Kereskedelmi és Hitelbank Zrt.

CONSOLIDATED SEMI-ANNUAL REPORT

30 June 2014

Budapest, 28 August 2014

CONTENT

Statement of the Issuer

K&H Bank Zrt., as the Issuer (represented by Hendrik Scheerlinck, CEO and Attila Gombás, CFO) hereby declare that K&H Bank Zrt.'s consolidated 2014 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, 28 August 2014

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

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Not audited 30 June 2014 MHUF	Audited 31 December 2013 MHUF
ASSETS		
Cash and cash balances with central banks	61 345	153 104
Financial assets	2 203 021	2 314 700
Held for trading	111 713	125 411
Designated at fair value through profit or loss	2 724	2 505
Available for sale	369 005	462 426
Loans and receivables	1 260 478	1 251 974
Held to maturity	451 867	468 976
Hedging derivatives	7 234	3 408
Tax assets	17 379	2 604
Current tax assets	118	685
Deferred tax assets	17 261	1 919
Investments in associated companies	559	2 142
Investment property	597	593
Property and equipment	40 402	41 981
Intangible assets	12 460	13 066
Other assets	34 092	34 081
Total assets	2 369 855	2 562 271
LIABILITIES AND EQUITY		
Financial liabilities	2 041 472	2 283 047
Held for trading	28 540	30 902
Designated at fair value through profit or loss	196 644	217 763
Measured at amortised cost	1 768 866	1 985 683
Hedging derivatives	47 422	48 699
Tax liabilities	3 992	602
Current tax liabilities	3 977	602
Deferred tax liabilities	15	-
Provisions for risks and charges	108 060	36 816
Other liabilities	39 531	29 316
Total liabilities	2 193 055	2 349 781
Share capital	140 978	140 978
Share premium	48 775	48 775
Statutory risk reserve	20 422	20 422
Available for sale reserve	6 763	(983)
Cash flow hedge reserve	1 381	(2 051)
Retained earnings	(41 519)	5 349
Total equity	176 800	212 490
Total liabilities and equity	2 369 855	2 562 271

Budapest, 28 August 2014

Hendrik Scheerlinck
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Share capital MHUF	Share premium MHUF	Statutory risk reserve MHUF	Available for sale reserve MHUF	Cash flow hedge reserve MHUF	Retained earnings MHUF	Total equity MHUF
Balance as at 1 January 2013	140 978	48 775	18 517	(2 519)	(3 444)	13 563	215 870
Net profit for the year	-	-	-	-	-	17 488	17 488
Other comprehensive income for the period	-	-	-	1 536	1 393	-	2 929
Total comprehensive income	-	-	-	1 536	1 393	17 488	20 417
Dividend	-	-	-	-	-	(23 797)	(23 797)
Transfer from retained earnings to statutory risk reserve	-	-	1 905	-	-	(1 905)	-
Total change	-	-	1 905	1 536	1 393	(8 214)	(3 380)
Balance as at 31 December 2013	140 978	48 775	20 422	(983)	(2 051)	5 349	212 490
of which revaluation reserve for bonds	-	-	-	(983)	-	-	(983)
Balance as at 1 January 2014	140 978	48 775	20 422	(983)	(2 051)	5 349	212 490
Net profit for the year	-	-	-	-	-	(46 868)	(46 868)
Other comprehensive income for the period	-	-	-	7 746	3 432	-	11 178
Total comprehensive income	-	-	-	7 746	3 432	(46 868)	(35 690)
Total change	-	-	-	7 746	3 432	(46 868)	(35 690)
Balance as at 30 June 2014	140 978	48 775	20 422	6 763	1 381	(41 519)	176 800
of which revaluation reserve for bonds	-	-	-	6 763	-	-	6 763

The dividend paid on ordinary shares was HUF 23 797 million – 0.168799 HUF/share in 2013.

Budapest, 28 August 2014

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Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED INCOME STATEMENT

	Not audited 1st half of year 2014 MHUF	Not audited 1st half of year 2013 MHUF
Interest income	61 525	73 464
Interest expense	(20 032)	(35 692)
Net interest income	41 493	37 772
Fee and commission income	32 679	27 288
Fee and commission expense	(7 870)	(7 620)
Net fee and commission income	24 809	19 668
Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange	11 077	8 848
Net realised gains / (losses) from available-for-sale assets	2 224	1 689
Dividend income	0	3
Other net income	(69 871)	4 246
Total income	9 732	72 226
Operating expenses	(58 908)	(63 996)
Staff expenses	(14 711)	(14 922)
General administrative expenses	(24 446)	(29 482)
Depreciation and amortisation of tangible and intangible assets	(3 910)	(3 751)
Bank tax	(15 841)	(15 841)
Impairment:	(7 621)	(6 264)
Loans and receivables	(7 344)	(5 993)
Other	(277)	(271)
Share in results of associated companies	42	137
Profit before tax	(56 755)	2 103
Income tax expense	9 887	(1 419)
Profit after tax	(46 868)	684

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Not audited 1st half of year 2014 MHUF	Not audited 1st half of year 2013 MHUF
Profit after tax	(46 868)	684
Other comprehensive income		
Available-for-sale equity instruments		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	-	209
Deferred tax impact on fair value changes	-	(44)
Transfer from available for sale reserve to net profit		
(Losses)/ gains on disposal	-	(1 153)
Deferred income tax	-	237
Available for sale debt instruments		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	9 626	(175)
Deferred tax impact on fair value changes	(1 986)	37
Transfer from available for sale reserve to net profit		
(Losses)/ gains on disposal	(2 224)	(537)
Amortisation of reclassified assets	2 357	3 161
Deferred income tax	(27)	(541)
Cash flow hedge		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	5 556	5 079
Deferred tax impact on fair value changes	(1 146)	(1 047)
Transfer from cash flow hedge reserve to net profit		
Gross amount	(1 232)	(4 667)
Deferred income tax	254	962
Total other comprehensive income	11 178	1 521
Total comprehensive income	(35 690)	2 205

Budapest, 28 August 2014

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Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CASH FLOWS

	Not audited 1st half of year 2014 MHUF	Not audited 1st half of year 2013 MHUF
OPERATING ACTIVITIES		
Profit before tax	(56 755)	2 103
Adjustments for:		
Net transfer from available for sale reserve	133	1 471
Net transfer from cash flow hedge reserve	(1 232)	(4 667)
Depreciation and impairment of property, plant and equipment, intangible assets, available-for-sale financial assets and other assets	4 188	4 029
(Profit)/Loss on the disposal of property and equipment	25	19
(Profit)/Loss on the disposal of investment property	2	4
(Profit)/Loss on disposal of investment	(644)	-
Change in impairment on loans and advances*	7 344	5 993
Change in other provisions	70 784	(545)
Unrealised valuation differences	4 507	(24 045)
Income from associated companies	(42)	(137)
Cash flows from operating profit before tax and before changes in operating assets and liabilities	28 309	(15 774)
Changes in financial assets held for trading	9 007	16 781
Changes in financial assets designated at fair value through profit or loss	(341)	366
Changes in financial assets available for sale	103 048	(127 613)
Changes in loans and receivables	(44 890)	19 864
Changes in financial assets held to maturity	2 974	5 257
Changes in other assets	1 020	3 918
Changes in operating assets	70 817	(81 427)
Changes in financial liabilities held for trading	517	(3 271)
Changes in financial liabilities designated at fair value through profit or loss	(22 212)	2 392
Changes in financial liabilities measured at amortised cost	(121 580)	52 712
Changes in other liabilities	17 011	4 599
Changes in operating liabilities	(126 264)	56 431
Income taxes paid	(12 078)	(2 170)
Net cash from/(used in) operating activities	(39 216)	(42 940)

* Including impairments on loans and receivables and loan commitments.

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2014 MHUF	Not audited 1st half of year 2013 MHUF
INVESTING ACTIVITIES		
Purchase of held-to-maturity securities	(25 672)	(78 448)
Proceeds from the repayment of held-to-maturity securities at maturity	39 807	40 638
Proceeds from the disposal of associated companies	2 173	-
Dividends received from associated companies	-	353
Purchase of intangible fixed assets	(1 145)	(1 405)
Purchase of property, plant and equipment	(936)	(1 076)
Proceeds from the sale of property, plant and equipment	247	442
Net cash from/(used in) investing activities	14 473	(39 496)
FINANCING ACTIVITIES		
Net cash from/(used in) financing activities	-	-
CHANGE IN CASH AND CASH EQUIVALENTS		
Net increase/(decrease) in cash and cash equivalents	(24 743)	(82 436)
Net foreign exchange difference	(1 027)	(1 433)
Cash and cash equivalents at beginning of the period	29 510	(13 388)
Cash and cash equivalents at end of the period	3 740	(97 257)

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2014 MHUF	Not audited 1st half of year 2013 MHUF
OPERATING CASH FLOWS FROM INTEREST AND DIVIDENDS		
Interest received	65 852	82 069
Interest paid	(27 284)	(38 305)
Dividend received*	-	356
COMPONENTS OF CASH AND CASH EQUIVALENTS		
Cash and cash balances with central banks	61 345	47 194
Loans and advances to banks repayable on demand and term loans to banks < 3 months	29 031	51 538
Deposits from banks repayable on demand and redeemable at notice	(86 636)	(195 989)
Total cash and cash equivalents	3 740	(97 257)

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

*Dividends received also includes dividends received from associated companies.

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

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

Budapest, 28 August 2014

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Chief Executive Officer

Attila Gombás
Chief Financial Officer

Consolidated Management Report

On 30 June 2014, the consolidated total assets of K&H Bank Group (hereunder "the Group") stood at HUF 2 370 billion. As a financial institution which offers banking and insurance products alike and has a nation-wide branch network of 210 branches, the Group offers the full range of financial services to its clients.

1. Economic environment

The market environment was favourable for Hungary's main trading partners. So export continued to be the major driver of the economic growth in Hungary, however the domestic sources (especially the state expenditures and investments) played more and more important role in the growth.

	2013 actual	2014 forecast
GDP growth	+1.1%	+3.3%
CPI (average)	+1.7%	+0.2%
Investments	+7.2%	+9.0%
Unemployment rate	+9.1%	+8.5%
Budget deficit (ESA) (in % of GDP)	-2.2%	-2.7%
Balance of payments (in % of GDP)	+3.0%	+2.9%

Source: MNB (National Bank of Hungary), KSH, K&H

In 1H14 European Central Bank announced more dovish monetary policy. FED continued its tapering program. National Bank of Hungary has continued the rate cut cycle, but the speed of it was slowed down. The reference rate was lowered from 3.0% at the beginning of the year to 2.3% in June. It was emphasized by MNB that the rate is very close to the level to achieve its targets.

2. The Strategic Objectives of the Group

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

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

Customer strategy:
Retail: customers are served based on the different segments' special needs.
Corporate clients: focus on cross-sales, intensify new client acquisition in selected areas.

Product strategy:
Retail:

- Innovative saving products and add-on services to keep up our market leader status.
- Growth in lending, based on a good understanding of credit risk.
- Strong focus on transactional banking.
- Fast and simple credit process.

SME:

- Reliable transactional banking services.
- More standard products fitting client needs with easy and quicker processes.
- Fast and simple credit process.

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

Strategy on distribution channels:
Branch-centric multi-channel distribution approach: although the diversity of channels and the role of tied agent, 3rd party and remote channels are significant, the most important channel will remain our extensive branch network.
Key differentiators of the Group:
- Being close to our clients: easy access both physically (see our large branch network) and virtually (see remote channels).
- Speaking our clients' language (investment to 'client-conform' communication).
- Clients' individual needs and profiles are permanently in focus (offered services always fit their real needs).
- The Group acts as 'one-stop-shop' for our clients (universal financial institution).

3. The Group's consolidated activities

3.1 Balance sheet

The Group's balance sheet total decreased by 7.5% compared to 31 December 2013:

Billion HUF	31 Dec 2013	30 Jun 2014	variance
Balance sheet total	2,562	2,370	-7.5%
Loans and receivables	1,252	1,260	+0.7%
Deposits from customers	1,881	1,712	-9.0%
Equity	212	177	-16.8%

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

- In the course of the period the amount of *loans and receivables* increased by 0.7%. Retail loans grew approximately by 3%, mainly due to the foreign exchange effect of the Forint depreciating against the Swiss Franc. The growth compared to previous periods was also supported by a slightly increasing loan demand on the market (and also by the growing market share of K&H Bank in new production). The driver in the SME and corporate segments was primarily the "Funding for Growth" scheme of the National Bank.

- *Deposits from customers* decreased by 9% during the year related to the change of the investment policy of funds managed by K&H Fund Management (funds place higher proportion of their Assets under Management in other financial investments, especially government papers vs. deposits placed with K&H Bank). The Group managed to further improve its market position in both retail and corporate loans and savings in the first half of the year.

Market share	30 June 2013	31 Dec 2013	30 June 2014*
Total assets	8.7%	8.7%	8.2%
Corporate loans	8.1%	8.3%	8.9%
Retail loans	8.5%	8.7%	8.9%
Corporate deposits	12.0%	11.7%	12.1%
Retail deposits+mutual funds	10.4%	10.7%	10.9%

** preliminary data*

- Shareholders’ equity decreased by 35.7 bln HUF in the first half of the year as a net balance of the following factors: profit of year 2014 (-46.9 bln HUF); cash flow hedge reserves (+3.4 bln HUF) and AFS revaluation reserves (+7.7 bln HUF).

Bank standalone	30 June 2013	31 Dec 2013	30 June 2014
Guarantee capital (bln HUF)	187.4	186.4	164.5
Capital adequacy ratio (%)	13.5	14.2	12.2

3.2 Profit & loss

billion HUF	30 June 2013	31 Dec 2013	30 June 2014	**Change**
Profit after tax	0.7	17.5	-46.9	-268%

The Bank Group’s profit for 1H14 includes HUF 70.9 billion (pre-tax) provision for the expected impact of the new law on consumer loan agreements related to foreign exchange margins and unilateral contract modifications (see its details under "other net income").

The evolution of the main P&L items in the first half of 2014:

- The *net interest and interest-type income* increased by 10% (1H14: HUF 41.5 bln, 1H13: HUF 37.8 bln). If we take into account the interest type result of FX swaps (reported under the heading of “net gains from financial instruments at fair value”), net interest income would remain at the level of previous year.

- The increase of *net fee and commission income* (1H14: HUF 24.8 bln, 1H13: HUF 19.7 bln) is not reflecting the real business performance, since the regular and one-off Financial Transactional Levy paid by the Bank is accounted for among operating expenses. Taking into consideration these items, commission income increased by 5% vs. the previous year on a comparable basis (mainly related to investment services).

- Within the *net gains from financial instruments at fair value* (1H14: HUF 11.1 bln, 1H13: HUF 8.8 bln) both the Treasury trading and sales income and the mark-to-market valuation result of ALM hedging derivatives increased compared to the previous year (off-setting the decrease of the interest type result of FX swaps).

- *Other net income*: K&H set aside one-off net provisions of 70.9 bln (pre-tax) in 2Q14 for both the correction to the bid-offer spreads and the unilateral changes to interest rates, using the methodology guideline issued by the Hungarian National Bank. On 29 July, the supervisory authority, the Hungarian National Bank, has issued a methodology guideline for the recalculation necessitated by the annulment of the bid-offer spread. Compliance with such methodology guideline is not a legal obligation, but merely a guideline that will serve as the basis for verification of the methodology by the Hungarian National Bank. Applying the Hungarian National Bank methodology guideline to the bid-offer spread and also to the unilateral changes to interest rates, leads to a provision which is 21.5 bln higher than the calculation method proposed by the Hungarian Banking Association, and followed by K&H Bank. Applying this last method, the provision would amount to 49.4 bln. K&H Bank is convinced that the calculation method proposed by the Hungarian Banking Association is fully in line with the Hungarian civil code and will therefore defend its position in the courts.

- The operating expenses of the Bank Group for the first half of 2014 was HUF 58.9 billion (1H13: HUF 64.0 billion)
    - on a comparable basis (filtering from both periods the regular Financial Transactional Levy /9.4 in 1H 2014 and 5.9 bln in 1H 2013/ and the one-off Financial Transactional Levy paid by the Bank in 1H13 /7.9 bln/) the operating expenses remained at the same level as the previous year (1% decrease compared to 2013)
    - the bank tax for the whole year (accounted for in 1H) is HUF 15.8 billion.

Impairments amounted to HUF 7.6 bln in H1 2014 (H1 2013: HUF 6.3 bln). In Retail business the bank's own and the government's payment easement programs had positive impact on portfolio quality and the related credit cost ratio. The portfolio quality in corporate and SME segments was stable, the credit impairment was also favourable in the period.

Non-performing loans	30 June 2013	31 Dec 2013	30 June 2014
Retail	18.6%	20.6%	20.6%
Corporate & SME	6.7%	7.0%	5.5%
Retail Car Leasing	24.2%	28.9%	33.6%
Total	**11.9%**	**12.9%**	**12.2%**

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

	2013 H1	**2014 H1**	**variance**
Cost / income	88.6%	605.3%	+516.7%
Cost / income*	66.7%	53.4%	-13.3%
Non-interest type income/ total income*	47.7%	48.5%	+0.8%
Commission income / total income*	27.2%	30.8%	+3.6%
Operating income */ average headcount(million HUF)	42.2	47.4	+12.2%
Operating expenses* / average headcount (million HUF)	28.2	25.3	-10.1%
Operating profit* / average headcount (million HUF)	14.1	22.1	+56.8%
Credit cost ratio	0.8%	1.0%	+0.2%
Non-performing loans	11.9%	12.2%	+0.3%
Loan / deposit	64.1%	62.9%	-1.2%
Capital**/total liabilities	9.4%	9.2%	-0.2%
Capital adequacy ratio (standalone)***	13.5%	12.2%	-1.3%
ROE (based on average balance of equity)****	6.8%	-39.3%	-46.1%
ROE (based on average balance of equity)*****	6.8%	15.4%	+8.6%
ROA (based on average balance sheet total)****	0.6%	-3.2%	-3.8%
ROA (based on average balance sheet total)*****	0.6%	1.3%	+0.7%

* excluding bank tax and provision for the new law on consumer loan agreements but including FTL related charges
** in addition to equity it also includes subordinated debt capital
*** according to the rules prescribed by the Hungarian supervisory authority (2013: Basel II, 2014: Basel III)
**** bank tax included on a pro rata basis
***** excluding provision for the new law on consumer loan agreements, bank tax included on a pro rata basis

The 2014 financial performance of the Group deteriorated significantly compared to the previous period due to the provision for the new law on consumer loan agreements. When cleaning the figures from this one-off item, the operating profit and efficiency ratios the Group's financial performance improved further compared to 2013. Considering profitability, the Group is still one of the most solid performers in the Hungarian banking sector with stable liquidity and solvency positions.

4. Introduction of important subsidiaries

Leasing operation

At the end of the first half of 2014 the Leasing operation consisted of 5 separate legal entities (3 entities were merged with K&H Bank Zrt.[1]).

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

On 30 July 2014 the **Group's leasing** portfolio stood at 49.4 billion HUF, which represents a 7% decrease compared to the end of the previous year. The decrease of the retail car financing portfolio continued (by HUF 4.8 billion in the first half of 2014, which is 17.2 % decrease). The truck, machinery, equipment and fleet portfolio increased by HUF 1.1 billion (4.2%).

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

K&H Fund Management (K&H FM) is fully owned by K&H Bank. The assets managed in investment funds increased from HUF 744 billion to HUF 818 billion, while total assets managed by K&H FM increased from HUF 864 billion to HUF 947 billion in the first half of 2014. The sum of total assets managed in funds represents the third biggest market share among the Hungarian Fund Management companies.
The decreasing yield environment continues to turn the attention of clients towards investment funds.
Concerning institutional portfolio management, there was no significant change in the level of assets under management.

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

In 2005, K&H Group decided to set up a group services centre under the management of K&H Bank, which is the 100% owner of K&H Csoportszolgáltató Kft. (KHCSK). The purpose of this unit was the centralisation and efficient organisation of supplementary service activities closely linked to the core activities of individual group members. Comprehensive service activities performed for the Group include the management of the real estate portfolio, logistical and bank security tasks, operative business responsibilities (the booking of trade receivables and payables, fixed assets etc.; tax accounting and payroll management).
The company takes out service level agreements and contracts with individual group members for each individual service. Since 2007, services offered by KHCSK have also been used by K&H Insurance and K&H Leasing Group's member companies as well. At present, KHCSK acts as a group services centre for 10 companies, including K&H Bank. Since May 1, 2008, KHCSK has also been performing the financial and accounting responsibilities and operative services of the Hungarian branch of KBC Global Services N.V. (KBC GSC). On 1 January 2008 the Tendering Directorate was set up, which is responsible for advisory and support services related to EU tenders. In 2009, the scope of the company's activities was extended with financial and accounting services provided for K&H Factoring, a company 100% owned by K&H Bank.
A directorate was established on 1 January 2012 for SZÉP Card operation. The SZÉP card is a cafeteria item and product at K&H Group. KHCSK is responsible for the entire operation of the SZÉP card system and the related transactions.

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

The K&H Factoring Zrt's main activity is factoring (purchase of receivables, financing, discounting). The company's business activities have started in 2010, (factoring) turnover has been increasing since then (2010: 5.9 bln, 2011: 22.3 bln, 2012: 54.5 bln; 2013: 72.6 bln, 2014. 1H: 34.9 bln). The amount of trade receivables towards debtors was HUF 6.6 billion on 30 June 2014.

[1] K&H Lízingház Zrt. was deleted from the company registry on 28 March 2014.

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 with a view to ensuring the sound management of value creation and all the associated risks to which the banking and insurance businesses are exposed. The Group's risk governance model is organised in three tiers:

- Overarching company and risk committees are the Board of Directors (BoD), the Risk and Compliance Committee (RCC), the Audit Board (AB), the Supervisory Board (SB), the Executive Committee (ExCo), the Country Team (CT) and the Capital and Risk Oversight Committee (CROC). These committees concentrate on overarching risk management and on monitoring value creation.
- Specialised risk councils (Credit Risk Council (CRC), Trading Risk Councils (TRC), Operational Risk Councils (ORC)) concentrate on implementing a group-wide framework for one particular type of risk and monitoring the associated risk management process. The risk councils are composed of representatives from line management and Value and Risk Management Division.
- Line management and activity-specific committees have primary responsibility for value and risk management on the operational level. Whereas 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 transfer synthesized message to senior 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 ensures that there is an ample flow of information to the members of the Board over the course of the year. Moreover, through the involvement of the Board in the annual round of approvals of risk-tolerance limits, the Board is able to take informed decisions on the degree of risk it finds acceptable for the Group and on the adequacy of the risk management structure.

5.2 Risk types

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

  In the framework of the Basel II program, late 2010 the Bank was granted the permission of HFSA 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.

  The economic conditions, especially the expected evolution of unemployment can have a considerably influence the future quality of the credit portfolio.

During 2012 and 2013 management reports were completely revised (now they show much more detailed information and more indicators on credit risk). This activity continued during 2014, with more emphasis on ad-hoc type reports focusing on given portfolios/types of risk (such reports include for example providing extra information on restructured deals, reports on “Funding for Growth” portfolio, or the vintage analysis of different segments). Main conclusions regarding credit risk for 2014: Corporate and SME portfolio remained stable, both portfolios showed slight improvement during the second quarter. Deterioration of retail portfolio continues, but slowed down somewhat in 1H 2014. The increasing disbursement of new loans during the second quarter having a positive effect on credit risk indicators both in secured and unsecured portfolios.

- **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 constantly 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). The banking book is characterized by increasing interest rate risk taking, to the extent allowed by the set limit.
  The risk taking has been moderate and continuously within the risk playing field in the trading book.
- **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. To eliminate this risk, the management seeks to diversify the financing sources and manages assets with due regard to liquidity requirements, maintaining a healthy balance between cash, liquid funds and promptly marketable securities. Short term liquidity risk is measured by the operational liquidity limit which establishes whether there is sufficient coverage for the 30-day cumulative liquidity gap. From 2011 structural liquidity is determined by the application of the coverage ratio, the calculation of the new regulatory and Basel III liquidity rates (LCR, NSFR) as well as by liquidity stress tests. The Risk Management Directorate prepares regular reports to the K&H Bank Capital and Risk Oversight Committee on the various liquidity indicators and limits.

	31 Dec 2013	30 Jun 2014	Regulatory requirement
Deposit coverage ratio (%)	63.0	61.5	20.0
Balance sheet coverage ratio (%)	27.9	26.9	10.0
Foreign currency financing ratio (%)	70.7	70.1	65.0

- 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. Additionally, K&H follows up the evolution of the risk profile of its activities via risk indicators. In order to assure the continuous availability of its customer services K&H has a complex business continuity process in place, that covers all activities of K&H 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

The number of bank employees was 3,404 at the end of the first half of 2014.

Development of the branch network

During the first half of 2014 the set-up, full or partial reconstruction of 14 branches was started or completed and a net number of 10 branches were closed.

In connection with the construction of the branches 7 cash-in terminals were installed and 5 non-branch terminals were deployed at other premises (mostly in hypermarkets). By mid 2014 altogether 440 ATMs were serving our customers.

The accessibility improvement of the branch network is being done concurrently with the constructions and reconstructions. Currently 158 of the 210 branches can be accessed without obstruction.

The most important IT development projects of 1H14 were the following:

- We issued Mastercard Paypass contactless bankcard product, all related developments were implemented.
- New functional modules supporting CRM services were launched as a next step towards an integrated branch front-end application.
- Several project size developments were completed to align with legal regulations (free cash withdrawal, FATCA directive).
- New Girinfo interface was developed and implemented increasing the efficiency of retail credit origination processes.

Budapest, 28 August 2014

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