Kereskedelmi és Hitelbank Zrt.

CONSOLIDATED SEMI-ANNUAL REPORT

30 June 2015

Budapest, 27 August 2015

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 2015 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, 27 August 2015

Hendrik Scheerlinck
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Not audited 30 June 2015 MHUF	Audited 31 December 2014 MHUF
ASSETS		
Cash and cash balances with central banks	463 197	423 651
Financial assets	1 946 935	1 917 743
Held for trading	131 525	99 529
Designated at fair value through profit or loss	2 682	2 571
Available for sale	153 503	126 579
Loans and receivables	1 234 182	1 256 381
Held to maturity	416 859	421 915
Hedging derivatives	8 184	10 768
Tax assets	13 971	13 465
Current tax assets	3 784	1 691
Deferred tax assets	10 187	11 774
Investments in associated companies	542	542
Investment property	772	850
Property and equipment	38 422	39 324
Intangible assets	9 920	10 048
Other assets	35 424	37 213
Total assets	2 509 183	2 442 836
LIABILITIES AND EQUITY		
Financial liabilities	2 240 685	2 176 854
Held for trading	52 486	46 142
Designated at fair value through profit or loss	212 635	196 709
Measured at amortised cost	1 975 086	1 933 865
Hedging derivatives	478	138
FV changes of hedged item under portfolio hedge of interest rate risk	1 225	1 236
Tax liabilities	227	12
Current tax liabilities	207	12
Deferred tax liabilities	20	-
Provisions for risks and charges	42 730	53 249
Other liabilities	38 908	31 769
Total liabilities	2 323 775	2 263 120
Share capital	140 978	140 978
Share premium	48 775	48 775
Statutory risk reserve	5 541	5 541
Available for sale reserve	6 191	8 662
Cash flow hedge reserve	3 183	4 007
Retained earnings	(19 260)	(28 247)
Total equity	185 408	179 716
Total liabilities and equity	2 509 183	2 442 836

Budapest, 27 August 2015

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 2014	140 978	48 775	20 422	(983)	(2 051)	2 309	209 450
Net profit for the year	-	-	-	-	-	(28 290)	(28 290)
Other comprehensive income for the period	-	-	-	9 645	6 058	-	15 703
Total comprehensive income	-	-	-	9 645	6 058	(28 290)	(12 587)
Dividend	-	-	-	-	-	(17 147)	(17 147)
Transfer from retained earnings to statutory risk reserve	-	-	(14 881)	-	-	14 881	-
Total change	-	-	(14 881)	9 645	6 058	(30 556)	(29 734)
Balance as at 31 December 2014	140 978	48 775	5 541	8 662	4 007	(28 247)	179 716
of which revaluation reserve for bonds	-	-	-	8 662	-	-	8 662
Balance as at 1 January 2015	140 978	48 775	5 541	8 662	4 007	(28 247)	179 716
Net profit for the year	-	-	-	-	-	8 987	8 987
Other comprehensive income for the period	-	-	-	(2 471)	(824)	-	(3 295)
Total comprehensive income	-	-	-	(2 471)	(824)	8 987	5 692
Total change	-	-	-	(2 471)	(824)	8 987	5 692
Balance as at 30 June 2015	140 978	48 775	5 541	6 191	3 183	(19 260)	185 408
of which revaluation reserve for bonds	-	-	-	6 191	-	-	6 191

Budapest, 27 August 2015

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Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED INCOME STATEMENT

	Not audited 1st half of year 2015 MHUF	Restated Not audited 1st half of year 2014 MHUF
Interest income	51 105	61 525
Interest expense	(14 238)	(20 032)
Net interest income	36 867	41 493
Fee and commission income	33 605	32 679
Fee and commission expense	(8 465)	(7 870)
Net fee and commission income	25 140	24 809
Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange	9 821	11 077
Net realised gains / (losses) from available-for-sale assets	665	2 224
Dividend income	0	0
Other net income	2 694	(69 871)
Total income	75 187	9 732
Operating expenses	(57 925)	(58 368)
Staff expenses	(14 598)	(14 711)
General administrative expenses	(24 340)	(24 518)
Depreciation and amortisation of tangible and intangible assets	(3 289)	(3 298)
Bank tax	(15 698)	(15 841)
Impairment:	(3 575)	(7 621)
Loans and receivables	(3 533)	(7 344)
Other	(42)	(277)
Share in results of associated companies	0	42
Profit before tax	13 687	(56 215)
Income tax expense	(4 700)	9 776
Profit after tax	8 987	(46 439)

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Not audited 1st half of year 2015 MHUF	Restated Not audited 1st half of year 2014 MHUF
Profit after tax	8 987	(46 439)
Other comprehensive income		
Available-for-sale equity instruments		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	-	-
Deferred tax impact on fair value changes	-	-
Transfer from available for sale reserve to net profit		
(Losses)/ gains on disposal	-	-
Deferred income tax	-	-
Available for sale debt instruments		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	(2 401)	9 626
Deferred tax impact on fair value changes	495	(1 986)
Transfer from available for sale reserve to net profit		
(Losses)/ gains on disposal	(665)	(2 224)
Amortisation of reclassified assets	(47)	2 357
Deferred income tax	147	(27)
Cash flow hedge		
Amounts to be reclassified subsequently to the income statement:		
Net gain / (loss) from fair value changes	(656)	5 556
Deferred tax impact on fair value changes	135	(1 146)
Transfer from cash flow hedge reserve to net profit		
Ineffective part	-	-
Gross amount	(382)	(1 232)
Deferred income tax	79	254
Total other comprehensive income	(3 295)	11 178
Total comprehensive income	5 692	(35 261)

Budapest, 27 August 2015

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Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CASH FLOWS

	Not audited 1st half of year 2015 MHUF	Restated Not audited 1st half of year 2014 MHUF
OPERATING ACTIVITIES		
Profit before tax	13 687	(56 755)
Adjustments for:		
Net transfer from available for sale reserve	(712)	133
Net transfer from cash flow hedge reserve	(382)	(1 232)
Depreciation and impairment of property, plant and equipment, intangible assets, available-for-sale financial assets and other assets	3 339	4 188
(Profit)/Loss on the disposal of property and equipment	(149)	25
(Profit)/Loss on the disposal of investment property	(20)	2
(Profit)/Loss on disposal of investment	-	(644)
Change in impairment on loans and advances*	3 533	7 344
Change in other provisions	52	70 784
Unrealised valuation differences	1 849	4 507
Income from associated companies	-	(42)
Cash flows from operating profit before tax and before changes in operating assets and liabilities	21 197	28 309
Changes in financial assets held for trading	(37 917)	9 007
Changes in financial assets designated at fair value through profit or loss	(147)	(341)
Changes in financial assets available for sale	(29 325)	103 048
Changes in loans and receivables	56 195	(44 890)
Changes in financial assets held to maturity	3 394	2 974
Changes in other assets	164	1 020
Changes in operating assets	(7 636)	70 817
Changes in financial liabilities held for trading	7 366	517
Changes in financial liabilities designated at fair value through profit or loss	16 269	(22 212)
Changes in financial liabilities measured at amortised cost	58 276	(121 580)
Changes in other liabilities	(4 441)	17 011
Changes in operating liabilities	77 471	(126 264)
Income taxes paid	(2 237)	(12 078)
Net cash from/(used in) operating activities	88 795	(39 216)

* Including impairments on loans and receivables and loan commitments.

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2015 MHUF	Restated Not audited 1st half of year 2014 MHUF
INVESTING ACTIVITIES		
Purchase of held-to-maturity securities	(25 810)	(25 672)
Proceeds from the repayment of held-to-maturity securities at maturity	27 472	39 807
Proceeds from the disposal of associated companies	-	2 173
Dividends received from associated companies	-	-
Purchase of intangible fixed assets	(1 202)	(1 145)
Purchase of property, plant and equipment	(1 919)	(936)
Proceeds from the sale of property, plant and equipment	552	247
Net cash from/(used in) investing activities	(907)	14 473
FINANCING ACTIVITIES		
Net cash from/(used in) financing activities	-	-
CHANGE IN CASH AND CASH EQUIVALENTS		
Net increase/(decrease) in cash and cash equivalents	87 889	(24 743)
Net foreign exchange difference	5 009	(1 027)
Cash and cash equivalents at beginning of the period	299 541	29 510
Cash and cash equivalents at end of the period	392 439	3 740

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2015 MHUF	Restated Not audited 1st half of year 2014 MHUF
OPERATING CASH FLOWS FROM INTEREST AND DIVIDENDS		
Interest received	54 810	55 432
Interest paid	(13 843)	(21 490)
Dividend received	-	-
COMPONENTS OF CASH AND CASH EQUIVALENTS		
Cash and cash balances with central banks	463 197	61 345
Loans and advances to banks repayable on demand and term loans to banks < 3 months	72 624	29 031
Deposits from banks repayable on demand and redeemable at notice	(143 383)	(86 636)
Total cash and cash equivalents	392 439	3 740

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

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

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

Budapest, 27 August 2015

Hendrik Scheerlinck
Chief Executive Officer

Attila Gombás
Chief Financial Officer

Consolidated Management Report

On 30 June 2015, the consolidated total assets of K&H Bank Group (hereunder “the Group”) stood at HUF 2,509 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

Following the GDP growth of 3.6% in 2014, the speed of the economic growth remained in the first half of 2015 as well. Compared to the previous periods household consumption has also shown signs of recovery in the first half of the year. The economic growth outlook is deteriorated by the slower investment activity and new orders, so an economic slowdown is expected already in 2H15. The internal and external balance positions of the Hungarian economy remained favourable and are expected to improve further in 2015.

	2014 actual	2015 forecast
GDP growth	+3.6%	+3.1%
CPI (average)	-0.2%	0.5%
Investments	+13.3%	+5.0%
Unemployment rate	7.1%	6.8%
Budget deficit (ESA) (in % of GDP)	-2.6%	-2.4%
Debt/GDP rate	76,9%	76.0%
Balance of payments (in % of GDP)	+4.1%	+4.2%

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

The European Central Bank has started a more vigorous monetary easing with launching a bond purchasing programme in 2015, while FED (the central bank of the United States) is expected to end its quantitative easing programme and most probably it will introduce monetary measures of tightening in the 2nd half of the year due to the improving economic outlook in the US. National Bank of Hungary restarted the rate cut cycle in March and decreased the base rate by 15bps on a monthly basis from 2.1% to 1.35% till end of July.

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 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 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 add-on 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
- e-bank / mobile bank
- tied agents and brokers

Our intention is to provide a unique customer experience through our seamlessly integrated channels and by offering a simple and easy journey to our clients from the first interest through the application for the product and contracting to the use of our products. To achieve this, the initiatives aimed at digitalization will be supported by 1.5 billion HUF of annual capital expenditures between 2014 and 2017.

Key differentiators of the Bank Group:
- being close to our clients: easy access both physically (via our large branch network) and virtually (via remote channels);
- K&H Group acts as a full service provider for our clients in banking and insurance (universal financial institution);
- expertise and advice in the whole spectrum of financial services;
- speaking our clients' language (simple and easy solutions, client-friendly communication).

3. The Group's consolidated activities

3.1 Balance sheet

The Group's total assets increased by 2.7% in the first half of 2015:

Billion HUF	31 Dec 2014	30 Jun 2015	variance
Total assets	2,443	2,509	+2.7%
Loans and receivables	1,256	1,234	-1.8%
Deposits from customers	1,804	1,873	+3.8%
Equity	180	185	+3.2%

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

- The decrease in *loans and receivables* is related to the corporate segment (early repayment in case of certain larger files). In the first half of the year loan portfolio in SME and retail segments increased further, the latter reflects the combined impact of the accelerated loan demand (volume of newly disbursed mortgages increased by 34% compared to H1 2014 in the banking sector) and K&H's improving market share in new mortgage lending (1H14: 11.8%, 1H15: 15.9%).
- *Deposits from customers* increased by 3.8% during the year. The Group managed to further improve its market position in both retail and corporate savings in the first half of the year.

Market share	30 June 2014	31 Dec 2014	30 June 2015*
Corporate loans	8.9%	10.0%	9.8%
Retail loans	8.9%	9.1%	9.1%
Retail mortgage loan new production	11.8%	14.0%	15.9%
Corporate deposits	12.1%	11.6%	12.0%
Retail deposits+mutual funds	10.9%	11.2%	12.3%

** preliminary data*

- Shareholders' equity increased by 5.7 bln HUF in the first half of the year as a net balance of the following factors: profit of year 2015 (+9.0 bln HUF); cash flow hedge reserves (-0.8 bln HUF) and AFS revaluation reserves (-2.5 bln HUF).

Bank standalone	30 June 2014	31 Dec 2014	30 June 2015
Guarantee capital (bln HUF)	164.5	171.2	184.7
Capital adequacy ratio (%)	12.2	12.3	13.4

3.2 Profit & loss

billion HUF	30 June 2014	31 Dec 2014	30 June 2015
Profit after tax	-46.4	-28.3	+9.0

The Bank Group's profit for 1H15 amounted to 9.0 billion HUF (including the full year banktax of 15.7 bln HUF), which is a significant improvement compared to the 46.4 billion HUF loss in the same period of last year (the result of 1H14 included 70.9 billion HUF pre-tax provision for the expected impact of the legislatory changes on consumer loan agreements related to foreign exchange margins and unilateral contract modifications[1]).

The evolution of the main P&L items in the first half of 2015:

- The *net interest and interest-type income* decreased by 11% (1H15: HUF 36.9 bln, 1H14: HUF 41.5 bln) related to the lower margins and volumes as a result of the consumer loan settlement and conversion.

- The 1% increase in *net fee and commission income* (1H15: HUF 25.1 bln, 1H14: HUF 24.8 bln) is primarily driven by investment services (increasing fee income from mutual fund sales distribution).

- Within the *net gains from financial instruments at fair value* (1H15: HUF 9.8 bln, 1H14: HUF 11.1 bln) Treasury related trading income is lagging behind the last year's performance.

- *Other net income*: in 1H14 K&H set aside one-off net provisions of 70.9 bln (pre-tax) for both the correction to the FX bid-offer spreads and the unilateral changes to interest rates, using the methodology guideline issued by the Hungarian National Bank. After the refinement of the related legislatory framework the provision was recalculated in 2H14 resulting in a lower estimation of 65.5 billion included in the audited Annual Report for 2014. Following the financial settlement with the FX mortgage debtors the realised loss was accounted for in 1H15 which turned out to be lower than the above mentioned provision in the audited Annual Report (this 2.4 bln positive impact can be seen as part of "other income" in 1H15 arising from the net balance of realised loss and related provision release).

- The operating expenses of the Bank Group for the first half of 2015 was HUF 57.9 billion (1H14: HUF 58.4 billion)

[1] Detailed description of the related legislatory changes and their financial impacts is included in the 2014 consolidated financial statements (Note 9)

- on a comparable basis (filtering from both periods the regular Financial Transactional Levy /10.0 in 1H 2015 and 9.4 bln in 1H 2014/) operating expenses would have decreased by 2% compared to the first half of 2014
- the bank tax for the whole year (accounted for in 1Q) is HUF 15.7 billion

Impairments amounted to HUF 3.6 bln in H1 2014 (H1 2014: HUF 7.6 bln). The lower impairment compared to the previous period was mainly related to the retail business due to the impact of the settlement. In corporate and SME segments the portfolio quality and the credit impairment was also favourable in the period. The higher NPL ratio in retail is due to technical reasons /decreasing share of performing portfolio within total retail loan portfolio due to the settlement/.

Non-performing loans	30 June 2014	31 Dec 2014	30 June 2015
Retail	20.6%	26.1%	26.8%
Corporate & SME	5.5%	6.4%	6.2%
Retail Car Leasing	33.6%	39.1%	45.7%
Total	**12.2%**	**12.0%**	**12.7%**

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

	2014 H1	2015 H1	variance
Cost / income	599.8%	77.0%	-522.7%
Cost / income*	52.7%	58.0%	+5.3%
Non-interest type income/ total income*	48.5%	52.6%	+4.1%
Commission income / total income*	30.8%	34.5%	+3.8%
Operating income */ average headcount(million HUF)	47.4	42.1	-11.0%
Operating expenses* / average headcount (million HUF)	25.0	24.5	-2.1%
Operating profit* / average headcount (million HUF)	22.4	17.7	-21.0%
Credit cost ratio	1.0%	0.5%	-0.5%
Non-performing loans	12.2%	12.7%	+0.5%
Loan / deposit	62.9%	52.4%	-10.5%
Capital**/total liabilities	9.2%	8.1%	-1.1%
Capital adequacy ratio (standalone)***	12.2%	13.4%	+1.2%
ROE (based on average balance of equity)****	-38.8%	17.8%	+56.6%
ROE (based on average balance of equity)*****	15.9%	15.1%	-0.8%
ROA (based on average balance sheet total)****	-3.2%	1.3%	+4.5%
ROA (based on average balance sheet total)*****	1.3%	1.1%	-0.2%

* 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 (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

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 2015 the Leasing operation consisted of 5 separate legal entities next to the leasing operations performed by the bank (3 entities were merged with K&H Bank Zrt. in previous years).

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

On 30 June 2015 the **Group's leasing** portfolio stood at HUF 47.5 billion, which represents a 0.5% increase compared to the end of the previous year. The decrease of the retail car financing portfolio continued in 2015 (by HUF 5.7 billion, which is a 30% decrease compared to the end of 2014), while the truck, real estate, machinery & equipment and fleet portfolio altogether increased by HUF 5.9 billion (by 21% compared to the end of 2014).

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

K&H Fund Management Plc. is owned fully by K&H Bank. The assets managed in investment funds increased from HUF 878 billion to HUF 982 billion, while total assets managed by K&H FM increased from HUF 1,018 billion to HUF 1,129 billion in the first half of 2015. The sum of total assets managed in funds means the second biggest market share among the Hungarian Fund Management companies.
The decreasing yield environment continues to turn the attention of clients towards investment funds.
In the first half of 2015, 7 funds were launched: 6 closed-end capital protected funds for retail clients, 1 absolute return fund.
Institutional portfolio managed assets increased from HUF 138 billion to HUF 146 billion.

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: 75.8 bln, 2015. 1H: 39.7 bln). The amount of trade receivables towards debtors was HUF 7.6 billion on 30 June 2015.

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 report to senior management.

The Board of Directors and the Risk and Compliance Committee have an important role to play in value creation and risk governance. Regular reporting to the Risk and Compliance Committee ensures that there is an ample flow of information to the members of the Board over the course of the year. Moreover, through the involvement of the Board in the annual round of approvals of risk-tolerance limits, the Board is able to take informed decisions on the degree of risk it finds acceptable for the Group and on the adequacy of the risk management structure.

5.2 Risk types

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

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

In the subsequent years, the bank paid special attention to the enhancement of the applied risk management methodology, with special regard to the analyses of the various stress scenarios affecting the credit portfolio (macro-economic indicators, foreign exchange rate changes and the changes in real estate values). An additional instrumental component of the further development of the risk management methodology was the revision of the management reports to better highlight the various quantitative risk indicators in order to allow the continuous monitoring of the credit portfolio. Based on MNB permission, the Bank will shift to IRB Advanced methodology for regulatory capital calculation from 30 September 2015.

Management reports were further fine-tuned during 2015, and amended with additional information. More emphasis was given to ad-hoc type reports, which always focus on a specific product or risk type. The causes for RWA change were given a separate report to shed more light on the drivers of capital consumption. Reports on forborne portfolio and Funding for Growth portfolio of the vintage analysis of different segments/products give an example of ad-hoc reports. A separate report will be prepared to monitor retail deals affected by the Curia decision (settlement, FX conversion). Since the conversion/settlement took place during March 2015 and only 3 months have passed it is still too early to determine any long term trends. The main conclusions for 2015 are:

- Corporate and SME portfolio are mainly stable with some improvements in risk indicators
- The quality of the loan portfolio disbursed in the MNB's funding for growth program is better than the existing portfolio, but it is too early to see any important long term trends
- Retail portfolio remained stable during the second quarter of 2015, no significant deterioration can be found. The new disbursements have a diluting effect on the existing portfolio (legacy book)

The economic conditions, especially the evolution of unemployment and the future evolution of the HUF interest rate levels can considerably influence the future quality of the credit portfolio.

- **Market risk** means the potential loss suffered by the Bank upon a change in the value of foreign currency and interest positions. Both the asset-liability management and market risk management are based on the methodology applied by the shareholder KBC Group. Accordingly, the Capital and Risk Oversight Committee continuously monitors banking and trading book risks and controls them by setting limits (in compliance with the limit policy of KBC). Interest risks are measured and controlled by the joint application of various methods and limits (gap analysis, interest sensitivity, duration, BPV, NII). There's also sovereign monitoring in place.

  The banking book is characterized by decreasing interest rate risk.

  Trading risk also remained moderate during the whole first half of the year.

- **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 ratios (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 2014	**30 Jun 2015**	**Regulatory requirement**
Deposit coverage ratio (%)	49.1	58.4	20.0
Balance sheet coverage ratio (%)	23.4	28.7	10.0
Foreign currency financing ratio (%)	73.5	117.3	80.0
Net stable funding ratio (NSFR) (%)	103.1	110.8	100.0
Liquidity coverage ratio (LCR) (%)	81.4	92.9	60.0

- 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. 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 3,454 at the end of the first half of 2015 (3,332 at the end of 2014).

Capital investments in the branch network:

- During the first half of 2015 the set-up, full or partial reconstruction of 7 branches was started or completed
- Built-in premium-banker offices were installed in 8 branches
- 24 Cash-In ATM terminals were installed
- By mid 2015 altogether 450 ATMs were serving our customers (incl. 32 pcs of Cash-in ATMs).

The most important IT development projects of first half 2015 were the following:

- Several project size developments were and are being completed to align with legal regulations (e.g. the consumer loan settlement and conversion, report for NAV on clients having foreign tax obligation)
- New functional extensions of CRM support services were launched as a next step towards an integrated branch front-end application
- Further enhancements for contactless POS terminals were made, K&H Bank issues Visa PayWave contactless bankcards, all related developments are in pilot phase
- Full PIN inheritance function for existing K&H cardholders was developed
- E-banking services were enhanced, by introducing new functionalities supporting client experience improvement.

Budapest, 27 August 2015

Hendrik Scheerlinck
Chief Executive Officer

Attila Gombás
Chief Financial Officer