (deposits + funds) as well during this period.
- *Shareholders' equity* increased by 2.8 bln (+0.8%) compared to 31 Dec 2019, main components: profit of 1H20 (+3.2 bln), higher cash flow hedge reserves (+1.1 bln) and revaluation reserve of securities (-1.5 bln).

	31 Dec 2019	30 Jun 2020
Guarantee capital (bln HUF)	357	374
Capital adequacy ratio (%)	18.7	17.6

3.2 Profit & loss

HUF Bln	2019 H1	2020 H1
Profit after tax	22.6	3.2

The Bank Group's profit for the first half of 2020 was negatively impacted by the one-off impacts of Covid19 pandemic:

- Modification loss from the moratorium: -3.6 bln (under a separate heading) [1]
- 19.0 bln Covid-19 related IFRS9 based collective impairments, consisting of two components:
    - 4.6 bln impact was calculated by the ECL models through the updated macroeconomic variables
    - 14.4 bln management overlay (calculated from an expert-based stress migration matrix).

[1] With the aim of mitigating the economic impact of the coronavirus, on 18 March 2020 a financial moratorium was announced for the retail and corporate debtors for principal, interest and fee payments which would become due until 31 December 2020 (Government decree of 47/2020 and 62/2020). The moratorium does not result in debt forgiveness: the unpaid interest and fee accumulated during the moratorium shall be redeemed after the moratorium in equal annual parts during the remaining tenor of the loan together with the due principal instalments. The tenor of the loan will be prolonged in a way that the debtor's new instalment covering the unpaid interest and fee as well next to the due capital shall not exceed the instalment determined in the original payment schedule. The payment moratorium is automatic for all eligible debtors and loans (but the debtor has the right to opt-out from the payment moratorium).
Although the debtors shall redeem all deferred payment obligations accumulated during the moratorium, as no interest can be charged on the unpaid interest the Group shall recognize a negative P&L impact arising from the time value of the payment deferral. According to actual estimations, the loss will amount to approximately HUF 3 600 million. The estimated negative impact is recognized as a modification to the gross carrying amount of the related loans in the Group's consolidated statement of financial position.

Disregarding the above items, the underlying financial performance of the Group would show further improvement compared to the reference period:

- *Net interest income* went up by 8.1% (1H19: 39.4 bln, 1H20: 42.6 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 moderate 3.1% growth in *net fee and commission income* (1H19: 31.3 bln, 1H20: 32.3 bln) was negatively impacted by a perceptible decrease in transactional income from March as a result of Covid-19.
- *Net gains from financial instruments at fair value & foreign exchange differences* went down (1H19: 9.8 bln, 1H20: 8.1 bln) primarily due to the technical loss in the credit, market and funding value adjustments related to the derivatives.
- The *operating expenses* of the Group for the first half of 2020 amounted to 55.5 bln (1H19: 55.2 bln) as the higher IT costs (significant digitalization and regulatory investments) were almost entirely compensated by savings in all other cost types.
- There was a 20.4 bln negative P&L impact of *impairment* on financial assets at amortised cost of which 19.0 bln was connected to the estimated Covid-19 impact (see above). Otherwise portfolio quality remained stable in all segments.

Non-performing loans ratio	31 Dec 2019	30 June 2020
Retail	6.8%	5.6%
Corporate & SME	2.0%	1.2%
Total	**4.1%**	**3.0%**

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

	2019 H1	**2020 H1**	**variance**
Cost / income	67.1%	64.6%	-2.5%
Cost / income *	52.9%	50.8%	-2.1%
Non-interest type income/ total income	52.1%	50.3%	-1.7%
Fee and commission income / total income	38.0%	37.6%	-0.4%
Operating income / average headcount	23.3	25.0	+7.1%
Operating costs ** / average headcount	14.0	14.5	+3.2%
Operating profit ** / average headcount	9.3	10.5	+13.0%
Credit cost ratio	-0.1%	1.0%	+1.1%
Non-performing loans	5.1%	3.0%	-2.1%
Loan / deposit ratio	65.4%	61.9%	-3.5%
Capital ***/total liabilities	10.4%	9.4%	-1.0%
Capital adequacy ratio (consolidated)	17.0%	17.6%	+0.6%
LCR	154%	250%	+96%
NSFR	154%	174%	+20%
ROE (based on average balance of equity)	14.3%	1.8%	-12.5%
ROE (based on average balance of equity) ****	14.2%	14.0%	-0.2%
ROA (based on average balance sheet total)	1.4%	0.2%	-1.2%
ROA (based on average balance sheet total) ****	1.4%	1.4%	0%

* excluding bank tax, net of FTL
** excluding bank tax
*** in addition to equity it also includes subordinated debt capital
**** excluding modification result on financial assets at amortized cost and Covid-19 related IFRS9 based collective impairments

On comparable basis, the financial performance of the Group shows considerable improvement in 1H20. 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 2020, 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 2020 the **Group's leasing** portfolio stood at 81.9 bln, which represents a 3% increase compared to the end of the previous year: this increase is entirely due to the actively managed portfolio (truck, real estate, machinery & equipment and fleet portfolio) as the discontinued retail car financing portfolio ran off by the end of December 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 decreased from 757 bln in December 2019 to 744 bln in June 2020 (meanwhile the total assets managed decreased from 844 bln to 837 bln in this period). The reduction of portfolio was primarily attributable to the deterioration of markets due to the pandemic situation.
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 2020, two derivative closed-end funds and one open-end-funds were launched; three derivative closed end funds had maturity, one institutional portfolio was terminated.
Based on a business transfer agreement, the actively managed portfolio was sold to the Hungarian branch of KBC Asset Management NV. on 1 July 2020.

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 continuously increasing since then (2020 1H: 81.6 bln HUF, +6.2% yoy). The amount of trade receivables towards debtors was 13.6 bln on 30 June 2020.

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 25% of the retail HUF mortgage loan portfolio is to be financed by long-term sources with maturity of at least 3 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 is 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 on 30 June 2020 is 141.5 bln, from which 100 bln fix bond issued at the stock exchange platform, 40 bln floater publicly issued mortgage bonds and 1.5 bln privately issued floater mortgage bonds.

The Mortgage Bank has joined the Mortgage bond purchase program published by MNB on 14 May 2020 with new bond issuances in July.

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). Based on MNB permission, the Bank shifted to IRB Advanced methodology for regulatory capital calculation from 30 September 2015.

As a response to the evolving crisis situation, management reports were focusing on the impact analysis, identification and monitoring of the vulnerable portfolios. At the end of Q2 2020 no perceptible evolution in the portfolio quality (such as PD migrations or other risk metrics) was observed that can be linked to the crisis. The effects of the crisis will most likely be shifted to a later period partially due to the moratorium and also because some time needs to pass before any changes in the portfolio can be observed.
The Bank instated some tightening of its underwriting process in order to account for the Covid pandemic. These measures are being reviewed regularly as portfolio evolutions and market/economic circumstances require it. The Bank prepared simulations and stress tests in order to quantify the possible effects of the crisis on ECL and capital. The results of these estimations are reflected in the figures of Q2 2020 and these estimations will be updated on a quarterly basis based on the updated macroeconomic forecasts.

The main conclusions for the first half of 2020 are:

- the performance of the corporate portfolio remained stable in 2020, increase of volume slowed down in the second quarter. Although some deterioration can be observed in some more vulnerable sectors, no trendlike worsening can be seen yet. Quality of the SME portfolio shows stable risk indicators, both NPL ratio and delinquencies.
- also retail portfolio remained stable. NPL volume continues to decrease mainly due to debt sale activity. Quality of new production remains good.

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 44.5% of the large risk limit, and the total volume of clients with large risk is at 9.7% of the total legal lending limit.

- **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 is also sovereign exposure monitoring in place.

  The banking book is characterized by stable interest rate risk taking, at full sovereign limit utilization. KBC group level Internal Capital Calculation Method was underpinned by the regulatory 200bp stress test result throughout the year to prove its conservative stance.

  Trading risk taking was stable at around 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), in the future FX positions will be migrated also (phase 2).
  From 2020 Q2, K&H Bank reports its trading risk capital requirement applying CRR. Art.94 – Derogation of Small Trading Book (STB), as a result of compliance with regulatory requirements. National Bank of Hungary (MNB) accepted that K&H Bank was going to use STB. Position risk' capital requirement is henceforth calculated under the credit risk framework, thus the trading risk capital requirement decreased significantly. There is continues daily monitoring and strong control environment in place which was accepted by MNB to provide STB compliance and regulatory requirements.

- **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 2019	30 Jun 2020	Regulatory requirement
NSFR (%)	154	174	n.a*
LCR (%)	154	250	100
FFAR** (DMM) (%)	137	156	100

* Regulatory limit is expected to be introduced in 2021.
** Foreign exchange funding adequacy ratio

- 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.

6. Operating Conditions of the Bank

Capital investments in the branch network:

- During the first half of 2020 the set-up, full or partial reconstruction of 17 branches was started or completed
- Premium-banking office was installed in 1 branch
- By mid 2020, altogether 483 ATMs were serving our customers (incl. 218 cash-in ATMs).

The number of branches at the end of June 2020 was 208.

The most important IT development projects in first half of 2020 were the followings:

- Several project size developments were initiated or completed to align with legal regulations such as: Domestic HUF Instant Payment, New AML, Regulatory Reporting, PSD2, HitReg, online/real time transaction Fraud management, Pandemic loan moratorium and bankcard management modification, management of Financial Data provision, NAV online data provision.
- Planning and further developments for the paperless and tellerless branch operations.
- Within the Digitalization programme the following major developments were in progress or delivered:
  - Multibank application: we moved on with the preparation of further API connection regarding account information and payment initiation service provision.
  - Apple pay – VISA an InApp related certification process was finished and the solution went live.
  - For the corporate clients the function of “Show Blocked Amount” via digital channels went live.
  - Travel and home insurance products are now available in e-Bank and MobileBank applications.
  - We made Third party vehicle/motor insurance contracting available in our K&H MobileBank application.
  - We made loan and investment data available in our mobile application.

Budapest, 26 August 2020

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer