Kereskedelmi és Hitelbank Zártkörűen Működő Részvénytársaság

CONSOLIDATED ANNUAL REPORT

31 December 2016

CONTENT

Statement of the Issuer

K&H Bank Zrt., as the Issuer (represented by Hendrik Scheerlinck, CEO and Attila Gombás, CFO) hereby declare that the Year 2016 Annual Report and the Year 2016 Consolidated Annual Report of K&H Bank Zrt. have been prepared to the best of the Issuer's knowledge, in compliance with the applicable accounting laws and regulations, and the financial details contained therein reflect a true and reliable status of the assets, liabilities, financial position and profitability of K&H Bank Zrt. and the companies involved in the consolidation, and the Management Report and Consolidated Management Report show a true and fair picture of the position, development and performance of K&H Bank Zrt. and the companies involved in the consolidation, including the major risks and uncertainties factors.

Budapest, April 28 2017

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

KERESKEDELMI ÉS HITELBANK ZÁRTKÖRŰEN MŰKÖDŐ RÉSZVÉNYTÁRSASÁG

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

FOR THE YEAR ENDED 31 DECEMBER 2016

WITH THE REPORT OF INDEPENDENT AUDITORS

pwc

INDEPENDENT AUDITOR'S REPORT
(Free translation)

To the shareholder of K&H Bank Zrt.

Opinion

We have audited the accompanying consolidated financial statements of K&H Bank Zrt. ("the Company") and its subsidiaries (together "the Group") which comprise the consolidated statement of financial position as of 31 December 2016 (in which the consolidated balance sheet total is MHUF 2,825,697), the consolidated income statement and consolidated statement of comprehensive income (the total profit after tax for the year is MHUF 38,877), the consolidated statement of changes in equity, the consolidated cash flows statement for the year then ended and the notes to the consolidated financial statements including a summary of the significant accounting policies.

In our opinion, the accompanying consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2016, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Basis for opinion

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

We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in Hungary. We have fulfilled our other ethical responsibilities in accordance with those requirements.

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

Other information: the consolidated business report

The other information comprises the consolidated business report of the Group. Management is responsible for the preparation of the consolidated business report in accordance with the provisions of Act C of 2000 on Accounting (the "Accounting Act") in force in Hungary and other relevant regulations. Our opinion on the consolidated financial statements does not cover the consolidated business report.

In connection with our audit of the consolidated financial statements, our responsibility is to read the consolidated business report and, in doing so, consider whether the consolidated business report is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

Based on the Accounting Act, in respect of the consolidated business report, our responsibility is to read the consolidated business report identified above and, in doing so, consider whether the consolidated business report has been prepared in accordance with the provisions of the Accounting Act and other relevant regulations, if any.

In our opinion, the 2016 consolidated business report of the Group, is consistent with the 2016 consolidated financial statements and the consolidated business report has been prepared in accordance with the Accounting Act.

As there is no other regulation prescribing further requirements for the consolidated business report, in respect of this, our opinion on the consolidated business report does not express the opinion required by Section (5) h) of 156 of the Accounting Act.

In addition, in light of the knowledge and understanding of the entity and its environment obtained in the course of the audit, we are required to report if we have identified material misstatements in the consolidated business report, and shall give an indication of the nature of any such misstatements. We have nothing to report in this respect.

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

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

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

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

Auditor's responsibilities for the audit of the consolidated financial statements

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

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

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that gives a true and fair view.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the Group audit. We remain solely responsible for our audit opinion.

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

Budapest, 13 April 2017

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

Translation note:

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

CONTENTS OF THE CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED INCOME STATEMENT

	Notes	2016 MHUF	Restated 2015 MHUF
Interest income		93 389	101 807
Interest expense		(23 367)	(27 973)
Net interest income	3;40	70 022	73 834
Fee and commission income		69 696	69 943
Fee and commission expense		(17 054)	(17 686)
Net fee and commission income	4	52 642	52 257
Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange	5	20 900	17 785
Net realised gains / (losses) from available-for-sale assets	6	5 288	665
Dividend income	7	2	-
Other net income / (expense)	8	14 728	18 130
Total income		163 582	162 671
Operating expenses		(98 280)	(102 095)
Staff expenses	11;40	(34 341)	(32 078)
General administrative expenses	9	(48 389)	(47 386)
Depreciation and amortisation of tangible and intangible assets	32;33	(7 993)	(6 876)
Bank tax	10	(7 557)	(15 755)
Impairment:	3;14	(10 091)	(13 090)
Loans and receivables	26	(9 134)	(12 288)
Other		(957)	(802)
Share in results of associated companies	13	-	-
Profit / (loss) before tax		55 211	47 486
Income tax expense	14	(16 334)	(9 663)
Profit / (loss) after tax		38 877	37 823
Earnings / (loss) per share in HUF (basic)	15	0.2757664	0.2682901

The figures of earnings / (loss) per share calculated for basic and diluted shares do not differ.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Notes	2016 MHUF	Restated 2015 MHUF
Profit / (loss) after tax		38 877	37 823
Other comprehensive income			
Available-for-sale equity instruments			
Amounts to be reclassified subsequently to the income statement:			
Net gain / (loss) from fair value changes	16	292	4 349
Deferred tax impact on fair value changes	29	(32)	(897)
Transfer from available for sale reserve to net profit:			
(Losses)/ gains on disposal	6	(4 565)	-
Deferred income tax	29	494	-
Available for sale debt instruments			
Amounts to be reclassified subsequently to the income statement:			
Net gain / (loss) from fair value changes	16	3 118	869
Deferred tax impact on fair value changes	29	(337)	(179)
Transfer from available for sale reserve to net profit:			
(Losses)/ gains on disposal	6	(723)	(665)
Amortisation of reclassified assets		(31)	(82)
Deferred income tax	29	82	154
Cash flow hedge			
Amounts to be reclassified subsequently to the income statement:			
Net gain / (loss) from fair value changes		1 148	607
Deferred tax impact on fair value changes	29	(103)	(125)
Transfer from cash flow hedge reserve to net profit:			
Ineffective part	27	272	394
Gross amount	27	(100)	(675)
Deferred income tax	29	(16)	58
Other	29	2 132	-
Total other comprehensive income		1 631	3 808
Total comprehensive income		40 508	41 631

Other includes the impact of the expected change of the applied income tax rate in 2017 (see Note 14).

Approved by the Board of Directors on 13 April 2017.

Hendrik Scheerlinck
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Notes	2016	Restated 2015	Restated as at 1 January 2015
		MHUF	MHUF	MHUF
ASSETS				
Cash and cash balances with central banks		222 020	68 715	77 547
Financial assets	16	2 534 120	2 431 286	2 263 847
Held for trading	27	95 274	81 735	99 529
of which assets pledged as collateral	*16*	*-*	*4 674*	*-*
Designated at fair value through profit or loss		-	-	2 571
Available for sale	25	193 110	163 245	126 579
of which assets pledged as collateral	*16*	*79 868*	*51 081*	*1 885*
Loans and receivables	23	1 803 046	1 746 912	1 602 485
of which assets pledged as collateral	*16*	*7 049*	*13 900*	*15 410*
Held to maturity	16	426 237	428 371	421 915
of which assets pledged as collateral	*16*	*225 838*	*235 747*	*214 081*
Hedging derivatives	27	16 453	11 023	10 768
Tax assets		2 750	13 902	13 655
Current tax assets		2 400	7 803	1 691
Deferred tax assets	29	350	6 099	11 964
Investments in associated companies	30	542	542	542
Investment property	31	1 010	740	850
Property and equipment	32	38 252	37 457	39 324
Intangible assets	33	12 060	11 723	10 048
Other assets	28	14 943	18 790	37 213
Total assets		2 825 697	2 583 155	2 443 026
LIABILITIES AND EQUITY				
Financial liabilities	16	2 512 972	2 286 854	2 176 854
Held for trading	27	31 806	35 859	46 142
Designated at fair value through profit or loss	21	200 131	216 315	196 709
Measured at amortised cost	16	2 277 915	2 034 669	1 933 865
Hedging derivatives	27	3 120	11	138
Fair value changes of hedged item under portfolio hedge of interest rate risk	27	6 185	3 164	1 236
Tax liabilities		36	15	12
Current tax liabilities		36	15	12
Provisions for risks and charges and credit commitments	26;34	2 437	7 765	53 249
Other liabilities	35;40	43 020	64 818	32 767
Total liabilities		2 564 650	2 362 616	2 264 118
Share capital	36	140 978	140 978	140 978
Share premium		48 775	48 775	48 775
Accumulated profit		39 724	5 560	(29 055)
Other reserves		31 570	25 226	18 210
Total equity	36;46	261 047	220 539	178 908
Total liabilities and equity		2 825 697	2 583 155	2 443 026

Approved by the Board of Directors on 13 April 2017.

Hendrik Scheerlinck
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

For breakdown of assets and liabilities by remaining maturity see Note 24.

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	Restated Retained earnings MHUF	Restated Total equity MHUF
2015							
Balance at the beginning of the period	140 978	48 775	5 541	8 662	4 007	(28 247)	179 716
Restatement (Note 2.7)	-	-	-	-	-	(808)	(808)
Restated balance at the beginning of the period	140 978	48 775	5 541	8 662	4 007	(29 055)	178 908
Net profit for the year	-	-	-	-	-	37 823	37 823
Other comprehensive income for the period (Note 5)	-	-	-	3 549	259	-	3 808
Total comprehensive income	-	-	-	3 549	259	37 015	40 823
Transfer from retained earnings to statutory risk reserve (Note 46)	-	-	3 208	-	-	(3 208)	-
Total change	-	-	3 208	3 549	259	33 807	40 823
Balance at the end of the period	140 978	48 775	8 749	12 211	4 266	5 560	220 539
of which revaluation reserve for shares (Note 16)	-	-	-	3 452	-	-	
of which revaluation reserve for bonds (Note 16)	-	-	-	8 759	-	-	
2016							
Balance at the beginning of the period	140 978	48 775	8 749	12 211	4 266	5 560	220 539
Net profit for the year	-	-	-	-	-	38 877	38 877
Other comprehensive income for the period (Note 5)	-	-	-	(195)	1 826	-	1 631
Total comprehensive income	-	-	-	(195)	1 826	38 877	40 508
Transfer from statutory risk reserve to retained earnings (Note 46)	-	-	4 713	-	-	(4 713)	-
Total change	-	-	4 713	(195)	1 826	34 164	40 508
Balance at the end of the period	140 978	48 775	13 462	12 016	6 092	39 724	261 047
of which revaluation reserve for shares (Note 16)	-	-	-	68	-	-	
of which revaluation reserve for bonds (Note 16)	-	-	-	11 948	-	-	

No dividend was paid in 2016 (and in 2015). For dividend proposed on ordinary shares in 2017 see Note 46.

Approved by the Board of Directors on 13 April 2017.

Hendrik Scheerlinck
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

CONSOLIDATED STATEMENT OF CASH FLOWS

	Notes	2016	Restated 2015
		MHUF	MHUF
OPERATING ACTIVITIES			
Profit / (loss) before tax		55 211	47 486
Adjustments for:			
Interest income	3	(93 389)	(101 807)
Interest expense	3	23 367	27 973
Net transfer from available for sale reserve	6	(5 319)	(747)
Net transfer from cash flow hedge reserve	5	172	(281)
Depreciation and impairment of property, plant and equipment, intangible assets, available-for-sale financial assets and other assets	32;33	8 897	7 691
(Profit)/Loss on the disposal of property and equipment	8	(156)	(260)
(Profit)/Loss on the disposal of investment property	8	(20)	(57)
(Profit)/Loss on the disposal of subsidiaries	8	(1)	-
Change in impairment on loans and advances and Held-to maturity assets*	12;26	9 203	12 288
Change in other provisions	34	(1 344)	(9 109)
Unrealised valuation differences	5	(334)	(17 694)
Cash flows from operating profit / (loss) before tax and before changes in operating assets and liabilities		(3 713)	(34 517)
Changes in financial assets held for trading		(13 091)	24 835
Changes in financial assets designated at fair value through profit or loss		-	2 483
Changes in financial assets held to maturity		2 699	(483)
Reclassification of assets from available-for-sale to held-to-maturity portfolio		(27 821)	-
Changes in financial assets available for sale		(30 745)	(30 819)
Changes in loans and receivables		173 697	(346 862)
Changes in other assets		9 210	12 319
Changes in operating assets		113 949	(338 527)
Changes in financial liabilities held for trading		(3 111)	(8 193)
Changes in financial liabilities designated at fair value through profit or loss		(15 315)	19 607
Changes in financial liabilities measured at amortised cost		255 407	204 190
Changes in other liabilities		(22 000)	(3 888)
Changes in operating liabilities		214 981	211 716
Income taxes paid		(8 365)	(4 788)
Interest received		94 703	104 284
Interest paid		(23 701)	(27 569)
Net cash from/(used in) operating activities		387 854	(89 401)

* Including impairments on loans and receivables and loan commitments.

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Notes	2016 MHUF	Restated 2015 MHUF
INVESTING ACTIVITIES			
Purchase of held-to-maturity securities		(75 800)	(80 762)
Proceeds from the disposal of held-to-maturity securities		23 404	20 000
Proceeds from the repayment of held-to-maturity securities at maturity		77 558	52 477
Proceeds from the disposal of a subsidiary or business unit, net of cash disposed		4 598	-
Purchase of intangible fixed assets	33	(3 798)	(4 368)
Purchase of property, plant and equipment	32	(6 884)	(3 607)
Proceeds from the sale of property, plant and equipment	32	613	894
Net cash from/(used in) investing activities		19 691	(15 366)
FINANCING ACTIVITIES			
Net cash from/(used in) financing activities		-	-
CHANGE IN CASH AND CASH EQUIVALENTS			
Net increase/(decrease) in cash and cash equivalents		407 545	(104 767)
Net foreign exchange difference		(2 228)	7 439
Cash and cash equivalents at beginning of the period		202 213	299 541
Cash and cash equivalents at end of the period		607 530	202 213

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Notes	2016 MHUF	Restated 2015 MHUF
OPERATING CASH FLOWS FROM DIVIDENDS			
Dividends received	7	2	-
COMPONENTS OF CASH AND CASH EQUIVALENTS			
Cash and cash balances with central banks		222 020	68 715
Loans and advances to banks repayable on demand and term loans to banks < 3 months	16	430 441	190 927
Deposits from banks repayable on demand and redeemable at notice	16	(44 931)	(57 429)
Total cash and cash equivalents		607 530	202 213

The difference between the interest cash flow and the interest result is immaterial. The interest cash flow results from the Group's banking activity and is part of the operating cash flow. For further information see Note 3.

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.

Approved by the Board of Directors on 13 April 2017.

Hendrik Scheerlinck
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

NOTE 1 – GENERAL

Kereskedelmi és Hitelbank Zártkörűen Működő Részvénytársaság ("K&H Bank Zrt." or "the Bank") is a limited liability company incorporated in Hungary. K&H Bank Zrt. and its subsidiaries ("the Group") provide a full range of banking services through a nation-wide network of 207 branches. As at 31 December 2016 K&H Bank Zrt.'s registered office was at Lechner Ödön fasor 9, Budapest.

The parent company of K&H Bank Zrt. is KBC Bank N.V. The ultimate parent is KBC Group N.V.

NOTE 2 – ACCOUNTING POLICIES

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

2.1 Basis of presentation

The consolidated financial statements have been prepared on a historical cost basis, except for held-for trading financial instruments, financial instruments designated at fair value through profit or loss, available-for-sale financial assets and hedging derivatives, which have been measured at fair value. The carrying values of recognized assets and liabilities that are hedged items in fair value hedges, and otherwise carried at amortised cost, are adjusted to record changes in fair value attributable to the risk that are being hedged.

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

2.1.1 Statement of compliance

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

Effective 1 January 2005, the change in the Hungarian Accounting Act allows the Group to prepare its consolidated financial statements in accordance with IFRS that have been adopted by the EU.

Certain accounting principles prescribed for statutory purposes are different from IFRS. In order to present the financial position and results of operations of the Group in accordance with IFRS certain adjustments have been made to the Group's Hungarian consolidated statutory accounts. Details on these adjustments are presented in note 44.

2.1.2 Basis of consolidation

The consolidated financial statements comprise the financial statements of the Bank and all entities it controlled as at 31 December 2016. The Bank and the entities which it controls are referred to collectively as "the Group". Control is presumed to exist if all of the following conditions are met:

- the Bank has power over the entity;
- the Bank has exposure, or rights, to variable returns from its involvement with the investee;
- the Bank has the ability to use its power over the investee to affect the amount of the investor's returns.

In case of the Bank's exclusive control the effects of all material intercompany balances and transactions are eliminated.

NOTE 2 – ACCOUNTING POLICIES (continued)

An investment in an associate is one in which the Bank holds, directly or indirectly, more than 20% of the voting rights and over which the Group exercises significant influence but which it does not control. Associates are accounted for under the equity method of accounting, and the pro-rata share of their income (loss) is included in the consolidated income statement. The Group's interest in an associate is carried in the consolidated statement of financial position at an amount that reflects its share of the net assets of the associate.

A list of subsidiary and associated companies is provided in Note 42.

2.2 Significant accounting judgements and estimates

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

Fair value of financial instruments

Where the fair values of financial assets and financial liabilities recorded on the consolidated statement of financial position cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The input to these models is taken from observable markets where possible, but where this is not feasible, a degree of judgement is required in establishing fair values. The judgements include considerations of liquidity and model inputs such as correlation and volatility for longer dated derivatives. For the sensitivity of the judgements used for fair value calculation see Note 20 and Note 45.3.

Allowance for impairment of loans and receivables and provision for commitments and contingent liabilities

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

Provision for litigations and claims

The amount of provision required to meet losses incurred as a result of litigations and claims is another principal area of estimation uncertainty in these financial statements. Refer to note 34 for further details.

2.3 Changes in accounting policies

Changes in IFRSs

The International Accounting Standards Board (IASB) has introduced numerous changes to the Standards that became effective in 2016.

NOTE 2 – ACCOUNTING POLICIES (continued)

The changes in accounting policies result from adoption of the following revised standards:

- *IAS1 Disclosure Initiative (amendment)*
- *Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)*
- *IFRS 5 Non-current Assets Held for Sale and Discontinued Operations*
- *IAS 34 Interim Financial Reporting*
- *IAS 16 Property, Plant and Equipment (amendment)*
- *IAS 38 Intangible Assets (amendment)*
- *IAS 27 Equity Method in Separate Financial Statements (amendment)*
- *IAS 16 and IAS 41 Agriculture: Bearer Plants (amendment)*
- *IFRS 11 Accounting for Acquisitions of Interests in Joint Operations (amendment)*
- *Annual improvements to IFRSs 2014*

Where transition provisions in IFRSs adopted give an entity a choice of whether to apply the new standard prospectively or retrospectively the Group has elected to apply the standard prospectively from the date of transition.

IAS1 Disclosure Initiative (amendment)

The amendments clarify that information should not be obscured by aggregating or by providing immaterial information. Materiality considerations apply to all parts of the financial statements.

Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)

The amendments confirm that the exemption from preparing consolidated financial statements for an intermediate parent entity is available to a parent entity that is a subsidiary of an investment entity, even if the investment entity measures all of its subsidiaries at fair value.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

Assets (or disposal companies) are generally disposed of either through sale or distribution to owners. The amendment clarifies that changing from one of these disposal methods to the other would not be considered a new plan of disposal, rather it is a continuation of the original plan. There is, therefore, no interruption of the application of the requirements in IFRS 5. This amendment must be applied prospectively.

IAS 34 Interim Financial Reporting

The amendment clarifies that the required interim disclosures must either be in the interim financial statements or incorporated by cross-reference between the interim financial statements and wherever they are included within the interim financial report (e.g., in the management commentary or risk report). The other information within the interim financial report must be available to users on the same terms as the interim financial statements and at the same time. This amendment must be applied retrospectively.

IAS 16 Property, Plant and Equipment (amendment)

The requirements of IAS 16 are amended to clarify that a depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. This is because such method reflects of economic benefits that arise from the operation of the business of which an asset is part, rather than the pattern of consumption of an asset’s expected future economic benefits.

IAS 38 Intangible Assets (amendment)

The requirements of IAS 38 are amended to introduce a rebuttable presumption that a revenue-based amortisation method for intangible assets is inappropriate for the same reasons as in IAS 16. However, the amendments states that there are limited circumstances when the presumption can be overcome: that the intangible asset is expressed as a measure of revenue and it can be demonstrated that revenue and the consumption of economic benefits of the intangible asset are highly correlated.

NOTE 2 – ACCOUNTING POLICIES (continued)

IAS 27 Equity Method in Separate Financial Statements (amendment)

The amendments allow an entity to account for investments in subsidiaries, joint ventures and associates in its separate financial statements at cost in accordance with the IAS 39 Financial Instruments: Recognition and Measurement for entities or using the equity method as described in IAS 28 Investments in Associates and Joint Ventures.

The amendments also clarify that when a parent ceases to be an investment entity, or becomes an investment entity, it shall account for the change from the date when the change in status occurred.

IFRS 11 Accounting for Acquisitions of Interests in Joint Operations (amendment)

The amendments of IFRS 11 such that the acquirer of an interest in a joint operation in which the activity constitutes a business, as defined in IFRS 3, is required to apply all of the principles on business combinations accounting in IFRS 3 and other IFRSs with the exception of those principles that conflict with the guidance in IFRS 11.

IAS 16 and IAS 41 Agriculture: Bearer Plants (amendment)

For the purpose of bringing bearer plants from the scope of IAS 41 into the scope of IAS 16 and therefore enabling entities to measure them at cost subsequent to initial recognition or at revaluation, a definition of a 'bearer plant' is introduced into both standards. A bearer plant is defined as "a living plant that: is used in the production or supply of agricultural produce; is expected to bear produce for more than one period; and has a remote likelihood of being sold as agricultural product, except for incidental scrap sales". The scope sections of both standards are then amended to clarify that biological assets except for bearer plants are accounted for under IAS 41 while bearer plants are accounted for under IAS 16.

Annual improvements to IFRSs 2014

The amendment to IFRS 7 adds guidance to help management determine whether the terms of an arrangement to service a financial asset which has been transferred constitute continuing involvement, for the purposes of disclosures required by IFRS 7. The amendment also clarifies that the offsetting disclosures of IFRS 7 are not specifically required for all interim periods, unless required by IAS 34.
The amendment to IAS 19 clarifies that for post-employment benefit obligations, the decisions regarding discount rate, existence of deep market in high-quality corporate bonds, or which government bonds to use as a basis, should be based on the currency that the liabilities are denominated in, and not the country where they arise.

The amendments have no major impact on the consolidated financial statements.

2.4 Summary of significant accounting policies

2.4.1 Foreign currency translation

Assets and liabilities denominated in foreign currencies are translated into HUF at exchange rates quoted by the National Bank of Hungary as at the date of the consolidated statement of financial position. Income and expenses arising in foreign currencies are converted at the rate of exchange on the transaction date. Resulting foreign exchange gains or losses are recorded in the consolidated income statement.

2.4.2 Financial instruments

Financial instruments are classified for measurement purposes as either financial instruments at fair value through profit or loss, financial assets and financial liabilities measured at amortised cost or available-for-sale financial instruments, as appropriate. When financial instruments are recognized initially, they are measured at fair value, plus, in the case of financial instruments not at fair value through profit or loss, directly attributable transaction costs. The Group determines the classification of its financial instruments after initial recognition and, where allowed and appropriate, re-evaluates this designation at each financial year-end.

NOTE 2 – ACCOUNTING POLICIES (continued)

2.4.2.1 Trade and settlement date accounting

All “regular way” purchases and sales of financial assets are recognized on the settlement date, i.e. the date the asset is delivered to the counterparty. Regular way purchases or sales are those that require delivery of assets within the time frame generally established by regulation or convention in the market place.

2.4.2.2 Financial instruments at fair value through profit or loss

Financial assets and financial liabilities classified in this category are designated by Management on initial recognition when the following criteria are met:

- the designation eliminates or significantly reduces the inconsistent treatment that would otherwise arise from measuring the assets or liabilities or recognising gains or losses on them on a different basis; or
- the assets and liabilities are part of a group of financial assets, financial liabilities or both which are managed and their performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy; or
- the financial instrument contains an embedded derivative, unless the embedded derivative does not significantly modify the cash flows or it is clear, with little or no analysis, that it would not be separately recorded.

Financial instruments classified as held-for-trading instruments are also included in the category ‘financial instruments at fair value through profit or loss’. Financial instruments are classified as held-for-trading instruments if they are acquired for the purpose of selling in the near term. Derivatives are also classified as held for trading unless they are designated and effective hedging instruments.

Instruments classified as financial instruments at fair value through profit or loss subsequently are measured at fair value, whereby in case of interest-bearing assets the change of the difference between the fair value and the amortised cost is recorded in the consolidated income statement as Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange. The interest component is recognized as interest income using the effective interest rate method.

The change in the fair value of non-interest-bearing assets is recorded in the consolidated income statement as Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange.

2.4.2.3 Derivatives

The Group enters into derivative instruments including FRA’s, forwards, swaps and options in the foreign exchange and money markets. Derivatives are stated at fair value. The fair value of a derivative is the equivalent of the unrealised gain or loss from marking to market the derivative using prevailing market rates or internal pricing models. Derivatives with positive fair values (unrealised gains) are included in assets and derivatives with negative fair values (unrealised losses) are included in liabilities in the consolidated statement of financial position.

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

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

NOTE 2 – ACCOUNTING POLICIES (continued)

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

In relation to fair value hedges which meet the conditions for hedge accounting, any gains or losses from re-measuring the hedging instrument to fair value are recognized immediately in the consolidated income statement. The hedged item is adjusted for fair value changes relating to the risk being hedged and the difference is recognized in the consolidated income statement.

In relation to cash flow hedges which meet the conditions for hedge accounting, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognized initially in the consolidated other comprehensive income in the cash flow hedge reserve and the ineffective portion is recognized in the consolidated income statement. The gains or losses on effective cash flow hedges recognized initially in the consolidated other comprehensive income are either transferred to the consolidated income statement in the period in which the hedged transaction impacts the consolidated income statement or included in the initial measurement of the cost of the related non-financial asset or liability.

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

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point in time, the cumulative gain or loss on a cash flow hedge recognized in the consolidated other comprehensive income remains in the consolidated other comprehensive income until the forecasted transaction occurs, when it is then transferred to the consolidated income statement for the period. Also at that time an item subject to a fair value hedge ceases to be revalued.

Cash flows from hedging activities are classified in the same line in the consolidated statement of cash flows as the item being hedged. When a forecasted transaction is no longer expected to occur, the cumulative gain or loss on the hedging instrument is recognized immediately in the consolidated income statement in Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange.

The Group assesses whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative when it first becomes a party to a contract. There is no subsequent reassessment.

2.4.2.4 Financial assets and financial liabilities measured at amortised cost

2.4.2.4.1 Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are carried at amortised cost using the effective interest method. Gains and losses are recognized in the consolidated income statement when the loans and receivables are derecognized or impaired, as well as through the amortisation process.

NOTE 2 – ACCOUNTING POLICIES (continued)

2.4.2.4.2 Financial liabilities at amortised cost

All money market and customer deposits are initially recognized at fair value plus transaction costs. After initial recognition, all interest bearing deposits, other than liabilities held for trading and other than financial liabilities designated at fair value through profit or loss, are subsequently measured at amortised cost, less amounts repaid. Amortised cost is calculated by taking into account any discount or premium on settlement. Premiums and discounts are amortised on a systematic basis to maturity using the effective interest method and taken to interest expense. For liabilities carried at amortised cost (which are not part of a hedging relationship), any gains or losses from revaluation to fair value are recognized in the consolidated income statement when liability is derecognized.

2.4.2.4.3 Held-to-maturity instruments

Non-derivative financial instruments with fixed or determinable payments and fixed maturity are classified as held-to-maturity when the Group has the positive intention and ability to hold to maturity. Instruments intended to be held for an undefined period are not included in this classification. Held-to-maturity instruments are subsequently measured at amortised cost. This cost is computed as the amount initially recognized minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initially recognized amount and the maturity amount. This calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums and discounts.

For instruments carried at amortised cost, gains and losses are recognized in the consolidated income statement when the instruments are derecognized or impaired, as well as through the amortisation process.

The Group is not allowed to classify any financial assets as held to maturity if the Group has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:

- are so close to maturity or the financial asset’s call date (less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset’s fair value;
- occur after the Group has collected substantially all of the financial asset’s original principal through scheduled payments or prepayments; or
- are attributable to an isolated event that is beyond the Group’s control, is non-recurring and could not have been reasonably anticipated by the Group.

Sales out of held-to-maturity instruments can be considered insignificant if on a yearly basis, the sales do not exceed 5% of the carrying amount of held-to-maturity instruments on 1 January of that financial year.

2.4.2.5 Available-for-sale financial instruments

Available-for-sale financial instruments are those non-derivative financial instruments that are designated as available-for-sale or are not classified as:

- financial instruments at fair value through profit or loss, or
- loans and advances and financial liabilities measured at amortised cost, or
- held-to-maturity instruments.

After initial recognition available-for sale financial instruments are measured at fair value with gains or losses being recognized as a separate component of equity until the instrument is derecognized or until the instrument is determined to be impaired at which time the cumulative gain or loss previously reported in the consolidated other comprehensive income is included in the consolidated income statement. However, interest calculated using the effective interest method is recognized in the consolidated income statement.

NOTE 2 – ACCOUNTING POLICIES (continued)

The fair value of instruments that are actively traded in organised financial markets is determined by reference to quoted market bid prices at the close of business on the statement of financial position date. For instruments where there is no active market, fair value is determined using valuation techniques. Such techniques include using recent arm's length market transactions, reference to the current fair value of another instrument, which is substantially the same and discounted cash flow analysis.

Available-for-sale investments include investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured. These investments are measured at cost less impairment.

2.4.2.6 Fair value hierarchy of financial instruments

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

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

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

The Group assesses the significance of fair value adjustments at portfolio level in function of the proportion of the fair value adjustment relative to the size of the underlying portfolio.

A fair value adjustment related to the unobservable input is considered to be material for the Group if this fair value adjustment makes up at least 5% of the nominal exposure of the underlying portfolio.

Changes to the fair value classification

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

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

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

NOTE 2 – ACCOUNTING POLICIES (continued)

2.4.3 Day 1 profit

For financial instruments at fair value fair value at initial recognition is best evidenced by the transaction price. A gain or loss on initial recognition is only recorded if there is a difference between fair value and transaction price which can be evidenced by other observable current market transactions in the same instrument or by a valuation technique whose inputs include only data from observable markets.
For other financial instruments, for which the transaction price is calculated using a valuation technique with level 3 inputs, the difference is initially recognised within (other) assets or (other) liabilities and are subsequently amortised on a straight line basis over the term of the instrument.

2.4.4 Repo and reverse repo agreements

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

2.4.5 Securities lending and borrowing

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

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

2.4.6 Allowances for impairment of financial assets

The Group assesses at each statement of financial position date whether there is any objective evidence that a financial asset or group of financial assets is impaired. A financial asset or group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred “loss event”) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated.

Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganisation and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

Impairment of financial assets shall be utilized at derecognition due to uncollectibility or transfer of ownership.

In case of equity instruments objective evidence of impairment exists if the fair value is significantly or permanently lower than the cost of the instrument. “Significant” means generally 15% or more and “permanent” means more than 1 year.

NOTE 2 – ACCOUNTING POLICIES (continued)

Once interests are overdue for more than three months, the interest accruals are reversed and interest is recognized using the effective interest rate to discount the future cash flows for the purpose of measuring the impairment loss (unwinding).

2.4.6.1 Financial assets measured at amortised cost

The Group first assesses whether objective evidence of impairment exists for financial assets.

If there is objective evidence that an impairment loss on individually significant financial assets carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced through use of an allowance account. The amount of the loss shall be recognized in the consolidated income statement.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not the foreclosure is probable.

If there is objective evidence that an impairment loss on individually not significant financial assets at amortised cost has been incurred or no objective evidence of impairment exists, whether the asset is significant or not, the asset is included in a group of financial assets with similar credit risk characteristics and that group of financial assets is assessed collectively for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.

For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of the Group's internal credit grading system that considers credit risk characteristics such as asset type, industry, geographical location, collateral type, past-due status and other relevant factors.

Impairment on a group of financial assets that are evaluated collectively for impairment is estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is applied on current observable data to reflect the effect of current conditions not existing in the past.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed. Any subsequent reversal of an impairment loss is recognized in the consolidated income statement, to the extent that the carrying value of the asset does not exceed its amortised cost at the reversal date.

When a loan is uncollectible, it is written off against the related allowance for loan impairment. Such loans are written off after all necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of allowance for loan impairment in the consolidated income statement.

2.4.6.2 Available-for-sale financial assets

If an available-for-sale asset is impaired, an amount comprising the difference between its cost (net of any principal payment and amortisation) and its current fair value, less any impairment loss previously recognized in the consolidated income statement, is transferred from equity to the consolidated income statement. Reversals in respect of equity instruments classified as available-for-sale are not recognized in the consolidated income statement. Reversals of impairment losses on debt instruments are reversed through the consolidated income statement if the increase in fair value of the instrument can be objectively related to an event occurring after the impairment loss were recognized in the consolidated income statement.

Interest continues to be accrued at the original effective interest rate on the reduced carrying amount of the asset and is recorded as part of the interest income.

NOTE 2 – ACCOUNTING POLICIES (continued)

2.4.6.3 Renegotiated loans

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

The Group considers a loan (receivable) renegotiated if the loan or credit arrangements are renegotiated, rescheduled (prolonged) and renegotiated upon the debtor's or the financial institution's initiative, within the framework of the amendment of the underlying contract, where the underlying contract is amended with a view to avoiding default because of the considerable deterioration in the financial condition or solvency of the borrower, on account of which he is unable to meet the obligations of repayment as originally contracted.

Such amendments result in significant changes in the terms and conditions of the underlying contract, bringing considerably more favourable terms for the client - by way of derogation from the market conditions pertaining to contracts of the same type bearing similar terms and conditions.

The amendments are representing, among others, the deferral of repayments (interest and/or principal) temporarily for a specific period (grace period), payment by instalments, modification of interest rates (for example repricing in the form of discount rates), capitalization of interest, changing the type of currency of denomination, extending the term of the loan, rescheduling instalment payments, reducing the level of collateralization or the level of security requested, or allowing other form of collateral or security, waiving the collateral or security requirement (non-collateralization), introducing new contract terms and conditions or eliminating certain existing terms and conditions.

Furthermore a supplementary agreement or a new contract may be concluded between the debtor and the Group, or between the borrower and an affiliate of the original lender, for a new loan for refinancing the debts (interest and principal) outstanding on account of the existing contract, or for undertaking additional commitments with a view to avoiding any further increase in risk exposure or to cutting losses, upon which the claims of the Group (including the financial institution participating as the affiliate of the original lender) arising on account of the aforesaid supplementary agreement or new contract are also recognized as renegotiated loans (receivables).

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

Derecognition of renegotiated loans

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

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

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

NOTE 2 – ACCOUNTING POLICIES (continued)

2.4.7 Offsetting

Financial assets and financial liabilities are only offset and the net amount reported in the consolidated statement of financial position when there is a legally enforceable right to set off the recognized amounts and the Group intends to either settle on a net basis, or to realise the asset and settle the liability simultaneously.

2.4.8 Derecognition of financial assets

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognized where:

- the rights to receive cash flows from the asset have expired; or
- the Group has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement; and
- either (a) the Group has transferred substantially all the risks and rewards of the asset, or (b) the Group has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

When the Group has transferred its rights to receive cash flows from an asset or has entered into a pass-through arrangement, and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognized to the extent of the Group's continuing involvement in the asset. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Group could be required to repay.

2.4.9 Derecognition of financial liabilities

A financial liability is derecognized when the obligation under the liability is discharged or cancelled or expires. Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognized in the consolidated income statement.

2.4.10 Leases

Determination of whether an arrangement contains a lease

The determination of whether an arrangement is, or contains a lease is based on the substance of the arrangement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset.

2.4.10.1 Where the Group is the lessee

Finance leases, which effectively transfer to the Group substantially all the risks and benefits incidental to ownership of the leased item, are capitalized at the present value of the minimum lease payments at the inception of the lease term. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income in the consolidated income statement.

Capitalized leased assets are depreciated over the shorter of the estimated useful life of the asset and the lease term.

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

NOTE 2 – ACCOUNTING POLICIES (continued)

2.4.10.2 Where the Group is the lessor

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

Lease income is recognized over the term of the lease so as to achieve a constant rate of interest on the remaining balance of the receivable.

Assets subject to operating leases are included in bank premises and equipment in the consolidated statement of financial position and lease payments received are presented as income in the consolidated income statement.

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

2.4.11 Revenue recognition

Interest income and fees related to financial instruments are recognized as part of the effective interest of the instrument, other fees (related to transactions and provided or rendered services) receivable or payable are recognized when earned, i.e. at completion of the transaction or after performing the service. Dividend income is recognized when the right to receive payment is established.

2.4.12 Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange

Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange include net realised gains from buying and selling financial assets and financial liabilities at fair value excluding available-for-sale investments, changes in their fair value and the effect of foreign currency translation.

2.4.13 Cash and cash equivalents

For the purposes of reporting cash flows, cash and cash equivalents comprise balances with an original maturity less than 90 days, including cash, balances due from banks and balances with the National Bank of Hungary (including obligatory reserves) decreased with deposits from banks repayable on demand.

2.4.14 Investment property

Real estate, received in debt settlement is classified as investment property. The investment property is measured initially at cost, including transaction costs, and subsequently measured at cost less any accumulated depreciation and any accumulated impairment losses. It is depreciated according to the straight-line method over the economic life of the investment property concerned. The useful life of investment properties is 33 years.

NOTE 2 – ACCOUNTING POLICIES (continued)

2.4.15 Bank premises and equipment

Bank premises and equipment are initially recorded at cost. Depreciation is provided on a straight-line basis over the estimated useful lives of bank premises and equipment, other than freehold land which is deemed to have an indefinite life. The useful lives of bank premises and equipment are presented below:

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

Replacements and improvements, which prolong the useful life or significantly improve the condition of the asset, are capitalized. Repairs and maintenance are charged to the consolidated income statement as incurred. The Group assesses at each reporting date whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

2.4.16 Intangible assets

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

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Typically the staff expenses and the cost related to the infrastructure needed for the software development are directly attributable to the internally generated software.

The useful lives of intangible assets are assessed to be either finite or indefinite. Intangible assets with finite lives are amortised over the useful economic life; the amortisation expense is recorded as operating expense in the consolidated income statements. The impairment assessment of intangible assets with finite lives is the same as tangible assets. The intangible assets owned by the Group are classified as assets with finite lives.

Intangible assets are stated at cost less accumulated amortisation. Amortisation is computed using the straight-line method over the estimated useful lives of the assets:

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

Core systems are types of standard software, which are back-end data applications for processing all transactions that have occurred during the day and generating postings. Core systems typically include current account, deposit and credit processing applications, interfaces to the general ledger and reporting tools.

According to the accounting policies of the Group
- licences, system software and standard software are capitalized;
- customized and internally generated software are capitalized only if the development costs of that exceed a certain amount. In 2015 and 2016 this threshold was HUF 120 million. Below this threshold the development cost are expensed when they occur.

NOTE 2 – ACCOUNTING POLICIES (continued)

By 'customized software' is meant purchased software and software models that are customized before being delivered or taken into use, with software having been developed in addition to existing standard software.

2.4.17 Commitments, contingent liabilities

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

Financial guarantees are initially recognized in the consolidated financial statement at fair value, in 'Other liabilities', being the premium received. Subsequent to initial recognition, the Group liability under each guarantee is measured at the higher of the amortised premium and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee.

Any increase in the liability relating to financial guarantees is taken to the consolidated income statement in 'Impairment on loans and receivables' including provisions for credit commitments. The premium received is recognized in the consolidated income statement in 'Net fee and commission income' on a straight line basis over the life of the guarantee.

Taking into account that IAS 39 and IAS 37 do not contain specific requirements related to the accounting treatment of commitments for issuing non-financial guarantees, the Group treats them in the same way as financial guarantees.

The allowance for losses on commitments and contingent liabilities reflects Management's best estimate of incurred losses on this portfolio. Management determines the adequacy of the allowance based upon reviews of individual items, recent loss experience, current economic conditions, the risk characteristics of the various categories of transactions and other pertinent factors.

2.4.18 Provisions

Provisions are recognized when the Group has a present obligation (legal or constructive) as a result of a past event, and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Any compensation that arises in relation to provisions for operational losses from claims and legal disputes regarding commercial activity are presented in other net income / (expense) when they become virtually certain.

2.4.19 Taxation

Current taxation is provided for in accordance with the fiscal regulations of Hungary.

Deferred taxation is provided using the liability method on all temporary differences at the reporting date. It is calculated at the tax rates that are expected to apply to the period when it is anticipated that the asset will be realised or the liabilities will be settled, and it is based on tax rates (and laws) that have been enacted or substantively enacted at the statement of financial position date.

2.4.20 Fiduciary assets

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

2.4.21 Dividend on ordinary shares

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

NOTE 2 – ACCOUNTING POLICIES (continued)

2.4.22 Equity reserves

The reserves recorded in equity on the Group's consolidated statement of financial position include:

Available-for-sale reserve which comprises changes in fair value of available-for-sale investments.

Cash flow hedge reserve which comprises the portion of the gain or loss on a hedging instrument in a cash flow hedge that is determined to be an effective hedge.

Statutory risk reserve which is set aside as 10% of the profit calculated in accordance with Hungarian Accounting standards for use against future losses.

2.4.23 Share based payment transactions

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

2.4.24 Defined benefit plans

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

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

2.4.25 Government grants

Government grants are assistance by government in the form of transfers of resources to the Group in return for past or future compliance with certain conditions relating to the operating activities of the entity.
A government grant is not recognised until there is reasonable assurance that the Group will comply with the conditions attaching to it, and that the grant will be received. Government grants are recognised in profit or loss on a systematic basis over the periods in which the Group recognises as expenses the related costs for which the grants are intended to compensate.

Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset. The Group applies the deferred income (gross) presentation method. (More information related to the recognised result on government grants in 2016 see Note 5.)

2.5 Future changes in accounting policies

IASs, IFRSs and IFRIC interpretations not yet effective

The Group has not applied the following IASs, IFRSs and Interpretations of the International Financial Reporting Interpretations Committee (IFRIC) that have been issued but are not yet effective:

NOTE 2 – ACCOUNTING POLICIES (continued)

IFRS 9 Financial Instruments (new)

Introduction

In July 2014, the IASB issued IFRS 9 (Financial Instruments) on the classification and measurement of financial instruments, as a replacement for the relevant requirements of the present IAS 39 (Financial Instruments: Recognition and Measurement). The mandatory effective date for IFRS 9 is 1 January 2018. A project relating to IFRS 9 has been running for some time both at KBC Group and at K&H Group level. In 2016, it moved from the design phase to the implementation phase, which will continue in 2017. The project is structured around two pillars, namely 'Classification & measurement' and 'Impairment', as well as a common work stream relating to the impact on reporting and disclosures.

The Group currently expects to use transition relief as regards disclosing comparative information at the date of initial application, but will probably provide certain pro forma comparative figures for significant items.

Classification & measurement

Classification and measurement of financial assets under IFRS 9 will depend on the specific business model in place and the assets' contractual cash flow characteristics. The project is at the stage where all the business models have been identified, analysed and documented. The characteristics of the contractual cash flows have been analysed to a large extent as well. Based on current market conditions, regulations, interpretation, assumptions and policies, the impact of first-time application is currently expected to be limited (subject to an audit review) and would be reflected primarily as the reversal of frozen available-for-sale reserves. These frozen reserves existed under IAS 39 due to historical reclassifications out of the 'Available-for-sale' category to the 'Held-to-maturity', but need to be reversed on transition to IFRS 9.

For financial liabilities, IFRS 9 changes the presentation of gains and losses on own credit risk for financial instruments designated at fair value through profit or loss. The Group will early adopt this aspect of IFRS 9 with effect from 1 January 2017 and the gains and losses on own credit risk will then go through other comprehensive income. The impact of early adoption is expected to be minimal given the current limited effect of own credit risk.

Impairment of financial assets

In 2016, work continued on fine-tuning IFRS 9-compliant impairment policies and modelling guidelines. Several IFRS 9 models have already been built based on existing Basel models and implementing them into the calculation engine is ongoing.

Financial assets that are subject to impairment will be classified into three stages:

- Stage 1: Performing
- Stage 2: Underperforming
- Stage 3: Non-performing or impaired

KBC Group has established policies and processes to assess whether credit risk has increased significantly at the end of each reporting period and, therefore, whether 'staging' is required (i.e. moving from one stage to another). The Group adopts these policies and processes. For the loan portfolio, a multi-tier approach has been adopted to staging, based on internal credit ratings, forbearance measures, collective assessment and days past due as a backstop. A similar multi-tier approach will be used for the investment portfolio, except that the Group intends to use the low-credit-risk exemption, meaning that all bonds in scope with a PD of 1 to 3 are considered to be in 'Stage 1', unless any of the other triggers indicate otherwise.

For 'Stage 1' and 'Stage 2' – under IAS 39 – the Group records incurred-but-not-reported (IBNR) impairment losses, which are influenced by emergence periods. Under IFRS 9, impairment of financial assets is calculated on a 12-month expected credit loss (ECL) basis for 'Stage 1' and on a lifetime ECL basis for 'Stage 2'. As a consequence, impairment levels are generally expected to increase. The Group does not expect any major impact on 'Stage 3'.

NOTE 2 – ACCOUNTING POLICIES (continued)

Forward looking information is incorporated into the staging criteria and measurement of ECL. Different macroeconomic factors are taken into consideration and the Group is currently considering more scenarios to evaluate a range of possible outcomes.

The impact of first time application depends on the regulatory framework and economic conditions at that time, as well as the composition of the portfolios.
Impairment levels under IFRS 9 will differ from current prudential requirements because of: (i) application of a through-the-cycle estimate for prudential purposes as opposed to a point-in-time estimate under IFRS 9; (ii) application of a 12-month PD for prudential purposes as opposed to a lifetime PD under IFRS 9 (for 'Stage 2' and 'Stage 3'); and (iii) inclusion of prudential floors and downturn adjustments in the PD, EAD and LGD estimates for prudential purposes.

Hedge accounting

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

IFRS 15 Revenue from Contracts with Customers (new)

In May 2014, the IASB issued IFRS 15 (Revenue from Contracts with Customers) concerning the recognition of revenue. IFRS 15 specifies how and when an IFRS reporter will recognise revenue as well as requiring such entities to provide users of financial statements with more informative, relevant disclosures.

IFRS 15 applies to an annual reporting period beginning on or after 1 January 2018. Early application is permitted. No major impact is expected.

The Group will apply this standard when it becomes mandatory.

IFRS 16 Leases (new)

IFRS 16 is a new standard dealing with the accounting for leases. IFRS 16 reflects the IASB's work on the replacement of IAS 17.

Under IFRS 16 a lessee recognises a right-of-use asset and a lease liability. The right-of-use asset is treated similarly to other non-financial assets and depreciated accordingly. This will typically produce a front-loaded expense profile as an assumed linear depreciation of the right-of-use asset and the decreasing interest on the liability will lead to an overall decrease of expense over the reporting period.

The lease liability is initially measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease.

For finance leases a lessor recognises finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the net investment. A lessor recognises operating lease payments as income on a straight-line basis.

The new standard does not significantly change the accounting for leases for lessors, hence the accounting impact is expected to be limited for the Group.

IFRS 16 applies to an annual reporting period beginning on or after 1 January 2019. Early application is permitted if IFRS 15 has also been applied.

The Group will apply this standard when it becomes mandatory.

NOTE 2 – ACCOUNTING POLICIES (continued)

Other
The IASB published several limited amendments to existing IFRSs in the course of 2016. They will be applied when they become mandatory, but their impact is currently estimated to be negligible.

The list of the referred amendments is as follows:

- Recognition of Deferred Tax Assets for Unrealised Losses - Amendments to IAS 12
  Effective date: 1 January 2017

- Disclosure Initiative - Amendments to IAS 7
  Effective date: 1 January 2017

- Amendments to IFRS 2, Share-based Payment
  Effective date: 1 January 2018

- Annual Improvements to IFRSs 2014-2016 cycle
  Effective date: 1 January 2017 for amendments to IFRS 12, 1 January 2018 for amendments to IFRS 1 and IAS 28

- IFRIC 22 - Foreign Currency Transactions and Advance Consideration
  Effective date: 1 January 2018

- Transfers of Investment Property - Amendments to IAS 40
  Effective date: 1 January 2018

2.6 Taxes and levies payable by financial institutions

Credit institutions and financial institutions are exposed to pay the so called “bank tax” introduced in 2010 in Hungary (see Note 10).

The actual bank tax and its reversal (if any) are recorded as expense in the financial period in which it is legally payable.

As the bank tax is payable based on non-net income measures it does not meet the definition of income tax under IFRS and is therefore presented as an operating expense in the consolidated income statement.

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

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

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

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

NOTE 2 – ACCOUNTING POLICIES (continued)

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

2.7 Reclassification and restatement

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

The restated notes are the following:

- Note 3 Net interest income
- Note 14 Income tax
- Note 15 Earnings/(Loss) per share
- Note 28 Other assets
- Note 29 Deferred tax assets and deferred tax liabilities
- Note 35 Other liabilities

Reclassifications

The reclassified notes are the following:

- Note 4 Net fee and commission income
- Note 11 Average number of personnel

Defined benefit plan

The recognition of certain collective benefit agreements were reconsidered in the Consolidated Financial Statements (see Note 40). The comparative figures were restated.

	Previously reported as at 1 January 2015	Restatement	Restated as at 1 January 2015
	MHUF	MHUF	MHUF
Consolidated statement of financial position			
Assets			
Deferred tax assets	11 774	190	11 964
Total liabilities and equity			
Other liabilities	31 769	998	32 767
Total equity	179 716	(808)	178 908

NOTE 2 – ACCOUNTING POLICIES (continued)

	Previously reported as at 31 December 2015	Restatement	Restated as at 31 December 2015
	MHUF	MHUF	MHUF
Consolidated statement of financial position			
Assets			
Deferred tax assets	5 900	199	6 099
Total liabilities and equity			
Other liabilities	63 771	1 047	64 818
Total equity	221 387	(848)	220 539
Consolidated income statement			
Interest expense	(27 924)	(49)	(27 973)
Income tax expense	(9 672)	9	(9 663)

Management believes the above restatements relating to 2015 are immaterial to the consolidated financial statements taken as a whole.

2.8 Change in estimate

The Group has started to recognise portfolio-based impairment on exposures related to the Hungarian government and the National Bank of Hungary in 2016.

NOTE 3 – NET INTEREST INCOME

	2016 MHUF	Restated 2015 MHUF
Loans and receivables	57 225	63 685
Held to maturity	20 921	24 855
Available-for-sale assets	6 528	5 969
Subtotal, interest income from financial assets not measured at fair value through profit or loss	84 674	94 509
Financial assets held for trading	2 120	2 002
Asset/liability management derivatives	832	1 312
Hedging derivatives	5 763	3 907
Other financial assets at fair value through profit or loss	-	77
Total interest income	93 389	101 807
Financial liabilities measured at amortised cost	(12 963)	(16 953)
Other liabilities not measured at fair value through profit or loss	(17)	(108)
Subtotal, interest income from financial assets not measured at fair value through profit or loss	(12 980)	(17 061)
Financial liabilities held for trading	(24)	(64)
Asset/liability management derivatives	(773)	(1 595)
Hedging derivatives	(2 804)	(1 532)
Other financial liabilities at fair value through profit or loss	(6 755)	(7 672)
Interest expense of defined benefit plans	(31)	(49)
Total interest expenses	(23 367)	(27 973)
Net interest income	70 022	73 834

The Group recorded HUF 183 million interest income (unwinding discount effect) on impaired assets in 2016 (HUF 376 million in 2015).

NOTE 4 – NET FEE AND COMMISSION INCOME

	2016	Reclassified 2015
	MHUF	MHUF
Brokerage services	1 708	1 184
Trust and fiduciary activities	12 037	14 468
Credit and guarantee fee income	3 243	3 216
Structured finance	269	259
Payment services	39 977	39 897
Card services	10 654	9 790
Other	1 808	1 129
Fee and commission income	69 696	69 943
Brokerage services	(1 667)	(1 631)
Credit and guarantee fee expense	(1 867)	(2 030)
Commissions to agents	(205)	(112)
Structured finance	-	(107)
Payment transactions	(5 295)	(5 005)
Card services	(5 346)	(6 872)
Insurance commissions	(2 558)	(1 923)
Other	(116)	(6)
Fee and commission expense	(17 054)	(17 686)
Net fee and commission income	52 642	52 257

Front-end fees related to loans and receivables are part of the effective interest rate method calculation and are recorded as interest income or expenses over the life of the underlying loan or receivable.

NOTE 5 – NET GAINS / (LOSSES) FROM FINANCIAL INSTRUMENTS AT FAIR VALUE THROUGH PROFIT OR LOSS AND FROM FOREIGN EXCHANGE

	2016 MHUF	2015 MHUF
Trading securities	1 313	151
Interest rate derivatives (including interest and fair value changes in trading derivatives)	3 825	2 169
Other financial instruments designated at fair value through profit or loss at initial recognition	31	856
Foreign exchange trading (including interest and fair value changes in trading foreign exchange derivatives)	15 903	14 328
Fair value adjustments in hedge accounting*	(172)	281
Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange	20 900	17 785

*Results of cash flow hedge derivatives transferred from Consolidated other comprehensive income to the Consolidated income statement amounted to HUF 100 million gain in 2016 (HUF 675 million gain in 2015) and HUF 272 million loss was recorded as the unrealised revaluation of the ineffective cash flow hedge transactions (HUF 394 million loss in 2015).

The changes in the fair value of financial liabilities designated at fair value through profit or loss attributable to credit risk amounted to HUF 8 million loss in 2016 (HUF 113 million loss in 2015) and HUF 17 million gain as at 31 December 2016 cumulatively (HUF 25 million gain as at 31 December 2015).

The change in the fair value of financial instruments at fair value through profit or loss, where the fair value calculation is based on non-observable parameters was HUF 93 million gain in 2016 (HUF 5 million loss in 2015).

HUF 902 million income was accounted for in 2016 due to the lending activity related interest rate swap deals (HIRS) linked to the National Bank of Hungary's Market Lending Scheme (PHP).

NOTE 6 – NET REALISED GAINS FROM AVAILABLE-FOR-SALE

	2016 MHUF	2015 MHUF
Fixed-income securities	723	665
Shares	4 565	-
Net realised gains from available for sale	5 288	665

In 2016 Visa Inc. purchased Visa Europe. The up-front consideration consisted of two parts: cash component and preferred shares in Visa Inc.. Gain resulting from the sale is presented as net realised gains from available-for-sale shares.

NOTE 7 – DIVIDEND INCOME

The Group recognised HUF 2 million dividend income in 2016 (no dividend income was recognised in 2015). The dividend was paid by Visa Inc..

NOTE 8 – OTHER NET INCOME / (EXPENSE)

	2016	2015
	MHUF	MHUF
Gain on property, plant and equipment	177	317
Sale of goods	395	680
Gain/(loss) on the disposal of held-to -maturity debt instruments	374	139
Revenue on other services	314	453
Gain / (loss) due to operational risks	(418)	2 208
Provision for expected loss in relation to the Curia Act	-	(279)
Adjustment of carrying amount of loans and advances due to reestimation of future cash flows	13 739	15 142
Other	147	(530)
Other net income / (expense)	14 728	18 130

The income of HUF 314 million reported as revenue on other services in 2016 (HUF 453 million 2015) results from finance and accounting, business management, technical, logistics and bank security services granted by the Group to other KBC Group entities operating in Hungary, but not included in the consolidation.

In case of impaired loans and advances converted to HUF the subsequent increase in future cash-flow estimation due to credit quality improvement recorded as part of “Adjustment of carrying amount of loans and advances due to reestimation of future cash flows” within “Other net income / (expense)” resulted in a HUF 13 739 million gain in 2016 (10 440 million gain in 2015). The subsequent decrease in future cash-flow estimation due to credit quality worsening is recorded as part of impairments for all loans and receivables.

NOTE 9 – GENERAL ADMINISTRATIVE EXPENSES

	2016 MHUF	2015 MHUF
IT expenses	(8 711)	(9 642)
Rental expenses	(2 819)	(2 707)
Repair and maintenance	(1 311)	(1 150)
Marketing expenses	(1 460)	(1 532)
Professional fees	(2 818)	(2 196)
Other facilities expenses	(4 132)	(4 351)
Communication expenses	(274)	(214)
Travel expenses	(91)	(92)
Training expenses	(478)	(307)
Personnel related expenses	(217)	(260)
Financial transaction levy	(21 326)	(21 403)
Other administrative expenses	(4 755)	(3 955)
Other provision	3	423
Total general administrative expenses	(48 389)	(47 386)

NOTE 10 – BANK TAX

The Group paid a bank tax of HUF 7 557 million in 2016 (HUF 15 755 million in 2015). The basis and the tax rate of the tax payable by financial institutions can differ per group members, dependent on their activities.

The tables below present the details of the bank tax paid by the group members in 2016 and 2015.

2016	Activity	Tax base	Tax rate	Tax
		MHUF	%	MHUF
Group members:				
K&H Bank Zrt.	Credit institution	2 888 110	0.258*	7 443
K&H Befektetési Alapkezelő Zrt.	Asset management	211 992	0.050	114
Total		3 100 102	0.244	7 557

2015	Activity	Tax base	Tax rate	Tax
		MHUF	%	MHUF
Group members:				
K&H Bank Zrt.	Credit institution	2 888 110	0.542*	15 648
K&H Befektetési Alapkezelő Zrt.	Asset management	211 992	0.050	107
Total		3 100 102	0.508	15 755

*Effective rate

The bank tax payable by the Group members for the year 2016 is calculated as follows.

For credit institutions the tax base includes the total asset value as at 31 December 2009, less:

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

The bank tax for credit institutions is payable at 0.15% on tax base below HUF 50 000 million and 0.24% on tax base above HUF 50 000 million in 2016 (0.53% in 2015).

In case of asset management companies the base of the tax is the quarterly calculated average value (sum of daily net asset values divided by the number of days in the quarter) of the distributed fund units kept on the client accounts by the distributor (excluding the shares held by a fund of fund). The applied tax rate is 0.05% per year.

The bank tax for the Group is expected to be HUF 5 580 million in 2017 (including estimated amount for funds). The decrease of the bank tax expected in 2017 is caused by the change of the tax base and the tax rates. In 2017 the tax base of credit institutions is the total asset value as at 31 December 2015 adjusted by the above mentioned decreasing items. The tax rate of 0.24% applied on tax base above HUF 50 000 million until 31 December 2016 was changed to 0.21% in 2017.

For the Bank the liability of HUF 5 451 million is established on January 1, 2017.

NOTE 11 – AVERAGE NUMBER OF PERSONNEL AND STAFF EXPENSES

	2016	Reclassified 2015
White-collar staff	3 594	3 471
Blue-collar staff	26	29
Management	38	36
Total average number of persons employed	3 658	3 536

	2016	Restated 2015
Wages and salaries	24 227	22 041
Social security charges	7 831	7 433
Defined benefit plan	(562)	-
Share based payments	63	183
Other staff expenses	2 782	2 421
Total staff expenses	34 341	32 078

NOTE 12 – IMPAIRMENT (income statement)

	2016 MHUF	2015 MHUF
Impairments and provisions on loans and receivables and credit commitments		
Specific impairments for loans and receivables	(10 017)	(12 564)
Specific provisions on credit commitments	735	(1 515)
Portfolio-based impairments and provisions	148	1 791
Total impairments and provisions on loans and receivables and credit commitments	(9 134)	(12 288)

For more detailed information on changes in the impairment loss see Note 26.

	2016 MHUF	2015 MHUF
Impairment on other		
Intangible assets	(149)	(8)
Investment property	(7)	(11)
Property and equipment	(728)	(777)
Held-to-maturity assets	(69)	-
Other	(4)	(6)
Total impairment on other	(957)	(802)

NOTE 13 – SHARE IN THE RESULTS OF ASSOCIATED COMPANIES

The carrying amount of HAGE Zrt. amounted to HUF 542 million as at 31 December 2016 (and 2015). Management believes that this carrying amount best represents the Group's share in the investment. The share in result of HAGE is fully impaired in 2016 similarly to previous years. The impairment recorded on HAGE Zrt. was HUF 166 million in 2016 (HUF 26 million in 2015). The current year's result and the impairment of the associates are recorded net within the consolidated income statement as "Share in the results of associated companies". (For further information on the main financial figures of the associated companies see Note 30.)

NOTE 14 – INCOME TAXES

The components of income tax expense for the year ended 31 December 2016 and 2015 are:

	Notes	2016 MHUF	Restated 2015 MHUF
Statutory income tax expense		(5 013)	(1 376)
Statutory income tax from self-revision of prior years		1 134	(217)
Local business tax expense		(3 271)	(3 195)
Investment services tax		(1 215)	-
Deferred taxes on income	29	(7 969)	(4 875)
Income tax (expense) / benefit		(16 334)	(9 663)

Statutory income tax expense

In 2016 and 2015, corporate income tax is payable at 10% on yearly profits below a limit of HUF 500 million and 19% on profits above the limit.

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

Investment services tax was introduced in 2016 in Hungary. The tax is payable at 5.6% on the result of investment services.

There is no procedure for final agreement of tax assessments in Hungary. The tax authorities may examine the accounting records and revise assessments for up to five years after the period to which they relate. Consequently, the Group may be subject to further assessments in the event of an audit by the tax authorities. The corporate tax returns for the Bank have been reviewed and closed off by the taxation authorities for the years up to 2013 excluding 2011. Management is not aware of any additional significant non-accrued potential tax liability which might arise relating to years not audited by the tax authorities.

The Group recorded a HUF 5 128 million deferred tax asset in the previous year for the tax allowance arised in accordance with the Act on Settlements. The Group utilized the tax allowance in 2016.

NOTE 14 – INCOME TAXES (continued)

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

	2016 MHUF	Restated 2015 MHUF
Profit / (loss) before tax	55 211	47 535
Income tax rate	19.00%	19.00%
Income tax calculated	(10 490)	(9 032)
Plus/minus tax effects attributable to:		
Tax base decreasing items from permanent differences	425	1 629
Adjustments related to prior years	1 134	(217)
Adjustment on opening balance of deferred taxes due to change in tax rate	(2 988)	-
Unrecognised tax credit used to reduce current tax expense	106	-
Local taxes and investment services tax	(4 255)	(3 195)
Tax base increasing items from permanent differences	(263)	1 143
Other	(3)	-
Total tax effects	(5 844)	(640)
Income tax expense (income tax calculated + total tax effects)	(16 334)	(9 672)

The effective income tax rate for 2016 is 29.58% (2015: 20.35%).

Adjustment on opening balance of deferred taxes due to change in tax rate includes the impact of the approved decrease of the income tax rate in 2017 from 19% to 9%.

NOTE 15 – EARNINGS / (LOSS) PER SHARE

Earnings / (loss) per share is the profit attributable to shareholders of the Group divided by the weighted average number of shares outstanding during the period, excluding treasury shares. There were no other potentially dilutive securities in existence at 31 December 2016 and 2015. The following amounts were used in the calculation of earnings / (loss) per share:

	2016	Restated 2015
Net profit attributable to shareholders (MHUF)	38 877	37 823
Weighted average shares outstanding (in millions)	140 978	140 978
Earnings / (loss) per share in HUF (basic)	0.2757664	0.2682901

The figures of earnings / (loss) per share calculated for basic and diluted shares do not differ.

NOTE 16 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT

	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial assets as at 31 December 2016							
Loans and advances to central banks*	-	-	-	86 206	-	-	86 206
Loans and advances to credit institutions and investment firms**	-	-	-	521 250	-	-	521 250
Loans and advances to customers	-	-	-	1 179 522	-	-	1 179 522
Trading receivables	-	-	-	19 758	-	-	19 758
Consumer credit	-	-	-	24 568	-	-	24 568
Credit card	-	-	-	5 444	-	-	5 444
Mortgage loans	-	-	-	449 579	-	-	449 579
Term loans	-	-	-	548 111	-	-	548 111
Finance leasing	-	-	-	44 072	-	-	44 072
Current account advances	-	-	-	87 255	-	-	87 255
Other	-	-	-	735	-	-	735
Equity instruments	559	-	1 558	-	-	-	2 117
Debts instruments	54 450	-	191 552	16 068	426 237	-	688 307
issued by public bodies	54 450	-	191 552	1 176	426 237	-	673 415
issued by financial corporations	-	-	-	14 892	-	-	14 892
Derivatives	40 265	-	-	-	-	16 453	56 718
Total carrying value	95 274	-	193 110	1 803 046	426 237	16 453	2 534 120

Debt instruments issued by public bodies include Hungarian government and Hungarian municipality bonds.
*The maturity of loans and advances to central banks is less than 90 days.
**From the total balance of loans and advances to credit institutions and investment firms HUF 412 669 million is either repayable on demand or is maturing in less than 90 days. Loans and advances to credit institutions, investment firms and customers include reverse repo transactions of HUF 384 116 million.

NOTE 16 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial assets as at 31 December 2015							
Loans and advances to central banks*	-	-	-	523 338	-	-	523 338
Loans and advances to credit institutions and investment firms**	-	-	-	73 632	-	-	73 632
Loans and advances to customers	-	-	-	1 133 989	-	-	1 133 989
Trading receivables	-	-	-	20 740	-	-	20 740
Consumer credit	-	-	-	21 094	-	-	21 094
Credit card	-	-	-	4 884	-	-	4 884
Mortgage loans	-	-	-	432 627	-	-	432 627
Term loans	-	-	-	531 915	-	-	531 915
Finance leasing	-	-	-	36 981	-	-	36 981
Current account advances	-	-	-	84 910	-	-	84 910
Other	-	-	-	838	-	-	838
Equity instruments	1 013	-	4 995	-	-	-	6 008
Debts instruments	40 555	-	158 250	15 953	428 371	-	643 129
issued by public bodies	40 555	-	158 250	1 430	428 371	-	628 606
issued by financial corporations	-	-	-	14 523	-	-	14 523
Derivatives	40 167	-	-	-	-	11 023	51 190
Total carrying value	81 735	-	163 245	1 746 912	428 371	11 023	2 431 286

Debt instruments issued by public bodies include Hungarian government and Hungarian municipality bonds.
*The maturity of loans and advances to central banks is less than 90 days.
**From the total balance of loans and advances to credit institutions and investment firms HUF 1 908 million is either repayable on demand or is maturing in less than 90 days. Loans and advances to credit institutions, investment firms and customers include reverse repo transactions of HUF 13 413 million.

NOTE 16 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

	Held for trading	Designated at fair value through profit or loss	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF
Financial liabilities as at 31 December 2016					
Deposits from central banks	-	-	-	172 500	172 500
Deposits from credit institutions and investment firms*	-	-	-	136 921	136 921
Deposits from customers and debt certificates	-	200 131	-	1 968 161	2 168 292
Deposits from customers	-	191 512	-	1 939 968	2 131 480
Demand deposits	-	-	-	1 404 079	1 404 079
Time deposits	-	191 512	-	243 416	434 928
Savings deposits	-	-	-	292 473	292 473
Debt certificates	-	8 619	-	28 193	36 812
Certificates of deposits	-	-	-	236	236
Non-convertible bonds	-	8 619	-	-	8 619
Non-convertible subordinated liabilities	-	-	-	27 957	27 957
Derivatives	24 295	-	3 120	-	27 415
Short positions	4 626	-	-	-	4 626
In debt instruments	4 626	-	-	-	4 626
Other	2 885	-	-	333	3 218
Total carrying value	31 806	200 131	3 120	2 277 915	2 512 972

*Of which HUF 44 931 million is deposits from banks repayable on demand.

Deposits from credit institutions and investment firms includes repo transactions of HUF 1 035 million.

NOTE 16 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

	Held for trading	Designated at fair value through profit or loss	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF
Financial liabilities as at 31 December 2015					
Deposits from central banks	-	-	-	188 096	188 096
Deposits from credit institutions and investment firms*	-	-	-	161 666	161 666
Deposits from customers and debt certificates	-	216 315	-	1 684 182	1 900 497
Deposits from customers	-	209 820	-	1 655 800	1 865 620
Demand deposits	-	-	-	1 025 232	1 025 232
Time deposits	-	209 820	-	354 045	563 865
Savings deposits	-	-	-	276 523	276 523
Debt certificates	-	6 495	-	28 382	34 877
Certificates of deposits	-	-	-	241	241
Non-convertible bonds	-	6 495	-	-	6 495
Non-convertible subordinated liabilities	-	-	-	28 141	28 141
Derivatives	25 971	-	11	-	25 982
Short positions	9 888	-	-	-	9 888
In debt instruments	9 888	-	-	-	9 888
Other	-	-	-	725	725
Total carrying value	35 859	216 315	11	2 034 669	2 286 854

*Of which HUF 57 429 million is deposits from banks repayable on demand.

Deposits from credit institutions and investment firms includes repo transactions of HUF 5 456 million.

NOTE 16 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

Assets pledged as collateral for liabilities and contingent liabilities

	2016	2015
	MHUF	MHUF
Assets pledged for:		
Repo liabilities	1 006	5 407
Refinancing credits with EIB	11 213	34 892
Funding for Growth Scheme launched by MNB	182 600	196 500
Derivative transactions	7 915	14 738
Clearing transactions	110 021	53 865
Total assets pledged as collateral	312 755	305 402

For the terms and conditions of assets pledged as collateral for repo liabilities see Note 17.

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

Under clearing transactions securities pledged to ensure the safety of the Continuous Linked Settlement (CLS) system are presented.

Details of financial instruments

Equity and debt instruments

The breakdown of equity and debt instruments is presented in the tables below.

	2016	2015
	MHUF	MHUF
Held for trading		
Hungarian Treasury bills	14 543	558
Hungarian government bonds issued in HUF	28 843	38 545
Hungarian government bonds issued in foreign currency	11 064	1 452
Hungarian Listed equity instruments	559	551
Hungarian Unlisted equity instruments	-	462
Total held for trading securities	55 009	41 568

NOTE 16 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

	2016 MHUF	2015 MHUF
Available for sale		
Hungarian government bonds issued in HUF	169 485	147 437
Hungarian government bonds issued in foreign currency	22 067	10 813
Unlisted equity instruments	1 558	4 995
Total available for sale	193 110	163 245

Available-for-sale equity instruments contain as at 31 December 2016 unlisted equity instruments in a value of HUF 646 million (HUF 646 million at the end of 2015) for which a fair value cannot be measured reliably. These investments are not traded on active markets. Management believes that the carrying value of the investments held at cost approximates their fair value.

These available-for-sale investments contain long term investments in companies where the Group does not have significant influence. These participations are not consolidated as either a subsidiary or through equity consolidation.

Available-for-sale investments disclosed on their net carrying amount are:

	2016 MHUF	2015 MHUF
Garantiqa Hitelgarancia Zrt.	640	640
SWIFT S.C.	6	6
	646	646

The Group recorded HUF 2 781 million gain after tax in other comprehensive income as a result of the fair value revaluation of available-for-sale debt instruments in 2016 (HUF 689 million gain after tax in 2015).

The unrealised result of available-for-sale debt instruments is cumulatively HUF 11 948 million gain after tax as at 31 December 2016 (HUF 8 759 million gain as at 31 December 2015).

NOTE 16 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

	2016 MHUF	2015 MHUF
Loans and receivables		
Bonds issued by municipality – issued in HUF	1 176	1 430
Bonds issued by financial corporations in HUF	14 892	14 523
Total loans and receivables debt instruments	16 068	15 953

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

	2016 MHUF	2015 MHUF
Held to maturity		
Hungarian government bonds issued in foreign currency	15 347	34 216
Hungarian government bonds issued in HUF	410 890	394 155
Total held to maturity	426 237	428 371

Refinancing credits

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

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

At 31 December 2016, Management believes that the Bank is in compliance with all significant covenants. Refinancing credits are presented as financial liabilities at amortised cost in the consolidated statement of financial position.

NOTE 16 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND PRODUCT (continued)

	2016 MHUF	2015 MHUF
Refinancing credits in the frame of the Funding for Growth Scheme	172 500	188 096
Other refinancing credits	87 335	98 800
Total refinancing credits	259 835	286 896

Non-convertible subordinated liabilities

	2016 MHUF	2015 MHUF
Subordinated loan from KBC Group	27 957	28 141
	27 957	28 141

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

In September 2015 the Group agreed on an additional subordinated debt of EUR 30 million with KBC Bank N.V. with conditions of 10 years maturity and a variable interest rate of 3 month-EURIBOR plus 3.05 percent per annum.

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

NOTE 17 – TRANSFERRED FINANCIAL ASSETS

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

	2016		2015	
	Carrying amount of transferred asset MHUF	Carrying amount of associated liability MHUF	Carrying amount of transferred asset MHUF	Carrying amount of associated liability MHUF
Held-for-trading debt instruments	-	-	4 674	4 717
Held-to-maturity debt instruments	1 006	1 035	733	739
Total transferred assets and associated liabilities	1 006	1 035	5 407	5 456

NOTE 17 – TRANSFERRED FINANCIAL ASSETS (continued)

Repo and reverse repo agreements

Under reverse repo transactions, the Group obtains legal ownership of the respective collateral received and, thus, is permitted to utilise the collateral; however, the same collateral must be delivered back to the borrower of the funds on maturity, which generates a liability recorded as financial liability held at amortised cost in the consolidated financial position. The fair value of securities accepted as collateral in connection with reverse repo transactions as at 31 December 2016 was HUF 376 220 million, of which HUF 4 626 million (reported as short positions in the consolidated statement of financial position) has been sold (31 December 2015 HUF 13 233 million and HUF 9 888 million respectively).

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

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

NOTE 18 – RECLASSIFICATION OF FINANCIAL ASSETS

The Group reclassified foreign currency denominated municipality bonds from available-for-sale to the loans and receivables portfolio, in order to eliminate the volatility in equity caused by the fair value changes of the instruments. The bonds have met the definition of loans and receivables and the Group has had both the intention and ability to hold the asset for the foreseeable future or until maturity as at the date of the reclassification (as of 1 July 2011).

The carrying value and the fair value of the assets classified out of the available-for-sale portfolio and classified to the Loan and receivables portfolio amounted to HUF 49 376 million as at 1 July 2011.

The following tables present the bonds' carrying amount and their impact before income tax on the comprehensive income as they are recognised after reclassification in the Consolidated Financial Statements and as they would be recognised, if no reclassification had been done.

	After reclassification MHUF	Without reclassification MHUF
Carrying amount as at 31 December 2016	1 176	1 152
Available for sale reserve (before tax)	-	(26)
Income statement (before tax)	-	-

	After reclassification MHUF	Without reclassification MHUF
Carrying amount as at 31 December 2015	1 430	1 417
Available for sale reserve (before tax)	-	(12)
Income statement (before tax)	-	-

NOTE 18 – RECLASSIFICATION OF FINANCIAL ASSETS (continued)

The fair value gain that the Group would have recognised in other comprehensive income if the financial assets had not been reclassified amounted to HUF 14 million loss in 2016 (HUF 42 million gain in 2015).

The reclassified bonds are valued at amortised cost after reclassification, their fair value adjustment recognised in other comprehensive income and included in the carrying amount as at the date of reclassification is amortised to the Income Statement.

Without reclassification these bonds would be valued at fair value and the changes in the fair value would be recognised in other comprehensive income.

The Group expected the following cash flows from reclassified assets as at 1 July 2011:

	Expected cash flows
	MHUF
Less than three months	363
More than three months but not more than one year	1 513
More than one but not more than five years	21 294
More than five years	48 270
Total	71 440

The average effective interest rate of the bonds was 5.21% as at 1 July 2011.

NOTE 19 – OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES

The following tables present the financial assets and liabilities which are subject to enforceable master netting agreements as at 31 December 2016:

	Amounts presented in the statement of financial position			Amounts not set off in the statement of financial position			
	Gross amount of recognised financial assets	Gross amount of financial liabilities set off	Net amounts of financial assets	Financial instruments	Cash collateral received	Securities collateral received	Net amount
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Derivatives	56 718	-	56 718	22 939	25 475	-	8 304
Reverse repurchase agreements	384 116	-	384 116	-	-	376 210	7 906
Total financial assets subject to offsetting or master netting agreements	440 834	-	440 834	22 939	25 475	376 210	16 210

	Amounts presented in the statement of financial position			Amounts not set off in the statement of financial position			
	Gross amount of recognised financial liabilities	Gross amount of financial assets set off	Net amounts of financial liabilities	Financial instruments	Cash collateral pledged	Securities collateral pledged	Net amount
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Derivatives	27 415	-	27 415	22 939	1 027	107	3 342
Repurchase agreements	1 035	-	1 035	-	-	1 006	29
Total financial liabilities subject to offsetting or master netting agreements	28 450	-	28 450	22 939	1 027	1 113	3 371

NOTE 19 – OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES (continued)

The following tables present the financial assets and liabilities which are subject to enforceable master netting agreements as at 31 December 2015:

	Amounts presented in the statement of financial position			Amounts not set off in the statement of financial position			
	Gross amount of recognised financial assets	Gross amount of financial liabilities set off	Net amounts of financial assets	Financial instruments	Cash collateral received	Securities collateral received	Net amount
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Derivatives	51 190	-	51 190	21 573	14 311	-	15 306
Reverse repurchase agreements	13 413	-	13 413	-	-	13 233	180
Total financial assets subject to offsetting or master netting agreements	64 603	-	64 603	21 573	14 311	13 233	15 486

	Amounts presented in the statement of financial position			Amounts not set off in the statement of financial position			
	Gross amount of recognised financial liabilities	Gross amount of financial assets set off	Net amounts of financial liabilities	Financial instruments	Cash collateral pledged	Securities collateral pledged	Net amount
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Derivatives	25 982	-	25 982	21 573	2 811	11	1 587
Repurchase agreements	5 456	-	5 456	-	-	5 407	49
Total financial liabilities subject to offsetting or master netting agreements	31 438	-	31 438	21 573	2 811	5 418	1 636

NOTE 19 – OFFSETTING OF FINANCIAL ASSETS AND LIABILITIES (continued)

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

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

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

Securities collaterals received are not recorded in the consolidated statements of financial position. Securities collaterals pledged are recognised in the consolidated statements of financial position in the appropriate portfolio (and are presented as assets pledged as collateral for liabilities and contingent liabilities in Note 16).

NOTE 20 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES

The table below presents information concerning the fair value of financial assets and liabilities for year 2016:

	Fair value							
	Quoted market price (level 1)	Valuation techniques - observable inputs (level 2)	Valuation techniques - un-observable inputs (level 3)	Total fair value	Total carrying amount	Unrecognised gain/(loss)	Recognised in other comprehensive income: un-observable input	Recognised in profit or loss: un-observable inputs*
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Cash and cash balances with central banks	35 458	186 562	-	222 020	222 020	-	-	-
Financial assets	628 745	762 968	1 188 035	2 579 748	2 534 120	45 628	249	3 030
Held for trading	54 294	37 537	3 443	95 274	95 274	-	-	3 030
Designated at fair value through profit or loss	-	-	-	-	-	-	-	-
Available for sale	160 399	31 153	1 558	193 110	193 110	-	249	-
Loans and receivables	-	622 123	1 183 034	1 805 157	1 803 046	2 111	-	-
Held to maturity	414 052	55 702	-	469 754	426 237	43 517	-	-
Hedging derivatives	-	16 453	-	16 453	16 453	-	-	-
Total financial assets and cash and cash balances with central banks	664 203	949 530	1 188 035	2 801 768	2 756 140	45 628	249	3 030
Financial liabilities								
Held for trading	4 733	23 723	3 350	31 806	31 806	-	-	(2 937)
Designated at fair value through profit or loss	-	200 131	-	200 131	200 131	-	-	-
Measured at amortised cost	-	101 387	2 178 337	2 279 724	2 277 915	(1 809)	-	-
Hedging derivatives	-	3 120	-	3 120	3 120	-	-	-
Total financial liabilities	4 733	328 361	2 181 687	2 514 781	2 512 972	(1 809)	-	(2 937)

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

NOTE 20 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

The table below presents information concerning the fair value of financial assets and liabilities for year 2015:

	Fair value							
	Quoted market price (level 1)	Valuation techniques - observable inputs (level 2)	Valuation techniques - un-observable inputs (level 3)	Total fair value	Total carrying amount	Unrecognised gain/(loss)	Recognised in other comprehensive income: un-observable input	Recognised in profit or loss: un-observable inputs*
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Cash and cash balances with central banks	33 148	35 567	-	68 715	68 715	-	-	-
Financial assets	526 685	810 409	1 135 821	2 472 915	2 431 286	41 629	4 349	2 027
Held for trading	39 986	39 369	2 380	81 735	81 735	-	-	2 027
Designated at fair value through profit or loss	-	-	-	-	-	-	-	-
Available for sale	127 535	30 715	4 995	163 245	163 245	-	4 349	-
Loans and receivables	-	623 027	1 128 446	1 751 473	1 746 912	4 561	-	-
Held to maturity	359 164	106 275	-	465 439	428 371	37 068	-	-
Hedging derivatives	-	11 023	-	11 023	11 023	-	-	-
Total financial assets and cash and cash balances with central banks	559 833	845 976	1 135 821	2 541 630	2 500 001	41 629	4 349	2 027
Financial liabilities								
Held for trading	9 899	23 580	2 380	35 859	35 859	-	-	(2 032)
Designated at fair value through profit or loss	-	216 315	-	216 315	216 315	-	-	-
Measured at amortised cost	-	118 492	1 920 172	2 038 664	2 034 669	(3 995)	-	-
Hedging derivatives	-	11	-	11	11	-	-	-
Total financial liabilities	9 899	358 398	1 922 552	2 290 849	2 286 854	(3 995)	-	(2 032)

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

NOTE 20 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

Hungarian government bonds have quoted market price except for some treasury bills and bonds maturing within 3 months, which are valued based on BUBOR yield curve within 3 months maturity. In 2016 held-for-trading debt instruments in an amount of HUF 181 million were transferred from Quoted market price to Valuation techniques-market observable inputs category due to this change in valuation (HUF 50 million in 2015).

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

Financial assets	Held-for trading-derivatives	Government bonds at fair value through profit or loss	Available-for-sale equity instruments	Total
	MHUF	MHUF	MHUF	MHUF
Balance as at 31 December 2015	2 380	-	4 349	6 729
Net gains / (losses)				
In profit or loss	1 857	-	-	1 857
In other comprehensive income	-	-	249	249
Settlement	(794)	-	(4 598)	(5 392)
Balance as at 31 December 2016	3 443	-	-	3 443

NOTE 20 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

Financial assets	Held-for trading-derivatives	Government bonds at fair value through profit or loss	Available-for-sale equity instruments	Total
	MHUF	MHUF	MHUF	MHUF
Balance as at 31 December 2014	2 022	2 571	-	4 593
Net gains / (losses)				
In profit or loss	778	(127)	-	651
In other comprehensive income	-	-	4 349	4 349
Settlement	(420)	(2 444)	-	(2 864)
Balance as at 31 December 2015	2 380	-	4 349	6 729

Financial liabilities	Held-for-trading derivatives
	MHUF
Balance as at 31 December 2015	2 380
Net (gains) / losses	
In profit or loss	1 578
Settlement	(608)
Balance as at 31 December 2016	3 350

NOTE 20 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

Financial liabilities	**Held-for-trading derivatives**
	MHUF
Balance as at 31 December 2014	2 006
Net (gains) / losses	
In profit or loss	646
Settlement	(272)
Balance as at 31 December 2015	2 380

Fair value of financial instruments

Financial instruments at fair value

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

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

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

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

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

The Group provides exotic derivatives on back to back basis, accordingly immaterial result is recorded on held-for-trading exotic derivatives in the consolidated income statement.

NOTE 20 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

The calculation of the fair value of Visa Inc. preferred shares is based on the amount of shares the Group holds, the conversion rate to Visa Inc. listed shares, the Visa Inc. share price as listed on the New York Stock Exchange and the illiquidity discount.

The difference between the fair value and the transaction price of financial instruments not recognised in profit or loss as at the beginning and the end of the period was immaterial in 2016 and 2015.

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

Available-for-sale equity instruments held at cost

Available-for-sale equity instruments contain as at 31 December 2016 equity instruments in a value of HUF 646 million (HUF 646 million at the end of 2015) which fair value cannot be measured reliably.

Management believes that the carrying value of the investments held at cost approximates their fair value (for more information see Note 16).

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

Held-to-maturity instruments

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

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

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

Loans and receivables and financial liabilities measured at amortised cost

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

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

NOTE 20 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES (continued)

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

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

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

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

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

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

NOTE 21 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS

	2016	2015
	MHUF	MHUF
Financial liabilities designated at fair value through profit or loss		
Term deposits:		
- retail	3 060	7 432
- corporate	6 688	9 425
- investment funds	181 764	192 963
Other issued bonds	8 619	6 495
	200 131	216 315

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

NOTE 21 – FINANCIAL ASSETS AND FINANCIAL LIABILITIES DESIGNATED AT FAIR VALUE THROUGH PROFIT OR LOSS (continued)

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

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

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

The amount that the Group would contractually be required to pay at maturity is HUF 2 877 million higher than the fair value of the deposits and issued bonds (HUF 6 152 million higher in 2015).

NOTE 22 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND GEOGRAPHIC LOCATION

The Group's financial assets, and financial liabilities before taking into account any collateral held or other credit enhancements as at 31 December 2016 can be analysed by the following geographical regions.

	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial assets								
Hungary	66 748	-	192 192	1 291 199	426 237	-	-	1 976 376
EMU countries	26 501	-	6	491 391	-	15 276	-	533 174
East-European countries	81	-	-	3 156	-	-	-	3 237
Russia	-	-	-	5 848	-	-	-	5 848
Other European countries	1 944	-	-	3 658	-	1 177	-	6 779
Non-European countries	-	-	912	7 794	-	-	-	8 706
Total	95 274	-	193 110	1 803 046	426 237	16 453	-	2 534 120
Financial liabilities								
Hungary	14 405	199 755	-	-	-	-	2 114 018	2 328 178
EMU countries	15 558	-	-	-	-	2 552	143 370	161 480
East-European countries	47	376	-	-	-	-	4 412	4 835
Russia	-	-	-	-	-	-	4 685	4 685
Other European countries	1 796	-	-	-	-	568	6 767	9 131
Non-European countries	-	-	-	-	-	-	4 663	4 663
Total	31 806	200 131	-	-	-	3 120	2 277 915	2 512 972

NOTE 22 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND GEOGRAPHIC LOCATION (continued)

The geographical breakdown of financial assets and financial liabilities as at 31 December 2015 is presented below:

	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial assets								
Hungary	56 654	-	158 798	1 667 813	428 371	-	-	2 311 636
EMU countries	23 534	-	88	55 652	-	10 867	-	90 141
East-European countries	9	-	-	4 695	-	-	-	4 704
Russia	-	-	-	9 041	-	-	-	9 041
Other European countries	1 538	-	4 359	4 572	-	156	-	10 625
Non-European countries	-	-	-	5 139	-	-	-	5 139
Total	81 735	-	163 245	1 746 912	428 371	11 023	-	2 431 286
Financial liabilities								
Hungary	15 992	215 700	-	-	-	-	1 865 173	2 096 865
EMU countries	16 890	30	-	-	-	4	151 875	168 799
East-European countries	1 019	55	-	-	-	-	4 237	5 311
Russia	-	-	-	-	-	-	4 808	4 808
Other European countries	1 958	160	-	-	-	7	3 917	6 042
Non-European countries	-	370	-	-	-	-	4 659	5 029
Total	35 859	216 315	-	-	-	11	2 034 669	2 286 854

NOTE 23 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND QUALITY

Credit quality per class of financial assets

The table below presents the credit quality by asset classes as at 31 December 2016:

	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Performing assets	95 259	-	193 110	1 755 922	426 237	16 453	2 486 981
Non-performing assets	15	-	-	89 929	-	-	89 944
Impairment	-	-	-	(42 805)	-	-	(42 805)
Total carrying value	95 274	-	193 110	1 803 046	426 237	16 453	2 534 120

The credit quality of assets as at 31 December 2015 can be presented as follows:

	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Performing assets	81 634	-	163 245	1 676 155	428 371	11 023	2 360 428
Non-performing assets	101	-	-	120 984	-	-	121 085
Impairment	-	-	-	(50 227)	-	-	(50 227)
Total carrying value	81 735	-	163 245	1 746 912	428 371	11 023	2 431 286

NOTE 23 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

The balances of individually impaired financial assets and commitments and contingent liabilities as at 31 December 2016 are shown in the following table.

	Available-for-sale equity instruments	Loans and receivables	Commitments and contingent liabilities	Total
	MHUF	MHUF	MHUF	MHUF
Individually impaired assets	-	27 062	8 518	35 580
Individually assessed impairment	-	(19 616)	(1 978)	(21 594)
Total	-	7 446	6 540	13 986

The balance of individually impaired financial assets and commitments and contingent liabilities as at 31 December 2015 are presented in the table below.

	Available-for-sale equity instruments	Loans and receivables	Commitments and contingent liabilities	Total
	MHUF	MHUF	MHUF	MHUF
Individually impaired assets	-	32 412	12 345	44 757
Individually assessed impairment	-	(29 890)	(5 960)	(35 850)
Total	-	2 522	6 385	8 907

NOTE 23 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

Aging analysis of past due but not impaired loans per class of financial assets

Aging analysis of past due but not impaired financial assets as at 31 December 2016 is as follows:

	Less than 30 days MHUF	30 days or more, but less than 90 days MHUF	Total MHUF
Loans to customers			
- Corporate	6 338	271	6 609
- Retail	28 170	6 067	34 237
Total	34 508	6 338	40 846

Aging analysis of past due but not impaired financial assets as at 31 December 2015 is as follows:

	Less than 30 days MHUF	30 days or more, but less than 90 days MHUF	Total MHUF
Loans to customers			
- Corporate	2 675	297	2 972
- Retail	30 719	8 351	39 070
Total	33 394	8 648	42 042

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

Collaterals behind impaired or past due financial assets amounted to HUF 114 408 million as at 31 December 2016 (HUF 139 308 million as at 31 December 2015). The amount of the collaterals includes the indexed or reviewed collateral value limited to the carrying amount of the related asset.

NOTE 23 – FINANCIAL ASSETS AND LIABILITIES, BREAKDOWN BY PORTFOLIO AND QUALITY (continued)

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

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

	2016 MHUF	2015 MHUF
Debt instruments*	688 307	643 129
Loans and advances	2 008 999	1 799 674
Derivatives*	56 718	51 190
Other assets	14 943	18 790
Total assets	2 768 967	2 512 783
Commitments to extend credit	529 556	373 190
Guarantees	167 334	148 037
Letters of credit	9 031	11 752
Total commitments and contingent liabilities	705 921	532 979
Total credit exposure	3 474 888	3 045 762

*For more information see Note 16.

The amounts shown above represent the current credit risk exposure, which may change over time as a result of changes in values (derivative financial instruments, financial investments, etc.) and changes in FX rates (due to FCY lending). The effect of collateral and other risk mitigation techniques is shown in Note 45.4.

Risk concentration of the maximum exposure to credit risk

Concentration of risk is managed by client/client group and by industry sector. The maximum credit exposure to any client or counterparty as of 31 December 2016 was HUF 29 941 million (HUF 25 180 million as of 31 December 2015) before taking account of any collateral or other credit enhancements.

NOTE 24 – REMAINING MATURITY OF ASSETS AND LIABILITIES

The following table shows a breakdown of the financial assets and financial liabilities by expected maturity at 31 December 2016:

	<=1 year MHUF	1-5 year MHUF	>5 year MHUF	Without maturity MHUF	Total MHUF
Financial assets					
Held for trading	28 251	62 966	3 498	559	95 274
Designated at fair value through profit or loss	-	-	-	-	-
Available for sale	3 188	77 106	111 258	1 558	193 110
Loans and receivables	935 541	496 971	370 534	-	1 803 046
Held to maturity	50 120	167 532	208 585	-	426 237
Hedging derivatives	663	13 413	2 377	-	16 453
Total financial assets	1 017 763	817 988	696 252	2 117	2 534 120

	<=1 year MHUF	1-5 year MHUF	>5 year MHUF	Without maturity MHUF	Total MHUF
Financial liabilities					
Held for trading	15 328	15 978	500	-	31 806
Designated at fair value through profit or loss	92 855	106 989	287	-	200 131
Hedging derivatives	-	255	2 865	-	3 120
Measured at amortised cost	1 992 434	199 156	86 325	-	2 277 915
Fair value changes of hedged item under portfolio hedge of interest rate risk	6 185	-	-	-	6 185
Total financial liabilities	2 106 802	322 378	89 977	-	2 519 157
Commitments and contingent liabilities	708 156	-	-	-	708 156
Total financial liabilities, commitments and contingent liabilities	2 814 958	322 378	89 977	-	3 227 313

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

NOTE 24 –REMAINING MATURITY OF ASSETS AND LIABILITES (continued)

The following table shows a breakdown of the financial assets and financial liabilities by expected maturity at 31 December 2015:

	<=1 year MHUF	1-5 year MHUF	>5 year MHUF	Without maturity MHUF	Total MHUF
Financial assets					
Held for trading	14 626	47 898	18 198	1 013	81 735
Designated at fair value through profit or loss	-	-	-	-	-
Available for sale	2 880	69 664	85 706	4 995	163 245
Loans and receivables	938 844	437 980	370 088	-	1 746 912
Held to maturity	88 113	207 374	132 884	-	428 371
Hedging derivatives	60	5 678	5 285	-	11 023
Total financial assets	1 044 523	768 594	612 161	6 008	2 431 286

	<=1 year MHUF	1-5 year MHUF	>5 year MHUF	Without maturity MHUF	Total MHUF
Financial liabilities					
Held for trading	17 770	8 138	9 951	-	35 859
Designated at fair value through profit or loss	79 812	132 186	4 317	-	216 315
Hedging derivatives	-	7	4	-	11
Measured at amortised cost	1 703 785	241 003	89 881	-	2 034 669
Fair value changes of hedged item under portfolio hedge of interest rate risk	3 164	-	-	-	3 164
Total financial liabilities	1 804 531	381 334	104 153	-	2 290 018
Commitments and contingent liabilities	539 191	-	-	-	539 191
Total financial liabilities, commitments and contingent liabilities	2 343 722	381 334	104 153	-	2 829 209

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

NOTE 24 –REMAINING MATURITY OF ASSETS AND LIABILITES (continued)

The remaining maturity of non-financial assets and liabilities held as at 31 December 2016 is presented in the table below.

The depreciation of property and equipment and intangible assets and deferred tax assets expected to be recorded in 2017 are reported in the shorter than 1 year category in the table.

	< 1 year MHUF	> 1 year MHUF	Total MHUF
Tax assets	2 750	-	2 750
Investments in associated companies	-	542	542
Investment property	1 010	-	1 010
Property and equipment	7 240	31 012	38 252
Intangible assets	2 819	9 241	12 060
Other assets	14 943	-	14 943
Total assets	28 762	40 795	69 557
Tax liabilities	36	-	36
Provisions for risks and charges	2 330	107	2 437
Other liabilities	43 020	-	43 020
Total liabilities	45 386	107	45 493

The remaining maturity of non-financial assets and liabilities held as at 31 December 2015 is presented in the table below.

	< 1 year MHUF	> 1 year MHUF	Total MHUF
Tax assets	13 603	100	13 703
Investments in associated companies	-	542	542
Investment property	740	-	740
Property and equipment	4 926	32 531	37 457
Intangible assets	2 676	9 047	11 723
Other assets	18 790	-	18 790
Total assets	40 735	42 220	82 955
Tax liabilities	15	-	15
Provisions for risks and charges	7 292	473	7 765
Other liabilities	63 771	-	63 771
Total liabilities	71 078	473	71 551

The expected remaining maturity breakdown above represents the current and non-current classification of non-financial assets and liabilities with the exception of deferred tax, property and equipment and intangible assets which are non-current assets / liabilities in their entirety according to the standard.

NOTE 25 – IMPAIRMENT ON AVAILABLE-FOR-SALE FINANCIAL ASSETS

No impairment was recognised on available-for-sale assets in 2016 and 2015.

NOTE 26 – IMPAIRMENT ON LOANS AND RECEIVABLES AND PROVISION FOR CREDIT COMMITMENTS (statement of financial position)

	2016 MHUF	2015 MHUF
Breakdown by type		
Specific impairment for loans and receivables	39 317	46 666
Specific provision on credit commitments	1 978	5 960
Portfolio-based impairment and provision	3 745	3 813
Impairment and provision on loans and receivables and credit commitments	45 040	56 439

	2016 MHUF	2015 MHUF
Breakdown by counterparty		
Impairment for loans and advances to customers (excluding banks)	42 802	50 227
Impairment for debt instruments issued by municipalities	3	-
Specific and portfolio based provision, credit commitments	2 235	6 212
Total impairment and provision on loans and receivables and credit commitments	45 040	56 439

For the definitions of specific and portfolio based impairments and provisions see Impairment assessment in Note 45.4.

NOTE 26 – IMPAIRMENT ON LOANS AND RECEIVABLES AND PROVISION FOR CREDIT COMMITMENTS (statement of financial position - continued)

	Specific impairment for loans and receivables	Specific provision on credit commitments	Portfolio-based impairments and provisions	Total
	MHUF	MHUF	MHUF	MHUF
Opening balance as at 1 January 2016	46 666	5 960	3 813	56 439
Movements with an impact on results				
Loan loss expenses	21 225	479	7 613	29 317
Loan loss recoveries	(11 208)	(1 214)	(7 761)	(20 183)
Discount effect	(183)	14	-	(169)
Movements without an impact on results				
Write-offs	(17 248)	(3 212)	-	(20 460)
Other	65	(49)	80	96
Closing balance as at 31 December 2016	39 317	1 978	3 745	45 040

NOTE 26 – IMPAIRMENT ON LOANS AND RECEIVABLES AND PROVISION FOR CREDIT COMMITMENTS (statement of financial position - continued)

	Specific impairment for loans and receivables	Specific provision on credit commitments	Portfolio-based impairments and provisions	Total
	MHUF	MHUF	MHUF	MHUF
Opening balance as at 1 January 2015	115 438	4 465	5 385	125 288
Movements with an impact on results				
Loan loss expenses	36 183	2 702	9 841	48 726
Loan loss recoveries	(23 619)	(1 186)	(11 633)	(36 438)
Discount effect	(376)	7	-	(369)
Movements without an impact on results				
Write-offs	(18 874)	-	-	(18 874)
Other	(62 086)	(28)	220	(61 894)
Closing balance as at 31 December 2015	46 666	5 960	3 813	56 439

HUF 62 086 million other movement in specific impairments for loans and receivables relates mainly to loans converted to HUF according to the Curia Act representing the shift between the gross carrying amount and impairment at the conversion date.

The Group realised HUF 12 533 million loss and HUF 4 777 gain on loans and advances sold (HUF 19 829 million loss and HUF 12 631 million gain in 2015). The net loss was presented as write-offs in the tables above.

NOTE 27 – DERIVATIVE FINANCIAL INSTRUMENTS

	Year ended 31 December 2016				Year ended 31 December 2015			
	Notional amount Assets	Notional amount Liabilities	Positive fair value Assets	Negative fair value Liabilities	Notional amount Assets	Notional amount Liabilities	Positive fair value Assets	Negative fair value Liabilities
Derivatives held for trading	**MHUF**	**MHUF**	**MHUF**	**MHUF**	**MHUF**	**MHUF**	**MHUF**	**MHUF**
Foreign exchange derivatives								
Currency forwards	66 014	67 142	145	(1 095)	91 803	93 077	299	(1 079)
Currency futures	29 355	29 361	96	(107)	21 229	21 223	16	(11)
Currency swaps	280 544	280 633	1 441	(1 553)	448 177	448 455	1 538	(1 977)
Currency options	284 900	284 900	3 974	(3 934)	194 555	194 555	3 036	(3 110)
Total foreign exchange derivatives	660 813	662 036	5 656	(6 689)	755 764	757 310	4 889	(6 177)
Interest rate derivatives								
Interest rate swaps	687 075	687 074	33 586	(14 659)	525 241	525 241	32 016	(15 962)
Cross currency interest rate swaps	266 602	267 426	795	(2 715)	268 360	268 068	1 917	(2 456)
Interest rate options	8 228	8 228	36	(36)	51 730	51 730	299	(299)
Forward rate agreements	-	-	-	-	51 312	-	-	(29)
Total interest rate derivatives	961 905	962 728	34 417	(17 410)	896 643	845 039	34 232	(18 792)
Equity options	-	228	-	-		448		(2)
Commodity swaps	2 924	2 924	120	(124)	7 802	7 802	833	(833)
Commodity options	1 109	1 109	72	(72)	3 780	3 780	213	(213)
Total derivatives held for trading	1 626 751	1 629 025	40 265	(24 295)	1 663 989	1 614 379	40 167	(25 971)
Derivatives designated as cash flow hedges								
Interest rate swaps	110 606	110 606	7 838	(133)	86 878	86 878	6 482	-
Derivatives designated as portfolio fair value hedges								
Interest rate swaps	495 589	495 589	8 615	(2 987)	158 100	158 100	4 541	(11)
Total derivatives held for hedging	606 195	606 195	16 453	(3 120)	244 978	244 978	11 023	(11)
Total derivative financial instruments	2 232 946	2 235 220	56 718	(27 415)	1 908 967	1 859 357	51 190	(25 982)

NOTE 27 – DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Options

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

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

Cash flow hedge of interest rate risk

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

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

The Group transferred HUF 100 million gain to the net profit from other comprehensive income excluding the ineffective part (536 million gain in 2015). In 2016 the Group transferred HUF 272 million loss to the net profit due to ineffectiveness (HUF 313 million loss in 2015). The result of the transfers were recorded as Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange in the consolidated income statement.

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

	2016		2015	
	Expected cash flows		Expected cash flows	
	Inflow	Outflow	Inflow	Outflow
	MHUF	MHUF	MHUF	MHUF
< 3 months	226	(150)	208	(213)
3-6 months	258	-	206	(83)
6 months - 1 year	1 435	(32)	1 191	(276)
1-2 years	1 920	(228)	1 697	(557)
2-5 years	4 681	(1 890)	4 605	(2 324)
> 5 years	164	(157)	971	(572)
Total	8 684	(2 457)	8 878	(4 025)

Forecast transactions for which hedge accounting had previously been used but which is no longer expected to occur amounted to HUF 8 million as at 31 December 2016 (no transaction as at 31 December 2015).

NOTE 27 – DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Portfolio fair value hedge of interest rate risk

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

The accumulated fair value changes of hedged item under portfolio hedge of interest rate risk is presented separately in the consolidated statement of financial position and amounted to HUF 6 185 million loss in 2016 (HUF 3 164 million loss in 2015). The loss recorded on the hedged item was compensated by a gain recorded on the hedging instrument in the same amount. The fair value changes of the hedged item and the hedging instrument in the current year is recorded as Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange in the consolidated income statement.

Individual fair value hedge of fixed rate available-for-sale bonds

The Group usually ensures the sufficient level of liquid assets by purchase of available-for-sale government bonds. The Group defines the risk to be hedged as the interest rate risk arising from changes in fair value of available-for-sale bonds to changes in the risk-free (interest rate swap) yield curve. The hedging instruments are fixed rate payer-floating rate receiver (BUBOR 3M-6M) interest rate swaps.

The changes in the fair value of the available-for-sale government bonds and the interest rate swaps due to interest rate risk are offset in the consolidated income statement and the unhedged credit spread of the bonds remains in the consolidated other comprehensive income. The change in the fair value of the hedged instrument amounted to a gain of HUF 1 961 million in 2016 (a loss of HUF 110 million in 2015).

NOTE 28 – OTHER ASSETS

	2016	2015
	MHUF	MHUF
Prepayments	174	3 141
Trade receivables	656	649
Receivables from employees	4	15
Receivables from bankcard service	7 140	4 521
Items in transit due to payment services	1 013	550
Receivables from compensation	59	30
Items in transit due to trading in securities	50	53
Income accruals and cost prepayments	4 553	4 365
Inventories	695	4 916
Other receivables	599	550
	14 943	18 790

Trade receivables and receivables from bankcard and payment services are performing short term receivables without any delay. Other receivables include a HUF 307 million non-performing other claim due to retail clients (HUF 303 million in 2015) for which a HUF 254 million impairment charge is recorded in the consolidated income statement (HUF 254 million in 2015).

NOTE 29 – DEFERRED TAX ASSETS AND DEFERRED TAX LIABILITIES

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

For the period ended 31 December 2016:

	Assets MHUF	Liabilities MHUF	Income statement MHUF	Equity MHUF
Employee benefits	46	-	(153)	-
Losses carry forward	1	-	(25)	-
Tangibles and intangibles assets	634	-	(834)	-
Provision for expected loss in relation to the Curia Act and adjustment of carrying amount of loans and advances due to re-estimation of future cash flows	-	-	(5 128)	-
Other provisions for risk and charges and credit commitments	59	-	(92)	-
Impairment for losses on loans and advances	91	-	(113)	-
Financial instruments at fair value	1 849	-	(1 041)	-
Fair value adjustments AFS	(1 458)	-	-	1 714
Cash flow hedge	(603)	-	-	506
Other*	(269)	-	(583)	-
Total	350	-	(7 969)	2 220

For the period ended 31 December 2015:

	Restated Assets MHUF	Liabilities MHUF	Restated Income statement MHUF	Equity MHUF
Employee benefits	199	-	9	-
Losses carry forward	26	-	(75)	-
Tangibles and intangibles assets	1 468	-	(113)	-
Provision for expected loss in relation to the Curia Act and adjustment of carrying amount of loans and advances due to re-estimation of future cash flows	5 128	-	(4 246)	-
Other provisions for risk and charges and credit commitments	151	-	2 546	-
Impairment for losses on loans and advances	204	-	37	-
Financial instruments at fair value	2 890	-	344	-
Fair value adjustments AFS	(3 172)	-	-	(922)
Cash flow hedge	(1 109)	-	-	(68)
Other*	314	-	(3 377)	-
Total	6 099	-	(4 875)	(990)

*Other includes the deferred tax assets and liabilities resulting from the temporary differences between the Hungarian and International Accounting Standards related to the amortisation of loan origination fees, reversal of interest income of impaired assets, financial leases and different carrying amounts of securities.

NOTE 29 – DEFERRED TAX ASSETS AND DEFERRED TAX LIABILITIES (continued)

In 2016 based on the corporate income tax law applied from 1 January 2017 on, income taxes were calculated on all temporary differences under the asset and liability method using a tax rate of 9% or 10.82% (9% corporate income tax and 1.82% local business tax) (in 2015 20.62% consisting of 19% corporate income tax and 1.62% local business tax).
Deferred income tax for tax losses carried forward is calculated to the extent that realisation of the related tax benefit is assessed as probable. The tax benefit resulting from losses arising before 1 January 2015 can be realised for 10 years after the financial period they arose in. Losses carry forward from financial periods beginning on or after 1 January 2015 can be utilized for 5 years.

From the total of HUF 706 million tax losses carried forward as at 31 December 2016 (HUF 1 308 million at 31 December 2015), HUF 701 million (HUF 1 171 million at 31 December 2015) has been assessed as not being probable, and therefore was not included in the base of the deferred tax calculation. Tax loss carried forward for which the tax asset was recognised in the consolidated statement of financial position amounted to HUF 5 million as at 31 December 2016 (HUF 137 million as at 31 December 2015).

Based on the group members' financial plans management believes that the unused tax loss for which deferred tax asset was recorded in the consolidated income statement can be used as income tax base decreasing item in the future periods.

NOTE 30 – INVESTMENTS IN ASSOCIATED COMPANIES

	2016 MHUF	2015 MHUF
HAGE Zrt.	542	542
Total	542	542

	2016 MHUF	2015 MHUF
Opening balance	542	542
- Sale of investments	-	-
- Carrying value, transfers, liquidation	-	-
- Share in the result for the period	-	-
Closing balance	542	542

NOTE 30 – INVESTMENTS IN ASSOCIATED COMPANIES (continued)

The Group does not have any share of the contingent liabilities of its associates incurred jointly with other investor.

The table below includes the financial information of the associates as at 31 December 2016.

	Total assets MHUF	Revenue MHUF	Profit or loss MHUF
HAGE Zrt.	10 935	7 518	604

The table includes preliminary financial data for HAGE Zrt.

The table below includes the financial information of the associates as at 31 December 2015.

	Total assets MHUF	Revenue MHUF	Profit or loss MHUF
HAGE Zrt.	10 852	7 437	169

NOTE 31 – INVESTMENT PROPERTIES

	Investment properties MHUF
At 31 December 2014	
Cost	900
Accumulated depreciation	(50)
Net book value	850
Movements in 2015	
Additions	156
Disposals - net	(242)
Impairment charge	(11)
Depreciation charge	(13)
At 31 December 2015	
Cost	798
Accumulated depreciation	(58)
Net book value	740
Movements in 2016	
Additions	501
Disposals - net	(208)
Impairment charge	(7)
Depreciation charge	(16)
At 31 December 2016	
Cost	1 087
Accumulated depreciation	(77)
Net book value	1 010

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

NOTE 31 – INVESTMENT PROPERTIES (continued)

The difference between the fair value and the carrying amount of the assets is immaterial as at 31 December 2016 (and as at 31 December 2015).

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

NOTE 32 – PROPERTY AND EQUIPMENT

	Land and buildings	IT equipment	Office equipment	Other	Total
	MHUF	MHUF	MHUF	MHUF	MHUF
At 1 January 2015					
Cost	49 109	14 797	9 793	2 685	76 384
Accumulated depreciation	(16 523)	(11 402)	(7 764)	(1 371)	(37 060)
Net book value	32 586	3 395	2 029	1 314	39 324
Movements in 2015					
Additions (acquired separately)	1 923	404	558	566	3 451
Disposals - net	(17)	(1)	-	(330)	(348)
Impairment charge	(690)	(3)	(13)	(71)	(777)
Depreciation charge	(2 278)	(981)	(648)	(284)	(4 191)
Other	-	(2)	-	-	(2)
At 31 December 2015					
Cost	47 895	11 424	9 824	2 616	71 759
Accumulated depreciation	(16 371)	(8 612)	(7 898)	(1 421)	(34 302)
Net book value	31 524	2 812	1 926	1 195	37 457
Movements in 2016					
Additions (acquired separately)	1 537	3 071	850	925	6 383
Disposals - net	-	(2)	-	(226)	(228)
Impairment charge	(623)	(25)	(76)	(5)	(729)
Depreciation charge	(2 437)	(1 221)	(628)	(345)	(4 631)
At 31 December 2016					
Cost	47 439	12 485	9 266	2 581	71 771
Accumulated depreciation	(17 438)	(7 850)	(7 194)	(1 037)	(33 519)
Net book value	30 001	4 635	2 072	1 544	38 252

NOTE 32 – PROPERTY AND EQUIPMENT (continued)

Expenditure on items in the course of construction amounted to HUF 4 858 million as at 31 December 2016 (HUF 4 259 million as at 31 December 2015).

Fully amortised tangible assets which were still in use amounted to HUF 12 894 million as at 31 December 2016 (HUF 15 278 million as at 31 December 2015).

NOTE 33 – INTANGIBLE ASSETS

	Acquired software MHUF	Other intangible assets MHUF	Total MHUF
At 1 January 2015			
Cost	37 179	6	37 185
Accumulated depreciation	(27 133)	(4)	(27 137)
Net book value	10 046	2	10 048
Movements in 2015			
Additions (acquired separately)	4 368	-	4 368
Impairment charge	(8)	-	(8)
Depreciation charge	(2 685)	-	(2 685)
At 31 December 2015			
Cost	41 453	6	41 459
Accumulated depreciation	(29 732)	(4)	(29 736)
Net book value	11 721	2	11 723
Movements in 2016			
Additions (acquired separately)	3 798	-	3 798
Impairment charge	(149)	-	(149)
Depreciation charge	(3 362)	-	(3 362)
Other	50	-	50
At 31 December 2016			
Cost	41 359	6	41 365
Accumulated depreciation	(29 301)	(4)	(29 305)
Net book value	12 058	2	12 060

Fully amortised intangible assets which were still in use amounted to HUF 21 359 million as at 31 December 2016 (HUF 23 459 million as at 31 December 2015).

NOTE 34 – PROVISIONS FOR RISK AND CHARGES

	Provision for restructuring	Provision for tax litigation and pending legal disputes	Other	Total
	MHUF	MHUF	MHUF	MHUF
Balance as at 1 January 2015	55	32 585	15 950	48 590
Amounts allocated	-	1 002	713	1 715
Amounts used	(31)	(21 933)	(16 065)	(38 029)
Unused amounts reversed	-	(10 820)	(3)	(10 823)
Discount effect	-	100	-	100
Other (foreign exchange revaluation)	-	-	(1)	(1)
Balance as at 31 December 2015	24	934	594	1 552
Amounts allocated	-	93	1	94
Amounts used	(14)	(874)	(459)	(1 347)
Unused amounts reversed	-	(37)	(53)	(90)
Other (foreign exchange revaluation)	-	-	(7)	(7)
Balance as at 31 December 2016	10	116	76	202

The balance of Provision for tax litigation and pending legal disputes as at 31 December 2015 included a HUF 31 795 million provision for the Group's liability to clients as a result of the fraud that occurred at K&H Equities during and prior to 2003.

The loss realized by the Group amounted to HUF 21 802 million in 2015 presented as Amounts used in the table above. The remaining provision of HUF 10 094 million and the previously expected compensation amount of HUF 7 076 million were reversed in 2015 in other net income / (expense).

The K&H Group is also party to litigation and claims arising in the normal course of business, the provision of HUF 116 million from the total provision for losses from tax litigation and pending legal disputes at 31 December 2016 relates to these litigations (HUF 934 million at 31 December 2015). Management considers the provision raised for the still pending cases adequate to cover any remaining potential losses.

The major part of other provisions as at 1 January 2015 was recorded related to the Curia Act on the expected loss arising from the pay-offs due to loans matured before 31 December 2014. The total loss of the Curia Act realized in 2015 amounted to HUF 15 639 million in 2015 which is presented as Amounts used in the table above.

In accordance with the Supreme Court (Curia) ruling as of 16 December 2016, HUF 983 million reimbursement was transferred to the account of the Group by the Competition Office related to the previously determined and financially settled fine in 2017 (this event had no impact on the consolidated financial statements in 2016).

Provisions on credit commitments of HUF 2 235 million as at 31 December 2016 (HUF 6 213 million as at 31 December 2015) is presented in Note 26. The total of HUF 202 million provision for risk and charges and the total of HUF 2 235 million provisions for credit commitments amounts to HUF 2 437 million (HUF 7 765 million in 2015).

NOTE 35 – OTHER LIABILITIES

	2016	Restated 2015
	MHUF	MHUF
Trade creditors	6 897	11 522
Lease liabilities	504	510
Items in transit due to payment services	14 280	33 876
Items in transit due to lending activity	1 436	675
Liabilities from bankcard service	3 377	2 500
Other	16 526	15 735
Total other liabilities	43 020	64 818

Other liabilities include mainly short term liabilities.

Other includes trading tax liabilities, social charges, liability from transactional levy not settled yet, liabilities due to employees (see Note 40) and other accrued charges and deferred income arising from the normal course of business recorded as general administrative expenses in the consolidated income statement.

NOTE 36 – SHARE CAPITAL

	2016	2015
	MHUF	MHUF
Ordinary shares issued and outstanding	140 978	140 978

The nominal value of the ordinary shares issued and outstanding at 31 December 2016 is HUF 1 per share (31 December 2015: HUF 1).

NOTE 36 - SHARE CAPITAL (continued)

Shareholders of the Bank:

	2016 Shareholding %	2015 Shareholding %
KBC Bank N. V.	100.00%	100.00%
	100.00%	100.00%

NOTE 37 – COMMITMENTS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES

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

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

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

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

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

NOTE 37 – COMMITMENTS, CONTINGENT ASSETS AND CONTINGENT LIABILITIES (continued)

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

	2016 MHUF	2015 MHUF
Credit commitments – undrawn amount		
Received	9 546	25 069
Given		
Irrevocable	259 056	213 433
Revocable	270 939	160 091
Total given	529 995	373 524
Collaterals		
Given	169 082	153 748
Guarantees received/collateral		
For impaired and past due assets		
Non-financial assets	200 697	228 334
Financial assets	8 843	2 204
For assets that are not impaired or past due		
Non-financial assets	1 313 418	1 180 957
Financial assets	681 171	298 018
Total guarantees received/collateral	2 204 129	1 709 513
Other commitments given – irrevocable	9 079	11 920

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

The total of collateral received to mitigate the maximum exposure to credit risk (value of the collateral as described below limited to the carrying amount of the related asset) amounts to HUF 1 217 398 million as at 31 December 2016 (HUF 829 696 million as at 31 December 2015). Collaterals include the fair value for financial instruments. The collateral value of retail mortgages comprise the indexed property value calculated from the property value at loan origination revalued via house price index. Corporate non-financial collaterals are presented based on their periodically reviewed collateral value.

Given collaterals include non-financial guarantees in an amount of HUF 121 631 million in 2016 (HUF 111 971 million in 2015).

Legal claims

Litigation is a common occurrence in the banking industry due to the nature of the business. The Group has an established protocol of dealing with such legal claims. Once professional advice has been obtained and the amount of damages reasonably estimated, the Group makes adjustments to account for any adverse effects which the claims may have on its financial standing. At year-end the Group had several unresolved legal claims in the amount of HUF 1 231 million (HUF 5 192 million as at 31 December 2015) where the Group has been advised by its legal advisor that it is possible, but not probable, that the action will succeed. Accordingly no provision for these claims has been made in these consolidated financial statements.

NOTE 38 – FINANCE AND OPERATING LEASES

Lessor position

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

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

The following tables indicate the key amounts of the Group’s lease activity:

	2016	2015
	MHUF	MHUF
Finance lease receivables		
Total of gross investment in the lease, receivable:		
less than one year	16 517	15 968
one to five years	29 210	26 317
more than five years	2 745	5 709
	48 472	47 994
The present value of minimum lease payments receivables*:		
less than one year	14 098	12 244
one to five years	27 504	22 739
more than five years	2 471	1 998
	44 073	36 981
Unearned finance income	4 399	11 013
Contingent rents recognized as income - gross	1 033	1 143
Non-guaranteed residual values	6 127	11 896

*Net of impairment.

The total impairment recorded on finance lease receivables amounted to HUF 1 335 million as at 31 December 2016 (HUF 2 926 million as at 31 December 2015).

NOTE 38 – FINANCE AND OPERATING LEASES (continued)

The Group has car lease contracts with third parties that do not comply with the definition of a finance lease under IFRS, such contracts are treated as operating leases in the consolidated financial statements:

	2016 MHUF	2015 MHUF
Total of future minimum lease payments:		
less than one year	-	31
	-	31
Contingent rents recognised as income - gross	-	32

The net carrying amount of property and equipment held for operating lease purposes is presented as follows:

	2016 MHUF	2015 MHUF
Other equipment	467	1 668
Accumulated depreciation	-	59

Lessee position

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

	2016 MHUF	2015 MHUF
Total of future minimum lease payments under non-cancellable operating leases:		
less than one year	1 066	1 002
one to five years	8 063	7 595
more than five years	595	1 323
	9 724	9 920

	2016 MHUF	2015 MHUF
Minimum lease payments recognized as expense	3 407	3 732

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

Half of the future minimum lease payments results from the renewable agreement related to a part of the new headquarter building, which part is not owned by the Group.

NOTE 39 – RELATED PARTY TRANSACTIONS

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

Parent:

KBC Bank N.V. owns 100.00% of the ordinary shares in K&H Bank (2015: 100.00%). The ultimate parent of the Group is KBC Group N.V.

Subsidiaries:

See list of subsidiaries in Note 42.

Associates:

See list of associates in Note 42.

Members of KBC Group and other related parties:

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

Other related parties through key management

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

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

NOTE 39 - RELATED PARTY TRANSACTIONS (continued)

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

	Parent	Associ-ates	Other related parties (KBC Group)	Other related parties (through key management)	Total
	MHUF	MHUF	MHUF	MHUF	MHUF
As at 31 December 2016					
Assets					
Loans and advances	442 090	181	46 758	2 517	491 546
Current accounts	9 914	-	105	8	10 027
Term loans	432 176	181	46 653	2 509	481 519
Finance leases	-	-	-	-	-
Other receivables	-	-	492	-	492
Total assets	442 090	181	47 250	2 517	492 038
Liabilities					
Deposits	23 512	65	29 710	1 070	54 357
Current accounts	22 744	65	29 674	1 053	53 536
Term deposits (with agreed maturity)	768	-	36	17	821
Subordinated liabilities	27 957	-	-	-	27 957
Other liabilities	328	-	936	-	1 264
Total liabilities	51 797	65	30 646	1 070	83 578
Income statement					
Net interest income	(918)	9	(106)	113	(902)
Interest income	628	9	7	115	759
Interest expense	(1 546)	-	(113)	(2)	(1 661)
Net fee and commission income	(95)	4	926	39	874
Fee and commission income	368	4	2 294	45	2 711
Fee and commission expense	(463)	-	(1 368)	(6)	(1 837)
Other net income / (expense)	32	-	(2 742)	-	(2 710)
Other income	17	-	434	-	451
Other expense	15	-	(3 176)	-	(3 161)
Total income statement	(981)	13	(1 922)	152	(2 738)
Off-statement of financial position items					
Commitments and contingent liabilities	58 951	-	5 754	10	64 715
Guarantees received	24 441	-	-	-	24 441
Notional amount of derivatives	1 212 633	-	3 156	-	1 215 789

The table excludes the fair value of derivatives.

NOTE 39 - RELATED PARTY TRANSACTIONS (continued)

	Parent	Associ-ates	Other related parties (KBC Group)	Other related parties (through key management)	Total
	MHUF	MHUF	MHUF	MHUF	MHUF
As at 31 December 2015					
Assets					
Loans and advances	47 406	271	2 372	6 814	56 863
Current accounts	774	-	2 372	8	3 154
Term loans	46 632	271	-	6 806	53 709
Finance leases	-	-	-	-	-
Other receivables	13	-	627	-	640
Total assets	47 419	271	2 999	6 814	57 503
Liabilities					
Deposits	47 001	46	20 562	1 905	69 514
Current accounts	14 951	46	18 681	1 390	35 068
Term deposits (with agreed maturity)	32 050	-	1 881	515	34 446
Subordinated liabilities	28 141	-	-	-	28 141
Other liabilities	354	-	947	-	1 301
Total liabilities	75 496	46	21 509	1 905	98 956
Income statement					
Net interest income	(380)	14	(129)	189	(306)
Interest income	151	14	3	192	360
Interest expense	(531)	-	(132)	(3)	(666)
Net fee and commission income	(472)	4	628	303	463
Fee and commission income	365	4	2 300	359	3 028
Fee and commission expense	(837)	-	(1 672)	(56)	(2 565)
Other net income / (expense)	(96)	-	(3 198)	-	(3 294)
Other income	41	-	936	-	977
Other expense	(137)	-	(4 134)	-	(4 271)
Total income statement	(948)	18	(2 699)	492	(3 137)
Off-statement of financial position items					
Commitments and contingent liabilities	30 977	-	5 227	154	36 358
Guarantees received	23 126	-	-	252	23 378
Notional amount of derivatives	970 134	-	6 900	-	977 034

The table excludes the fair value of derivatives.

NOTE 39 - RELATED PARTY TRANSACTIONS (continued)

Transactions with key management

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

Loans

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

The outstanding amount of the housing loans of key management at 31 December 2016 was HUF 370 million (HUF 410 million at 31 December 2015), with the long-term maturity obligations ranging from 15-20 years.

Deposits

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

At 31 December 2016 the outstanding amount of deposits was HUF 606 million (HUF 659 million at 31 December 2015). In 2016 the Bank paid HUF 2 million interest on these deposits (HUF 4 million in 2015).

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

Type of benefit	2016 MHUF	2015 MHUF
Short-term employee benefits	2 174	2 012
Other long-term benefits	32	57
Share based payment (cash settled)	113	91
Total benefits	2 319	2 160

The liability of HUF 242 million (HUF 336 million in 2015) resulting from the carrying amount of share based payment is recorded as other liability in the consolidated statement of financial position.

Share based payment

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

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

NOTE 39 - RELATED PARTY TRANSACTIONS (continued)

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

Structure for 2016 variable compensation of material Senior General Management (SGM) and Key Identified Staff (KIS)

	Individual variable remuneration awarded for 2016 performance year			
	Upfront part		Deferred part	
In case of SGM-s, if the total variable is below the limit prescribed in the Remuneration Policy	(50% of award)		(50% of award)	
In case of SGM-s, if the total variable is above the limit prescribed in the Remuneration Policy	(40% of award)		(60% of award)	
In case of all KIS whose variable compensation is below the limit prescribed in the Remuneration Policy	(60% of award)		(40% of award)	
In case of all KIS whose variable compensation is equal to or exceeds the limit prescribed in the Remuneration Policy	(40% of award)		(60% of award)	
	Cash (50% of Upfront)	Non-cash instrument (50% of Upfront)	Cash (50% of Deferred)	Non-cash instrument (50% of Deferred)
Vesting schedule	fully vested at grant	fully vested at grant	3/5-year equal vesting tranches	3/5-year equal vesting tranches
Retention period		retention period ends April 2018/2020		retention period ends one year after vesting

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

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

NOTE 39 - RELATED PARTY TRANSACTIONS (continued)

	2016		2015	
	number of shares	weighted average share price* HUF/share	number of shares	weighted average share price* HUF/share
Outstanding as at the beginning of the period	15 052	11 748	19 553	10 069
Granted	4 075	15 501	4 037	15 936
Exercised	(7 895)	10 121	(8 360)	10 043
Transferred**	-	-	(178)	10 043
Outstanding as at the end of the period	11 232	13 924	15 052	11 748

*Share prices as at the grant date weighted by the number of shares granted at that date.
**Shares granted to employees moving between KBC entities during the year may increase/decrease the number of shares to be exercised or paid off by the Group. These changes are presented as transferred shares.

The value of the phantom shares outstanding as at 31 December 2016 based on the year-end closing price of KBC shares was 17 459 HUF/share (17 385 HUF/share as at 31 December 2015).

There were no shares exercisable as at 31 December 2016 (and as at 31 December 2015).

The weighted average share price of shares converted to cash as at the date of the exercise was 15 501 HUF/share in 2016 (15 936 HUF/share in 2015).

The weighted average remaining contractual life of phantom shares outstanding as at 31 December 2016 is 12 months (13 months as at 31 December 2015).

The Group applied the share based payment plan for the 2016 performance as well.

As at 31 December 2016 the information related to the number of phantom shares for the 2016 performance is not available, since the first grant date is in April 2017.

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

NOTE 40 – DEFINED BENEFIT PLAN

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

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

	2016 MHUF	2015 MHUF
Defined benefit obligations at the beginning of the period	1 047	998
Current service cost	(562)	-
Interest cost	31	49
Defined benefit obligation at end of the period	516	1 047

Interest cost on defined retirement benefit plans are recorded as interest expense in the consolidated income statement (see Note 3). Current service cost includes the effect of the renegotiation of defined benefit plans. Current service costs are recorded as staff expenses in the consolidated income statement (see Note 11).

NOTE 41 – AUDITOR'S REMUNERATION

The remuneration recognised due to the audit of annual accounts performed by Ernst & Young Audit Kft. and PricewaterhouseCoopers Könyvv. Kft. amounted to HUF 180 million in 2016 (HUF 209 million in 2015). In 2016 an additional remuneration of HUF 3 million was either accrued or paid to Ernst & Young Audit Kft. for other services, such as agreed upon procedures related to internal control statement of management (HUF 5 million in 2015).

NOTE 42 – SUBSIDIARIES AND ASSOCIATES

	Principal activities	Effective Shareholding 2016	Effective Shareholding 2015
Fully consolidated subsidiaries		%	%
K&H Jelzálogbank Zrt.	Credit institutions	100	-
K&H Autópark Kft.	Operating lease	100	100
K&H Eszközlízing Kft.	Operating lease	100	100
K&H Alkusz Kft. "v.a."	Insurance broker	-	100
K&H Lízing Zrt. "v.a."	Finance lease	-	100
K&H Ingatlanlízing Zrt.	Finance lease	100	100
K&H Befektetési Alapkezelő Zrt.	Fund manager	100	100
K&H Csoportszolgáltató Kft.	Group service center	100	100
K&H Equities Zrt.	Business and management consultancy	100	100
K&H Faktor Zrt.	Other financial services	100	100
Not consolidated investments under control			
K&H csúcstámadás zártkörű alap	Investment fund	91	91
Associates consolidated using the equity method			
HAGE Zrt.	Meat processing	25	25

The Group owns 91% of the equity instruments in K&H csúcstámadás zártkörű alap. The investment fund is managed by K&H Befektetési Alapkezelő Zrt., one of the Bank's subsidiaries therefore the Group has control over the fund. The fund is recorded as held-for-trading equity instrument in the consolidated financial statements and is valued at fair value. The Group does not consolidate the fund considering that changing the valuation (consolidation versus valuation at fair value) would have an immaterial impact on the financial figures presented in the consolidated financial statements.

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

K&H Alkusz Kft. and K&H Lízing Zrt. were liquidated in 2016. The liquidation had no material impact on the result of the Group.

In 2016 the Bank founded a mortgage bank. K&H Jelzálogbank Zrt. was registered as at 12 May 2016.

NOTE 43 – SUBSEQUENT EVENTS

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

NOTE 44 – RECONCILIATION OF STATUTORY ACCOUNTS TO IFRS ACCOUNTS

	Profit for the year	Shareholders' equity [1]	Assets	Subordinated debt and liabilities
	MHUF	MHUF	MHUF	MHUF
Bank accounts prepared under Hungarian Accounting Rules	47 134	212 295	2 863 253	2 603 824
Adjustments for IFRS accounts				
Capitalization of VAT, finance leases and revaluation of real estates	128	(3 193)	(2 559)	506
Portfolio-based allowance for loan losses	169	(1 671)	(1 195)	307
Specific allowance for loan losses	(193)	1 122	775	(154)
Carrying amount of securities[2]	4 147	(2 599)	(8 046)	(9 594)
Fair valuation of financial instruments (excluding AFS and cash flow hedge)	(2 921)	(8 402)	1 902	13 225
Fair valuation of AFS portfolio	(1 869)	13 239	11 371	1
Cash flow hedge	(1 320)	1 320	-	-
Funding for Growth Scheme	-	-	(10 164)	(10 164)
Amortisation of loan origination fees	333	844	1 136	(41)
Adjustment of carrying amount of loans and advances due to re-estimation of future cash flows	36	-	(14)	(50)
Defined benefit plans	1 405	(1 047)	-	(358)
Income tax	(7 683)	7 986	221	(82)
Bank standalone IFRS	39 366	219 894	2 856 680	2 597 420
Subsidiaries accounts prepared under Hungarian Accounting Standards	2 423	5 143	59 594	52 028
Adjustments for IFRS accounts				
Portfolio-based allowance for loan losses	5	(9)	(4)	-
Finance leases	(60)	(202)	(230)	32
Deferred tax	(57)	64	7	-
Subsidiaries standalone IFRS	2 311	4 996	59 367	52 060
Adjustments for consolidation	(2 800)	(2 720)	(90 350)	(84 830)
Balance per IFRS report	38 877	222 170	2 825 697	2 564 650

[1] Excluding the current year profit
[2] The carrying amount of securities differs under Hungarian and International Accounting Rules. The difference results from the diverse accounting treatment of delivery repos in the past.

NOTE 45 – RISK MANAGEMENT

45.1 General

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

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

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

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

The Group has Recovery Plan prepared according to the guidelines set out by local supervisor.

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 Audit Board (AB), Risk and Compliance Committee (RCC), the Executive Committee (ExCo), the Country Team (CT) and the Capital and Risk Oversight Committee (CROC). These committees concentrate on overarching risk management and on monitoring value creation.
- Specialised risk councils (Credit Risk Council (CRC), 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 relevant Value and Risk Management departments.
- Line management and activity-specific committees have primary responsibility for value and risk management on the operational level. Whereas Value and Risk Management departments measure risks, economic capital and value creation for all relevant business entities and reports their findings directly to line management and the relevant activity-specific committees.
- Within CRO Services Division the Risk Integration and Support Directorate is dedicated to overarch the three existing risk centres of competence (Credit Risk, Market and Liquidity Risk and Non-financial Risks), enhance coordination and report to 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 relevant members of the Board over the course of the year. Moreover, through the involvement of the entire Board in the annual round of approvals of risk-tolerance limits, the Board is able to take informed decisions on the degree of risk it finds acceptable for the Group and on the adequacy of the risk management structure.

NOTE 45 – RISK MANAGEMENT (continued)

Risk measurement and – monitoring

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

- Identification of risks is a process of discovering and defining material risks, namely those risks that could have a positive or negative impact on the financial position of the Group. Identification of risks is further ensured with setting up New and Active Products Process (NAPPs) in all business domains.

- Measurement of risks; qualitative and quantitative assessment of exposure to risk. The Group uses amongst others the following risk measures for the following most significant risk types:
  - Credit default and migration risks: nominal positions (outstanding/exposure), PD (probability of default), LGD/EL (loss given default/expected loss), credit concentration ratios, loan delinquency ratios, renegotiated loan ratios, credit loss ratios, RWA, stress test results;
  - Trading risk: BPV (basis point value), historic VaR (value at risk), and stress test results;
  - ALM (asset-liability management) risk: BPV, results of stress test on interest income, parametric VaR;
  - Operational risk: KRI (key risk indicator), results of risk self-assessment, level of compliance with Group Standards, availability of crisis management plans;
  - Liquidity risk: liquidity gaps, loan-to-deposit ratio, liquidity coverage ratio (LCR), net stable funding ratio (NSFR), liquidity concentration ratios, stress test results.

- Setting limits; is a way of authorizing specific forms of risk taking. A limit indicates how much risk the Group considers being 'an acceptable maximum' for a portfolio or a segment of a portfolio. They reflect the general risk appetite, set by the Board of Directors. This general risk appetite cascades down in specific risk limits or tolerances that reflect the degree of acceptable variation to the achievement of objectives. Risk limits are agreed upon by the Board of Directors.

- Reporting; delivery of risk measurement results and compliance with the limits (comparison of risk exposure with the risk limit) to the decision makers (relevant risk committees) in a structured format. The main types of reports used in the Group:
  - exposures to key risk types,
  - key risk indicators,
  - limit breaches,
  - losses,
  - advice from risk management department regarding the risk response.

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

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

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

45.2 Liquidity risk and funding management

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

NOTE 45 – RISK MANAGEMENT (continued)

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

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

The Group assesses the following liquidity risk aspects:

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

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

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

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

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

For the expected maturity of assets and liabilities see Note 24.

NOTE 45 – RISK MANAGEMENT (continued)

The following tables present the future undiscounted cash flows of financial liabilities and commitments and contingent liabilities by remaining contractual maturity as at 31 December 2016. For held-for-trading derivatives fair values are disclosed in the table.

	Held-for-trading derivatives	Held-for-trading short positions in debt instruments	Designated at fair value through profit or loss	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial liabilities						
On demand	-	-	-	-	1 743 472	1 743 472
Less than three months	2 676	4 602	14 054	76	158 497	179 905
More than three months but not more than one year	5 141	2 885	79 202	1 662	101 805	190 695
More than one but not more than five years	15 978	-	109 261	4 483	204 973	334 695
More than five years	500	-	309	7	92 826	93 642
Total	24 295	7 487	202 826	6 228	2 301 573	2 542 409

	Commitments to extend credit	Guarantees	Letters of credit	Total
	MHUF	MHUF	MHUF	MHUF
Commitments and contingent liabilities				
On demand	529 995	169 082	9 079	708 156
Less than three months	-	-	-	-
More than three months but not more than one year	-	-	-	-
More than one but not more than five years	-	-	-	-
More than five years	-	-	-	-
Total	529 995	169 082	9 079	708 156

NOTE 45 – RISK MANAGEMENT (continued)

The tables below present the future undiscounted cash flows of financial liabilities and commitments and contingent liabilities by remaining contractual maturity as at 31 December 2015. For held-for-trading derivatives fair values are disclosed in the table.

	Held-for-trading derivatives	Held-for-trading short positions in debt instruments	Designated at fair value through profit or loss	Hedging derivatives	Measured at amortised cost	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
Financial liabilities						
On demand	-	-	41	-	1 364 741	1 364 782
Less than three months	2 851	9 824	24 761	-	244 494	281 930
More than three months but not more than one year	5 031	-	55 864	1 038	109 548	171 481
More than one but not more than five years	8 138	-	138 219	3 416	247 748	397 521
More than five years	9 951	-	3 568	399	99 164	113 082
Total	25 971	9 824	222 453	4 853	2 065 695	2 328 796

	Commitments to extend credit	Guarantees	Letters of credit	Total
	MHUF	MHUF	MHUF	MHUF
Commitments and contingent liabilities				
On demand	373 524	153 748	11 752	539 024
Less than three months	-	-	-	-
More than three months but not more than one year	-	-	-	-
More than one but not more than five years	-	-	-	-
More than five years	-	-	-	-
Total	373 524	153 748	11 752	539 024

The Group's exposure to the risk arising from the outflows of cash or other financial asset which can occur significantly earlier or can be for significantly different amounts from the data presented in the tables above is immaterial.

NOTE 45 – RISK MANAGEMENT (continued)

The Group uses different ratios to measure and limit liquidity risk that arises from financial intermediation. The operational liquidity is monitored via limits on the unsecured liquidity gap, stress tests and “Basel III” and local regulatory liquidity indicators. From a structural liquidity point of view a group wide stable funding ratio is used. The Group is also analysing liquidity stress test results.

Operational liquidity is measured by the unsecured liquidity gap limit. The operational liquidity gap is the difference between the cash in and outflows in different time horizons (5 day, 30 days) and an internal limit was set for the gap to be covered by National Bank of Hungary eligible collaterals. The Group had sufficient liquidity gap surplus in 2016 and 2015, having increasing reliance on sight deposits.

Liquidity stress tests

Contingency liquidity risk is assessed in the Group on the basis of several liquidity stress scenarios. The aim of the stress tests is to measure how the liquidity buffer of the Group evolves under stressed scenarios. For each scenario the evolution of the liquidity buffer is calculated: this is the amount of excess liquidity per time bucket. Excess liquidity is the amount of cash that is available which is not required to cover immediately maturing liabilities. The simulated liquidity buffer is the sum of two components: the expected cash evolution under stressed scenarios and the expected liquidity increasing actions under stressed scenarios. In essence, there are four different types of stress tests: K&H specific empirical scenario, 2013’s Cyprus banking crisis inspired empirical scenario, Combined general market turmoil and Central Europe specific scenarios, and a reverse stress scenario. Under all scenarios the Group would achieve the internally set survival period of one month and also the time to wall period is indicated which is sufficiently remote in each stress test.

Basel III and regulatory ratios

LCR and NSFR ratios prescribed in regulation from Basel III origin on liquidity measurement are calculated and reported regularly as key liquidity risk measure. Effective LCR threshold is 100% since 1 October 2015, the Group’s LCR ratio stood at 176% at the end of 2016 and at 127% at the end of 2015 meeting all time the regulatory minimum requirement. NSFR is effective from 2018 with 100% threshold. The Group stood at 148% at the end of 2016 and at 158% at the end of 2015.

45.3 Market Risk

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as interest rates and foreign exchange rates. The Group classifies exposures to market risk into either trading or non-trading portfolios.

Market risk – trading

The Group is exposed to market risk via the trading books of the Bank’s dealing room and via the FX exposure of the subsidiaries. The Group has set limits on the level of market risk that may be accepted. The Group applies VaR methodology to assess the market risk positions held and to estimate the potential economic loss based on a number of parameters and assumptions for various changes in market conditions. VaR is defined as an estimate of the amount of money that can be lost on a given portfolio due to market risk, over a defined holding period, to a given confidence level. The measure only considers the market risk of the current portfolio and does not attempt to capture possible losses due to further trading or hedging, counterparty default or operational losses.

In practice the actual trading results will differ from the VaR calculation and in particular, the calculation does not provide a meaningful indication of profits and losses in stressed market conditions. To determine the reliability of the VaR models, actual outcomes are monitored regularly to test the validity of the assumptions. Market risk positions are also subject to regular stress tests to assess if the Group would withstand market shocks.

NOTE 45 – RISK MANAGEMENT (continued)

There are a number of different approaches used in the industry to generate VaR, with each having a varying level of suitability for different sizes and types of portfolios. The Group has chosen to use the historical VaR methodology to measure and manage market risks in the trading book.

The hVaR approach uses the actual historic market performance to simulate possible future market evolutions. The hVaR methodology does not rely on assumptions regarding the distribution of price fluctuations or correlations, but is based on patterns of experience over the previous two years (500 scenario dates). The hVaR that the Group applies is an estimate - using a confidence level of 99% and ten-day holding period. The use of the 99% confidence level means that, within a one day horizon, losses exceeding the VaR figure should occur, on average, once every hundred days. However, the VaR method will not tell us how much we will lose on that day, only that it is expected to exceed a certain amount. HVaR has rapidly become the standard VaR approach in large, internationally active banks. Moreover, hVaR provides a much better fit with the increased emphasis on scenario-based risk management, which includes stress testing.

Beside the hVaR calculations and stress-test risk concentrations are also monitored via secondary limits: FX concentration limits to limit FX risk stemming from a particular foreign currency position, and basis-point-value (BPV) limits for interest rate risk. BPV limits are set per currency and per time bucket.

VaR results can be presented as follows:

	Foreign exchange	Interest rate	Total VAR
	MHUF	MHUF	MHUF
2016 – 31 December	39	150	153
2016 – Average daily	97	372	387
2016 – Highest	369	627	659
2016 – Lowest	16	148	151
2015 – 31 December	69	260	263
2015 – Average daily	157	285	361
2015 – Highest	696	507	767
2015 – Lowest	28	136	150

The Group's average limit utilization was well below the hVaR limit.

The Group does not have exposure to direct equity risk. Trading portfolio regularly buys back notes in closed and open-end capital protected funds from K&H Asset Management Funds so as to assure secondary market for these notes. Typically all funds are made of deposit and different option structures. The trading risk is managed with a EUR 5 million net nominal limit on these notes and above one year maturity all components are fully hedged. The structure of notes which are kept in trading book is dismantled and the option part is hedged back-to-back within the limits.

Market risk – Non-trading

The Capital and Risk Oversight Committee (CROC) is responsible for controlling the value creation, the maturity transformation and the market risks of the banking book. Risk tolerance levels are allocated by KBC Group and approved by the K&H Board of Directors.

Majority of the Group's ALM risks are interest rate related risks; consequently the tolerance level is limited in BPV terms (10-basispoint upward parallel yield curve shift impact on net present value). The interest rate risk is also measured with scenario analyses (including stressed environment). ALM-Capital Model determines the amount of capital that is required in view of the ALM risk profile in the banking. ALM-CM measures the impact of very severe events on the Available Capital under Pillar I. Its scope is limited to 'risks to capital', i.e. the risks that cause a decrease of the regulatory available capital. Banking book's inherent risks are interest rate risk, inflation and equity risk that are measured and monitored according to the Group approach. Foreign currency or real-estate risk is not inherent in the banking book.

NOTE 45 – RISK MANAGEMENT (continued)

The BPV tables below present the results of reasonable possible changes of the fair value of the financial instruments held at fair value on 31 December 2016 and 2015. Possible alternatives were calculated based on the scenarios of 10, 100, and 200 basis point parallel shifts in yield curves. The banking book is limited in BPV by an internally set limit. The results contain the impact of derivative exposures too.

NOTE 45 – RISK MANAGEMENT (continued)

UP Scenarios, 31 December 2016	denomination	Sensitivity of equity MHUF	Sensitivity of profit or loss MHUF	Total sensitivity MHUF
10 bp parallel up	CHF	-	-	-
	EUR	(293)	102	(191)
	HUF	(643)	-	(643)
	USD	-	(10)	(10)
10 bp parallel up total		(936)	92	(844)
100 bp parallel up	CHF	-	-	-
	EUR	(2 856)	997	(1 859)
	HUF	(6 287)	36	(6 251)
	USD	-	(101)	(101)
100 bp parallel up total		(9 143)	932	(8 211)
200 bp parallel up	CHF	-	-	-
	EUR	(5 555)	1 938	(3 616)
	HUF	(12 272)	144	(12 129)
	USD	-	(196)	(196)
200 bp parallel up total		(17 827)	1 886	(15 941)

DOWN Scenarios, 31 December 2016	denomination	Sensitivity of equity MHUF	Sensitivity of profit or loss MHUF	Total sensitivity MHUF
10 bp parallel down	CHF	-	-	-
	EUR	295	(103)	192
	HUF	646	1	647
	USD	-	10	10
10 bp parallel down Total		941	(92)	849
100 bp parallel down	CHF	-	-	-
	EUR	3 023	(1 060)	1 963
	HUF	6 615	44	6 659
	USD	-	106	106
100 bp parallel down total		9 639	(910)	8 728
200 bp parallel down	CHF	-	-	-
	EUR	6 227	(2 192)	4 035
	HUF	13 587	177	13 764
	USD	-	217	217
200 bp parallel down total		19 814	(1 798)	18 016

NOTE 45 – RISK MANAGEMENT (continued)

UP Scenarios, 31 December 2015	denomination	Sensitivity of equity MHUF	Sensitivity of profit or loss MHUF	Total sensitivity MHUF
10 bp parallel up	CHF	-	-	-
	EUR	(168)	(56)	(224)
	HUF	(800)	(35)	(834)
	USD	-	(2)	(2)
10 bp parallel up total		(968)	(93)	(1 060)
100 bp parallel up	CHF	-	-	-
	EUR	(1 637)	(548)	(2 184)
	HUF	(7 740)	(337)	(8 077)
	USD	-	(22)	(22)
100 bp parallel up total		(9 377)	(907)	(10 283)
200 bp parallel up	CHF	-	-	-
	EUR	(3 183)	(1 066)	(4 250)
	HUF	(14 943)	(653)	(15 597)
	USD	-	(44)	(44)
200 bp parallel up total		(18 126)	(1 763)	(19 891)

DOWN Scenarios, 31 December 2015	denomination	Sensitivity of equity MHUF	Sensitivity of profit or loss MHUF	Total sensitivity MHUF
10 bp parallel down	CHF	-	-	-
	EUR	169	56	225
	HUF	805	35	840
	USD	-	2	2
10 bp parallel down Total		974	93	1 067
100 bp parallel down	CHF	-	-	-
	EUR	1 374	578	2 312
	HUF	8 327	359	8 686
	USD	-	22	22
100 bp parallel down total		9 701	959	11 020
200 bp parallel down	CHF	-	-	-
	EUR	3 573	1 189	4 762
	HUF	17 295	742	18 037
	USD	-	44	44
200 bp parallel down total		20 868	1 975	22 843

NOTE 45 – RISK MANAGEMENT (continued)

Currency risk

Currency or foreign exchange (FX) risk basically arises from mismatches in the currency structure of the Group's assets and liabilities. Positions are monitored on a daily basis and the hedging strategy of the Group is to close all material FX positions in the bank's banking book, thus currency risk is managed exclusively within the trading book. Trading FX exposure is managed within the trading limit, and the global hVaR limit of the Group. For details see the market risk-trading section above.

Fair valuation

One of the building blocks of a sound market risk management is also the prudent valuation of positions valued at Fair Value. This applies to *HFT instruments*: Held For Trading (adjustments impact P&L), *FIFV instruments*: financial instruments subject to the Fair Value option (adjustments impact P&L) and *AFS instruments*: Available for Sale (adjustments impact equity).

The Group's overall Valuation Framework stipulates that, when available, published independent price quotations from well-established active markets are used to determine Fair Value. In case of non-active markets, other valuation techniques (i.e. mark-to-model) are used in order to arrive at realistic estimates of Fair Value.

Consequently a daily independent valuation of front-office positions is performed by the Treasury Middle Office. Market-observed prices used in the valuation are regularly validated by the Market and Liquidity Risk Department via a formal parameter review process. Apart from market parameters, valuation techniques/models are also subject of independent review by the Market and Liquidity Risk Department.

45.4 Credit risk

Credit risk is the potential shortfall relative to the value expected consequent on non-payment or non-performance by an obligor (a borrower, guarantor, counterparty to an inter-professional transaction or issuer of a debt instrument), due to that party's insolvency or lack of willingness to pay, or to events or measures taken by the political or monetary authorities of a particular country. The latter risk is also referred to as 'country risk'.

Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values, as recorded in the consolidated statement of financial position. The Group makes available to its customers guarantees which may require that the Group makes payment on their behalf. Such payments are collected from customers based on the terms of the credit contracts. They expose the Group to similar risks to loans and these are mitigated by the same control processes and policies.

Credit risk is managed at both transactional and portfolio level. Managing credit risk at the transactional level means that there are sound procedures, processes and applications in place to estimate the risks before and after accepting individual credit exposures. Managing the risk at portfolio level encompasses periodic reporting on (parts of) the consolidated loan portfolio, monitoring limit discipline and the specific portfolio management function.

NOTE 45 – RISK MANAGEMENT (continued)

Credit quality per class of financial assets

The credit quality of financial assets is managed by the Group using internal credit grades (both on client and facility level). It is the Group's policy to maintain accurate and consistent risk ratings across the credit portfolio. All internal risk ratings are tailored to the various categories and are derived in accordance with the Group's rating policy. The Group deems the client rating calculated on the basis of default-adjusted PD (probability of default) algorithm as the governing rating. The calculation of default-adjusted PD is the automatic calculation of certain criteria of the default concept listed below, based on the figures available in the internal systems of the Group. This facilitates the partially automated default recognition within the clientele with active covenants. Group's assets have been distributed among classes based on the Basel III PD rating for Corporate and SME counterparties, and based on the facility rating for Leasing and Retail exposures according to the table below.

<table>
<tr><th>(PD) Debtor rating category</th><th>IFRS7 asset class category</th><th>Facility rating category</th></tr>
<tr><td>1</td><td rowspan="2">High grade</td><td rowspan="2">Problem-free, low risk</td></tr>
<tr><td>2</td></tr>
<tr><td>3</td><td rowspan="2">Standard grade</td><td rowspan="2">Problem-free, medium risk</td></tr>
<tr><td>4</td></tr>
<tr><td>5</td><td rowspan="5">Sub-standard grade</td><td rowspan="3">Problem-free, high risk</td></tr>
<tr><td>6</td></tr>
<tr><td>7</td></tr>
<tr><td>8</td><td rowspan="2">Monitor</td></tr>
<tr><td>9</td></tr>
<tr><td>10</td><td rowspan="4">Non-performing</td><td>Monitor</td></tr>
<tr><td rowspan="2">11</td><td>Substandard</td></tr>
<tr><td>Doubtful</td></tr>
<tr><td>12</td><td>Bad</td></tr>
</table>

Credit risk management at transactional level

Acceptance

Credit proposals are submitted in writing by a commercial entity. Unless a small amount or a low risk is involved, a loan adviser screens the proposals and makes a recommendation. In principle, significant loan decisions are taken jointly by two or more managers. Matrices that take account of such parameters as the group risk total, the risk class, type of counterparty (private individuals, companies, etc.), loss given default rate (LGD) determine at what level decisions should be taken. The 'group risk total' is the sum of all credit and limits that all companies in the borrower or counterparty's group already have or have applied for from all KBC group entities. The 'risk class' reflects the assessment of the risk and is determined primarily on the basis of internally developed rating models.

Supervision and monitoring

How the credit is monitored is determined primarily by the risk class, determined based on the Probability of Default (PD) classification of the client. The 'normal' loan portfolio is split up into internal rating classes ranging from 1 (lowest risk) to 9 (highest non-defaulted risk). Loans to small and medium-sized enterprises and large corporations in this portfolio are reviewed periodically, at least once a year, however based on risk signals (such as a significant change in the risk class) more frequent, so called ad-hoc monitoring process is initiated. It is not only credit that is monitored, credit decisions are too, as part of the so-called ex-post monitoring procedure, i.e. a member of a credit committee will supervise decisions taken at the decision level immediately below, by checking whether the decision is consistent with the lending policy. Any exposure vis-á-vis a PD8-9 rated client must be monitored more strictly than usual.

NOTE 45 – RISK MANAGEMENT (continued)

Defaulting obligors are put into PD classes 10, 11 or 12. In case of PD class 10 at least one of the following conditions under the definition of "default" is met, but none of conditions defined under PD11-12:

- Specific provision has been raised in relation to the client (for at least one exposure item) or part of its exposure was charged off within one year.
- The credit institution consents to a distressed renegotiation of the credit obligation where this is likely to result in a diminished financial obligation caused by material forgiveness or postponement of principal, interest or –where relevant – fees.
- Forborne exposures in line with the rules of the European Banking Authority (EBA).
- If K&H Group or another KBC Bank entity has suspended one or more credit lines, or the continued drawing of a certain credit line, or if K&H Bank receives official information that any other financial institution having a relationship with the client, has suspended one or more credit lines, or the continued drawing of a certain credit line.

Class 11 groups borrowers that have any material amount payable by the client to any member of the KBC Group and that has been overdue for more than 90 days. For overdrafts days past due commence, once an obligor has breached an advised limit or has drawn credit without authorisation and the underlying amount is material. For credit cards the start date of days past due is the due date of the minimum repayment obligation.

Class 12 comprises borrowers if:

- Any member of the KBC Group has fully or partially terminated any exposure in relation with the client.
- Liquidation proceedings have been launched against the client or the Group initiated a liquidation procedure against the client.

Credit risk management at portfolio level

Monitoring is also conducted on a portfolio basis, inter alia by means of regular reports on the consolidated credit portfolio. The largest risk concentrations are, in addition, monitored via periodic reports. Limits are in place at borrower or counterparty level and for specific activities. Whereas some limits are still in notional terms, more advanced concepts (such as 'risk weighted asset', 'expected loss' and 'loss given default') are increasingly being used.

Country risk, banking

Country risk is managed by setting limits per country and per maturity. It is calculated for each country separately according to a conservative method. Proposals for setting or changing country limits are handled centrally at KBC head office and, after independent credit advice is taken, submitted for approval at the relevant level of decision authority. Before any new transactions are entered into, availability under the country limits and, where relevant, the sub-limits concerned have to be checked.

The following risks are included:

- credit (including so-called medium- and long-term export credit, IFC 'B' loans and performance risks);
- bonds and shares in the investment portfolio;
- placements and (the weighted risk for) other transactions between professional clients (such as exchange transactions and swaps);
- short-term commercial transactions (such as documentary credit and pre-export finance).

NOTE 45 – RISK MANAGEMENT (continued)

In principle, individual transactions are charged against country limits according to the following rules:

- in case of fully fledged guarantees the guarantor's country limit is charged for the country risk;
- if a transaction is carried out with the office/branch of a company which has its head office in another country, the transaction will be assigned to the country where the office/branch is located, unless the rating of the country where the head office is located is lower, in which case the transaction will be assigned to this last country;
- exposure in the counterparty's national currency and risks in respect of countries in the euro area are not included, but are reported separately.

The industry breakdown of loans and advances is presented in the table below:

	2016	2015
	MHUF	MHUF
Industry sector		
Agriculture, forestry and fishing	74 026	81 008
Mining and quarrying	7 185	1 106
Manufacturing	200 903	188 088
Electricity, gas, steam and air conditioning supply	10 982	12 876
Water supply	9 553	10 331
Construction	25 582	16 877
Wholesale and retail trade	117 993	112 213
Transport and storage	60 738	53 540
Accommodation and food service activities	19 462	23 936
Information and communication	3 302	4 595
Financial and insurance activities	5 104	40 989
Real estate activities	55 250	49 904
Professional, scientific and technical activities	35 295	33 529
Administrative and support service activities	6 219	6 355
Public administration and defence, compulsory social security	32 212	1
Education	800	741
Human health services and social work activities	3 488	2 915
Arts, entertainment and recreation	445	467
Central bank	272 781	523 338
Individuals	539 199	512 123
Central governments	3 128	16 166
Municipalities	8 337	9 803
Credit institutions	521 256	73 636
Other services	3 115	6 649
Gross loans and advances	2 016 355	1 781 186
Portfolio-based impairment for loan losses	(3 500)	(3 561)
Specific impairment for loan losses	(39 317)	(46 666)
Total impairment on loans and advances (see Note 26)	(42 817)	(50 227)
Total loans and advances	1 973 538	1 730 959

NOTE 45 – RISK MANAGEMENT (continued)

Collateral and other credit enhancements

In compliance with its business policy the Group does not grant collateral-based financing (i.e. financing that is not based on the loan repayment capacity of the client), however, there is one exception to this rule in case of a special credit type when the loan is collateralized with cash deposit. The borrower's cash flow represents the primary – direct – source of loan repayment to the Group.

The inclusion of any type of collateral is subject to the assessment of the credit solvency of the client/guarantor, in the course of which the assets in question must be evaluated in compliance with the concerning internal regulations.

The main types of collateral applied are as follows:

- for retail lending, mortgages over residential real estate,
- for commercial lending, mortgage on real estate properties (both commercial and residential), state and institutional guarantees, and pledge on inventory and trade receivables,
- for securities lending cash deposits or security pledges.

The Group also obtains guarantees from parent companies for loans to their subsidiaries.

Relationship-managers monitor the market value of collaterals, regularly request for a review of the concerning collateral or requests additional collateral behind the deal if necessary. For defaulted counterparties, collaterals are assessed thoroughly to estimate expected recovery in order to set necessary level of impairments.

The carrying amount of investment properties and other assets, which were obtained by the Group by taking possession during 2016 to HUF 589 million (HUF 261 million in 2015).

The Group sells its assets obtained as collateral instead of using them for its operation.

Credit quality of not impaired nor past due assets

The credit quality of unimpaired and not past due assets as at 31 December 2016 is presented in the table below:

	Cash and cash balances with central banks	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
High grade	222 020	83 374	-	191 552	619 619	426 237	16 344	1 559 146
Standard grade	-	1 733	-	1 558	553 164	-	-	556 455
Sub-standard grade	-	10 152	-	-	542 293	-	109	552 554
Non-performing	-	15	-	-	1 223	-	-	1 238
Total carrying value	222 020	95 274	-	193 110	1 716 299	426 237	16 453	2 669 393

NOTE 45 – RISK MANAGEMENT (continued)

The credit quality of unimpaired and not past due assets as at 31 December 2015 is presented in the table below:

	Cash and cash balances with central banks	Held for trading	Designated at fair value through profit or loss	Available for sale	Loans and receivables	Held to maturity	Hedging derivatives	Total
	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF	MHUF
High grade	68 715	65 795	-	158 250	179 021	428 371	10 870	911 022
Standard grade	-	2 938	-	4 995	1 053 477	-	-	1 061 410
Sub-standard grade	-	12 901	-	-	437 388	-	153	450 442
Non-performing	-	101	-	-	10 174	-	-	10 275
Total carrying value	68 715	81 735	-	163 245	1 680 060	428 371	11 023	2 433 149

NOTE 45 – RISK MANAGEMENT (continued)

Credit risk exposure for each internal risk rating

The table below includes outstanding exposure of loans and loan commitments to customers and banks (without any money market position). Past due assets are distributed to the internal risk rating classes.

	Historical default rates* 2016	Average unsecured share of exposure 2016	Total 2016	Historical default rates* 2015	Average unsecured share of exposure 2015	Total 2015
	%	%	MHUF	%	%	MHUF
High grade	0.00	60.97	191 516	0.00	65.18	299 428
Standard grade	0.14	53.53	625 902	0.20	55.19	567 105
Sub-standard grade	3.23	38.28	590 813	2.39	38.28	617 247
Impaired	100.00	23.14	134 193	100.00	23.88	177 070
Total			1 542 424			1 660 851

* Impaired portfolio per credit grades compared to last year's total non-impaired portfolio.

Impairment assessment

The main considerations for the loan impairment assessment include whether any payments of principal or interest are overdue or there are any known difficulties in the cash-flows of the counterparties, credit rating downgrades, or infringement of the original terms of the contract. The Group addresses impairment assessment in two areas:

- individually assessed impairments
- collectively assessed impairments

Collectively assessed impairments

Portfolio-based impairment

Impairments are assessed collectively and on a portfolio basis for losses on loans and advances and on loan commitments if there is no objective evidence that an impairment loss has incurred individually (PD1-9 performing). For such loans and receivables impairment losses are recorded on a 'portfolio basis', using IRB Advanced parameters for calculation. This methodology is reviewed regularly.

Statistical impairment

Impairments are assessed on a portfolio basis applying statistical methods for losses on loans and advances if there is an objective evidence that an impairment loss has incurred (PD10-12 non-performing), but the loans and advances are not significant individually (including credit cards, residential mortgages and unsecured consumer lending).

NOTE 45 – RISK MANAGEMENT (continued)

Individually assessed impairments

Impairments are assessed individually on loans and advances and on loan commitments that are individually significant (> EUR 1.25 million), if there is objective evidence that an impairment loss has occurred (PD10-12 non-performing).

Items considered when determining impairment amounts include the sustainability of the counterparty's business plan, its ability to improve performance once a financial difficulty has arisen, projected receipts, the availability of other financial support and the realisable value of collateral, and the timing of the expected cash flows. The impairment losses are evaluated at each reporting date, unless unforeseen circumstances require more careful attention. The Group records such impairments based on an estimate of the net present value of the recoverable amount.

Provisions on commitments and contingent liabilities shall be created, and impairment for loans and receivables (commitments to clients) accounted for, on the basis of a realistic assessment of the situation so that the provision created and the value of impairment do not exceed the extent of expected future loss.

In some cases no impairment is presented for non-performing loans and advances in the consolidated financial statements. In case of loans and advances converted to HUF according to the Curia Act and derecognised and recognised again under IAS 39 the decrease of the loan's carrying amount resulting from credit quality worsening before the conversion is recorded as adjustment of the carrying amount before any impairment at initial recognition instead of recording impairment.

Statistical and individually assessed impairments are mentioned together as specific impairments in the Group's consolidated financial statements.

Internal credit risk models and Basel III

In order to quantify credit risks, the Group has developed various rating models, both for the purpose of determining how creditworthy borrowers are and to estimate the expected loss of various types of transactions. These models support credit risk management in such areas as pricing, the credit process (acceptance and monitoring) and determining portfolio-based impairment. A number of models are uniform throughout the entire KBC Group (for instance, the models for governments, banks, international large companies and project finance), while others have been designed for specific segments (SMEs, private individuals, etc.). The same internal rating scale is used throughout the KBC Group.

From January 2011, these models are also used for calculating the regulatory capital requirements for credit risk according to the Internal Rating Based (IRB) Approach. The Bank used the IRB 'Foundation' Approach until 2015 Q3 when the IRB-Advanced license was granted by the regulator.

The far-reaching introduction of rating models in the branch network has not only stimulated risk-awareness, it has also resulted in the models themselves being constantly tested against the market. Indeed, keeping the rating models up to date is just as important as developing them. An appropriate framework for the governance of the life cycle of risk models is thus in place, with model ownership (the credit function) being separate from responsibility for model validation (the Value and Risk Management Directorate). A central validation unit at KBC Group level and the Chief Risk Officer on local level is responsible for the final validation and approval of all models.

NOTE 45 – RISK MANAGEMENT (continued)

45.5 Credit risk – forborne loans

The policy on forbearance is based on the directive of the European Banking Authorities (EBA) harmonizing the definitions of forbearance and non-performing loans within the EU from 30/09/2014 on.

Forbearance is similar to distressed renegotiations, whereby the bank agrees to renegotiate the existing contracts and obligations for a borrower with financial difficulties in order to avoid default (e.g. in order to avoid overdue interest, rent, capital and/or fees).

Forbearance measures consist of concessions towards a debtor facing or about to face difficulties in meeting its financial commitments.

A concession refers to either of the following actions:

a) a modification of the terms and conditions of an existing contract because the debtor is considered unable to comply with the terms and conditions of the contract due to its financial difficulties and whereby the modification in principle would not have been granted in case the debtor would not have been in financial difficulties;
b) a total or partial refinancing of a troubled debt contract because the debtor is considered unable to comply with the terms and conditions of the troubled debt due to its financial difficulties and whereby the partial refinancing in principle would not have been granted in case the debtor would not have been in financial difficulties.

The above means that an exposure should be perceived as forborne in case that two conditions are met:

a) The bank granted concessions towards the borrower
b) due to the fact that he borrower has financial difficulties.

The forbearance classification is discontinued when all the following conditions are met:

- the contract is considered as performing, including if it has been reclassified from the non-performing category after an analysis of the financial condition of the debtor showed it no longer met the conditions to be considered as non-performing;
- a minimum 2 year probation period has passed from the date the forborne exposure was considered as performing;
- regular payments of more than an insignificant aggregate amount of principal or interest have been made during at least half of the probation period;
- none of the exposures to the debtor is more than 30 days past-due at the end of the probation period.

A non-performing exposure for which forbearance measurement has been applied cannot be considered as performing for at least one year after the forbearance measurement.

The rating category of the debtor does not improve due to the forbearance measurement. The Group classify borrowers with forborne exposures to at least PD9. In the following cases forborne borrowers are classified to a default status (i.e. at least PD 10):

- a second forbearance during the probation period;
- in case of 30 days past due for an amount exceeding the default materiality threshold of 2% of the exposure or HUF 250 000 during the probation period;
- partial and/or full debt forgiveness.

Forbearance measurement is applied on facility level (not on entire exposure).

NOTE 45 – RISK MANAGEMENT (continued)

The following table presents forborne loans, loan commitments and guarantees in comparison to loans, loan commitments and guarantees for which no forbearance measurement has been applied.

	2016		2015	
	Forborne	Not forborne	Forborne	Not forborne
	MHUF	MHUF	MHUF	MHUF
Gross loans	44 038	1 791 609	35 276	1 756 719
Specific impairment	(10 681)	(28 636)	(9 129)	(37 537)
Portfolio based impairment	(274)	(3 226)	(108)	(3 477)
Total loans and advances	33 083	1 759 747	26 039	1 715 705

For comparative information to the total loan portfolio see Note 26.

	2016		2015	
	Forborne	Not forborne	Forborne	Not forborne
	MHUF	MHUF	MHUF	MHUF
Commitments and guarantees	272	707 884	187	539 004
Specific impairment	(113)	(1 865)	(77)	(5 883)
Portfolio based impairment	-	(257)	-	(252)
Total Commitments and guarantees	159	705 762	110	532 869

The table includes the amount of forborne commitments and guarantees given to corporate clients. The amount of forborne commitments and guarantees for which specific impairment was recognised amounted to HUF 272 million as at 31 December 2016 (HUF 187 million as at 31 December 2015).

The following table explains the change of forborne loans.

	2016	2015
	MHUF	MHUF
Balance as at the beginning of the period	26 039	41 793
Loans which have become forborne	17 717	5 187
Loans which are no longer considered to be forborne	(5 458)	(561)
Repayments	(7 615)	(19 924)
Change in the impairment of forborne loans	1 684	416
Other	716	(872)
Balance as at the end of the period	33 083	26 039

NOTE 45 – RISK MANAGEMENT (continued)

	2016 MHUF	2015 MHUF
Balance as at the beginning of the period	110	180
Loan commitments and guarantees which are no longer considered to be forborne	-	(52)
Change in the provision on forborne loan commitments and guarantees	-	7
Other	49	(25)
Balance as at the end of the period	159	110

The Group recorded HUF 1 612 million interest income on forborne loans in the consolidated income statement in 2016 (HUF 1 406 million in 2015).

The following table includes the analysis of forborne loans as at 31 December 2016.

	Impaired MHUF	Past due but not impaired MHUF	Not impaired nor past due MHUF	Total MHUF
Gross loans	26 610	6 632	10 796	44 038
Specific impairment	(10 681)	-	-	(10 681)
Portfolio based impairment	-	(74)	(200)	(274)
Total forborne loans and advances	15 929	6 558	10 596	33 083

The table below presents the analysis of forborne loans as at 31 December 2015.

	Impaired MHUF	Past due but not impaired MHUF	Not impaired nor past due MHUF	Total MHUF
Gross loans	17 653	5 762	11 861	35 276
Specific impairment	(9 129)	-	-	(9 129)
Portfolio based impairment	-	(11)	(97)	(108)
Total forborne loans and advances	8 524	5 751	11 764	26 039

For comparative information to the total loan portfolio see Note 23.

NOTE 45 – RISK MANAGEMENT (continued)

The disaggregation of forborne loans (net of impairment) by business segments is presented below.

	2016 MHUF	2015 MHUF
Retail	29 648	17 679
Corporate	3 435	8 360
Total forborne loans and advances	33 083	26 039

The industrial breakdown of forborne loans is included in the table below.

Industry sector	2016 MHUF	2015 MHUF
Agriculture, forestry and fishing	751	805
Manufacturing	412	102
Electricity, gas, steam and air conditioning supply	539	6 088
Construction	1 471	2 068
Wholesale and retail trade	378	887
Transport and storage	21	20
Accommodation and food service activities	1 992	2 230
Information and communication	9	26
Financial and insurance activities	445	-
Real estate activities	3	3 225
Professional, scientific and technical activities	4	-
Administrative and support service activities	-	1
Individuals	38 013	19 824
Forborne loans and advances - gross	44 038	35 276
Portfolio-based impairment for loan losses	(274)	(108)
Specific impairment for loan losses	(10 681)	(9 129)
Total impairment on forborne loans and advances	(10 955)	(9 237)
Total forborne loans and advances	33 083	26 039

For comparative information to the total loan portfolio see Note 45 – Credit risk.

The table below includes the geographical breakdown of forborne loans.

	2016 MHUF	2015 MHUF
Hungary	44 038	35 276
Total forborne loans and advances	44 038	35 276

For comparative information to the total loan portfolio see Note 22.

NOTE 45 – RISK MANAGEMENT (continued)

45.6 Operational risk

In line with KBC Group, the Group applies the official Basel definition of Operational Risk and Operational Risk Management. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people or systems and from external events. It includes legal and tax risks, but excludes strategic and systemic risks. The Group takes reputation risk into account to a certain level. When controls fail to adequately perform, operational risks can result in financial loss, damage to reputation, have legal or regulatory consequences. The operational risks cannot be completely eliminated; but using sound control framework these risks can be mitigated to an acceptable level.

Processes and risk event types together are used as common and universal/uniform framework of reference for reporting purposes. The Group implemented the use of a uniform set of processes, risk event types, risk mitigating/measuring processes and a toolkit for operational risk management.

The first element of the toolkit is the use of *Group-wide Control requirements (Group Key Controls)* which are the key controls, defined by a centre of competence intended to control or mitigate major inherent risks. All KBC Group entities must implement these Key Controls. The compliance with the Group Key Controls is monitored via a benchmarking (assessment) exercise, assessments which are used to determine the gap between the group-wide requirements and the local practice. The derived action plans are continuously monitored and reported to the Capital and Risk Oversight Committee and Operational Risk Councils. The Local line management is responsible for translating the Group Key Controls into local procedures as well as for the timely and proper implementation of action plans.

Risk Self-Assessments aim to identify and assess the operational risk inherent in all material products, activities, processes and systems by the line management with the involvement of other concerned parties.

A '*Case Study Assessment'* is the process of testing the level of the protection of the current control environment against severe operational risk events that have actually happened in the banking and insurance industry by detecting gaps in subsequent control layers.

In line with the guidelines of KBC, the Group collects the *operational loss events* in a unified and integrated database which is also used for analysis and reporting purposes.

The method and framework of *Key Risk Indicators* were implemented in 2009. These are measurable metrics or indicators which help the organization with monitoring the inherent and / or residual exposure to certain key risks, and combine the measurement of risk with the actual management of risk. Changes in the risk exposure versus the risk tolerance of the Group are measured by warning and alert thresholds that are set for each Key risk indicator.

Risk scans for operational, and business and reputation risks were performed there by the main business lines, Information security and ICT (Information and Communication Technology), to assess the most important non-financial risks using a top-down approach.

In order to assure the continuity of its critical business services, the Group has an extensive business continuity framework in place, that includes business continuity plans for material activities, the testing of such plans in order to be prepared for potential crisis situations.

NOTE 46 – SOLVENCY AND CAPITAL

In accordance with Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises (banking law) and the EU Regulation No 575/2013 on prudential requirements for credit institutions and investment firms (CRR), the Group must have a minimum capital in place. The Group reports its level of capital adequacy situation to the National Bank of Hungary (MNB) on a quarterly basis and also forecasts are prepared to the Capital and Risk Oversight Committee (CROC) of the Group on a regular basis. When needed, the Group's Executive Committee decides and proposes to KBC Group any necessary steps that the Committee believes need to be taken (such as capital increase, subordinated debt increase, dividend payment etc.).

	2016 MHUF	2015 MHUF
Tier 1 capital elements	202 378	207 489
Adjustments due to prudential filters	(6 390)	(4 299)
Other transitional adjustments	-	(17 033)
Tier 1 total	195 988	186 157
Tier 2 capital elements	27 992	28 181
Other transitional adjustments	-	(643)
Tier 2 total	27 992	27 538
Guarantee capital	223 980	213 695

According to Hungarian capital adequacy regulations, the Group's capital adequacy ratio (tier 1 + tier 2; the latter includes subordinated debts) at 31 December 2016 was 15.29% (13.90% at 31 December 2015). The Group fulfilled the capital requirements set by MNB continuously during years 2016 and 2015 and at 31 December 2016 (and at 31 December 2015).

The Bank is required to set aside 10% of its profit calculated in accordance with Hungarian Accounting standards as a statutory reserve for use against future losses. The balance of this reserve as at 31 December 2016 was HUF 13 463 million (HUF 8 749 million as at 31 December 2015).

According to Hungarian corporate and banking law, only the profit for the current period and the positive retained earnings included in the statutory standalone financial statements may be distributed to the shareholders. Additionally, this can occur only after the Group establishes the required minimum level of statutory risk reserve.

Accordingly, the Bank had distributable reserves of HUF 81 808 million as at 31 December 2016 (HUF 38 588 million as at 31 December 2015).

The dividend proposed on ordinary shares for approval by the shareholder (not recognized as a liability as at 31 December 2016) is HUF 38 877 million – 0.275766 HUF/share (no dividend in 2015).

Approved by the Board of Directors on 13 April 2017.

Hendrik Scheerlinck
Chief Executive Officer
Member of the Board

Attila Gombás
Chief Financial Officer
Member of the Board

K&H Bank Zrt.

Management report (consolidated)
31 December 2016

On 31 December 2016, the consolidated total assets of K&H Bank Group (hereunder "the Group") stood at HUF 2,826 billion. As a financial institution which offers banking and insurance products alike and has a nation-wide branch network of 207 branches, the Group offers the full range of financial services to its clients.

1. Economic environment

Following the GDP growth of 3.1% in 2015, the pace of the economic growth slowed down to 2% in 2016. Household consumption was the major contributor to the economic growth in 2016, while the investments were weaker mainly due to the temporary lower European Union funds inflow. Among the sectors the agriculture and services were the main drivers of the growth, while construction pulled it back. The internal and external balance positions of the Hungarian economy remained favourable, the state debt was decreasing slightly further and its currency composition also improved. Hungary regained the investment grade at all three big rating agencies in 2016.

	2015 actual	2016 preliminary
GDP growth	+3.1%	+2.0%
CPI (average)	-0.1%	+0.4%
Households' consumption	+3.1%	+4.2%
Investments	+1.9%	-14.7%
Unemployment rate	6.2%	4.4%
Budget deficit (ESA) (in % of GDP)	-1.6%	-1.7%
Debt/GDP rate	74.7%	73.5%
Balance of payments (in % of GDP)	+3.4%	+4.5%

Source: MNB, KSH, K&H

The European Central Bank continued its aggressive asset purchasing program (preserving a loose monetary policy environment also in 2016) while the FED has raised its base rate one more time thanks to the improving economic figures and in its public announcements made reference to further steps of monetary restrictions. The Hungarian National Bank (MNB) restarted the rate cut cycle again in March and decreased the base rate by 15 bps steps from 1.35% to 0.90% till the end of May. This level stayed until the end of the year. As a part of its self-financing program the central bank announced further steps to reshape its monetary policy tools (tightening of the interest rate corridor, further limitations in the 3 months deposit instrument) and started its Growth Supporting Program (with the aim of gradual phasing out of Funding for Growth scheme and introducing the new Market based Lending Scheme). MNB pumped extra HUF liquidity into the markets via swaps as well. As a consequence of these measures the interbank market rates were pushed well below the base rate level.

2. The Strategic Objectives of the Group

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 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 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.

<u>Product strategy:</u>

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.

<u>Strategy on distribution channels:</u>

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 expression of interest through the application for the product and contracting to the use of our products. To achieve this, K&H has been allocating HUF 1.5 billion per annum to digitalisation initiatives since 2014 and we are determined to keep on heavily investing in this area in the future as well in order to meet our clients' ever increasing expectations.

<u>Key differentiators of the Bank Group:</u>

- 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

The Group's total assets increased by 9.4% in 2016.

HUF Billion	31 Dec 2015	31 Dec 2016	Variance
Total assets	2,583.2	2,825.7	+9.4%
Loans and receivables	1,746.9	1,803.0	+3.2%
Deposits from customers	1,865.6	2,131.5	+14.3%
Equity	220.5	261.0	+18.4%

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

- The growth in *loans and receivables* exceeded the growth rate of the banking sector both in retail and in corporate segment:
  - there was 5% growth in the loan portfolio of SME segment in 2016, facilitated by the MNB's Funding for Growth program
  - both corporate and retail loan volumes increased (by 4 % and 3%, respectively) due to the additional demand for credit
  - the lower volume of placements to MNB (2016: HUF 86 billion, 2015: HUF 523 billion) was offset by the increased receivables from credit institutions (2016: HUF 521 billion, 2015: HUF 74 billion): as part of its self-financing program, MNB announced further steps to limit the deposits of the commercial banks (placed at MNB), hence the bank held the extra liquidity in short-term interbank placements at the end of the period, mainly with K&H Bank's parent bank KBC.

- *Deposits from customers* increased by 14.3% during the year, and within that deposits of all business segments (retail, SME, corporate) increased.

- *Shareholders' equity* increased by HUF 40.5 billion primarily due to the result of year 2016 (HUF +38.9 billion), the cash flow hedge reserves (HUF +1.8 billion), while AFS revaluation reserves decreased (HUF -0.2 billion). According to the shareholder's resolution the total IFRS consolidated net result of 2016 will be paid out as dividend.

HUF Billion	31 Dec 2015	31 Dec 2016
Profit after taxation	37.8	38.9

In 2016 the Group's net result amounted to HUF 38.9 billion, which is a 3% improvement compared to the previous year's result (2015: HUF 37.8 billion).

The evolution of the main P&L items:

- In comparison with the previous year, *net interest income* decreased by nearly 5% (2016: HUF 70.0 billion, 2015: HUF 73.8 billion) mainly because of the negative impact of the lower interest rate environment partially compensated by the increasing loan and deposit volumes.
- The 1% increase in *net fee and commission income* (2016: HUF 52.6 billion, 2015: HUF 52.3 billion) is primarily driven by the increased transactional income which compensated the lower income on mutual funds.
- The increase in *net gains from financial instruments at fair value* (2016: HUF 20.9 billion, 2015: HUF 17.8 billion) is mainly related to the favourable Treasury income. HUF 0.9 billion income was accounted for in 2016 due to the lending activity related interest rate swap deals (HIRS) linked to the Hungarian National Bank's Market Lending Scheme (PHP).
- In 2016 Visa Inc. purchased Visa Europe. Gain resulting from the sale of our share (HUF 4.6 billion) is presented as part of *net realised gains from available-for-sale shares* (2016: HUF 5.3 billion, 2015: HUF 0.7 billion).
- *Other net income* includes the one-off and recurring effects of the consumer loan settlement and conversion (in 2016 HUF 13.7 billion gain was accounted for as the subsequent adjustment of carrying amount of the converted loans derecognised and recognised in accordance with IAS 39)[1].
- *Operating expenses* amounted to HUF 98.3 billion in 2016 (2015: HUF 102.1 billion), disregarding banktax and financial transaction levy there is a 5% growth compared to the previous year primarily because of the higher IT expenses and regulatory fees.
- Impairments on loans and receivables amounted to HUF 9.1 billion in 2016 (considering also the subsequent adjustment of carrying amount of the converted loans derecognised and recognised in accordance with IAS 39 accounted for under the heading of "other net income" there is a HUF 4.6 billion positive impact). In Retail business the bank's own and the government's payment easement programs had positive impact on the portfolio quality and the related credit cost ratio. The portfolio

[1] See details in the Consolidated Financial Statements (2015: Note 9 and Note 10, 2016: Note 8)

quality and the credit impairment in corporate and SME segments have shown further development in 2016.

Non-performing loans	31 Dec 2015	31 Dec 2016
Retail	24.9%	18.5%
Corporate	4.2%	3.1%
Retail car loans	51.9%	55.0%
Total	13.3%	9.8%

Detailed description on financial instruments' valuation is included in the consolidated financial statements (in the following notes: 16-23 and 27), while Note 45 in the consolidated financial statements is about risk management.

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

HUF million	**2015**	**2016**	**variance**
Cost / income	62.8%	60.1%	-2.7%
Cost / income *	58.5%	60.5%	+2.0%
Non-interest type income/ total income *	50.0%	62.4%	+12.4%
Fee and commission income / total income *	35.4%	35.1%	-0.3%
Operating income * / average headcount	41.7	41.0	-1.8%
Operating costs * / average headcount	24.4	24.8	+1.6%
Operating profit * / average headcount	17.3	16.2	-6.6%
Credit cost ratio	0.12%	-0.32%	-0.44%
Non-performing loans	13.3%	9.8%	-3.5%
Loan / deposit ratio	63.5%	57.4%	-6.1%
Capital **/total liabilities	9.6%	10.2%	+0.6%
Solvency ratio (consolidated)	13.9%	15.3%	+1.4%
ROE (based on average balance of equity)	19.6%	16.0%	-3.6%
ROE (based on average balance of equity) ***	17.3%	16.0%	-1.3%
ROA (based on average balance sheet total)	1.5%	1.4%	-0.1%
ROA (based on average balance sheet total) ***	1.3%	1.4%	+0.1%

* excluding bank tax and impact of consumer loan settlements (Curia decision) but including financial transaction levy
** in addition to equity it also includes subordinated debt capital
*** excluding the impact of consumer loan settlements (Curia decision)

Considering profitability, the Group is one of the most solid performers in the Hungarian banking sector with stable liquidity and solvency positions.

4. Introduction of strategically important subsidiaries

Leasing operation

At the end of December 2016 the Leasing operation consisted of 3 separate active 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

On 31 December 2016 the **Group's leasing** portfolio stood at HUF 47,6 billion, which represents a 5% increase compared to the end of the previous year. Retail car financing continued to decrease (reduced by HUF 5.2 billion, which is a 63% reduction compared to the end of 2015), while the truck, real estate, machinery & equipment and fleet portfolio altogether increased by HUF 7.5 billion (20%) compared to the end of 2015.

K&H Fund Management Zrt.

K&H Fund Management Zrt. is fully owned by K&H Bank. The assets managed in investment funds decreased from HUF 1.012 billion to HUF 808 billion during the year. Main drivers are the low interest rate environment and fluctuation of capital markets which avert the focus of investors from investing in money market, balanced and equity funds. In the current interest rate environment, private investors preferred high yield retail government papers more than before.
The sum of assets managed in funds means the third biggest market share among the Hungarian Fund Management companies. Beside the increase of institutional portfolio managed assets from HUF 152 billion to HUF 160 billion, the total assets managed by K&H FM decreased from HUF 1.164 billion to HUF 968 billion in 2016.

In 2016 fifteen derivative closed-end funds were launched.

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

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

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 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, accounting and operative services of the Hungarian branch of KBC Group Hungarian Branch (KBC GHB). In 2009, the scope of the company's activities was extended with financial and accounting services provided to K&H Factoring, a company 100% owned by K&H Bank. A directorate was established on 1 January 2012 for SZÉP Card operations. 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.

A new subsidiary, K&H Mortgage Bank Zrt. was established by K&H Bank during the year 2016, therefore KHCSK's clientele was extended with this new K&H entity, too.

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 (2015: HUF 96.9 billion, 2016: HUF 113.6 billion, it means 17% increase compared to prior year). The amount of trade receivables towards debtors was HUF 13.7 billion on 31 December 2016. The profit after tax of the company has reached HUF 184 million in year 2016.

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

From April 1st 2017 the Hungarian National Bank (MNB) implements 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 rules, at least 15% of retail HUF mortgage loan portfolio is to be financed by long-term sources with maturity over 1 year (be it mortgage bonds or refinancing mortgage loans taken out from mortgage credit institutions). The commercial banks have to decide whether they will turn to an existing mortgage bank to refinance part of their retail mortgage loan portfolio or set up a mortgage bank for refinancing purposes. After careful analysis of the market, K&H Bank has opted for establishing a mortgage bank.

The K&H Mortgage Zrt. was established as a 100% subsidiary of K&H Bank Zrt. in January of 2016 with HUF 3 billion equity (which was increased by HUF 500 million in Q4 2016).

The total assets of Mortgage Bank stood at HUF 3.498 million on 31 December 2016. Its core business activity (refinancing of retail mortgage loan portfolios of K&H Bank Zrt, mortgage bond issuance) started in Q1 2017.

Budapest, 28 April 2017

Hendrik Scheerlinck	Attila Gombás
Chief Executive Officer	Chief Financial Officer