Kereskedelmi és Hitelbank Zrt.

CONSOLIDATED SEMI-ANNUAL REPORT

30 June 2018

Budapest, 30 August 2018

CONTENT

Statement of the Issuer

K&H Bank Zrt., as the Issuer (represented by David Moucheron, CEO and Attila Gombás, CFO) hereby declare that K&H Bank Zrt.'s consolidated 2018 Semi-annual Report has been prepared in compliance with the applicable accounting laws and regulations, to the best of the Issuer's knowledge, and that the financial details contained therein reflect a true and reliable status of the assets, liabilities, financial position and profit of K&H Bank Zrt. and of the companies involved in the consolidation, and that the consolidated management report shows a true and fair picture of the position, development and performance of K&H Bank Zrt. and the companies involved in the consolidation, also including the major risks and uncertainties pertaining to the remaining six months of the financial year.

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

Budapest, 30 August 2018

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

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Not audited 30 June 2018	Audited 1 January 2018	Audited 31 December 2017
	MHUF	MHUF	MHUF
ASSETS			
Cash and cash balances with central banks	609 971	437 842	437 846
Cash	37 171	36 789	36 789
Cash balances with central banks	210 865	201 542	201 542
Other demand deposit with credit institutions	361 935	199 511	199 515
Financial assets	2 532 707	2 478 854	2 497 478
Held for trading	95 373	98 191	98 191
Available for sale	-	-	194 208
Loans and receivables	-	-	1 758 515
Held to maturity	-	-	423 500
Mandatorily fair value through profit or loss	21 711	21 405	-
Fair value trough other comprehensive income	103 444	72 032	-
At amortised cost	2 303 504	2 264 162	-
Hedging derivatives	8 675	23 064	23 064
Fair value changes of hedged item under portfolio hedge of interest rate risk	1 803	1 360	-
Tax assets	2 543	3 850	2 864
Current tax assets	393	2 843	2 843
Deferred tax assets	2 150	1 007	21
Investments in associated companies	-	542	542
Investment property	1 748	1 476	1 476
Property and equipment	35 938	37 144	37 144
Intangible assets	14 989	14 525	14 525
Non-current assets held for sale and disposal groups	-	1 921	1 921
Other assets	20 839	19 861	19 880
Total assets	3 220 538	2 997 375	3 013 676
LIABILITIES AND EQUITY			
Financial liabilities	2 902 125	2 674 000	2 674 000
Held for trading	94 995	36 474	36 474
Designated at fair value through profit or loss	104 878	120 509	120 509
Measured at amortised cost	2 689 440	2 512 914	2 512 914
Hedging derivatives	12 812	4 103	4 103
FV changes of hedged item under portfolio hedge of interest rate risk	-	12 560	12 560
Tax liabilities	403	12	840
Current tax liabilities	403	12	12
Deferred tax liabilities	-	-	828
Provisions for risks and charges	1 624	1 791	1 559
Other liabilities	47 783	56 870	56 871
Total liabilities	2 951 935	2 745 233	2 745 830
Share capital	140 978	140 978	140 978
Share premium	48 775	48 775	48 775
Accumulated profit	61 554	33 792	38 480
Other reserves	17 296	28 597	39 613
Total equity	268 603	252 142	267 846
Total liabilities and equity	3 220 538	2 997 375	3 013 676

Budapest, 30 August 2018

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Share capital MHUF	Share premium MHUF	Statutory risk reserve MHUF	Revaluation reserve – former available for sale reserve MHUF	Revalu-ation reserve - Cash flow hedge MHUF	Revalu-ation reserves – other MHUF	Retained earnings MHUF	Total equity MHUF
Balance as at 1 January 2017	140 978	48 775	13 462	12 016	6 092	-	39 724	261 047
Early adoption of IFRS 9	-	-	-	-	-	21	(21)	-
Net profit for the year	-	-	-	-	-	-	41 821	41 821
Other comprehensive income for the period	-	-	-	3 945	(156)	66	-	3 855
Total comprehensive income	-	-	-	3 945	(156)	87	41 821	45 697
Dividend	-	-	-	-	-	-	(38 877)	(38 877)
Transfer from retained earnings to statutory risk reserve	-	-	4 168	-	-	-	(4 168)	-
Total change	-	-	4 168	3 945	(156)	87	(1 245)	6 799
Balance as at 31 December 2017	140 978	48 775	17 630	15 961	5 936	87	38 479	267 846
of which								
revaluation reserve for shares	-	-	-	334	-	-	-	334
revaluation reserve for bonds	-	-	-	15 627	-	-	-	15 627
Balance as at 1 January 2018	140 978	48 775	17 630	15 961	5 936	87	38 479	267 846
First time application impact of IFRS9	-	-	-	(11 265)	-	-	(4 690)	(15 955)
Net profit for the year	-	-	-	-	-	-	27 760	27 760
Other comprehensive income for the period	-	-	-	(1 497)	(9 527)	(29)	-	(11 053)
Total comprehensive income	-	-	-	(12 761)	(9 527)	(29)	27 760	752
Realised gain on equity instruments	-	-	-	-	-	-	5	5
Total change	-	-	-	(12 762)	(9 527)	(29)	23 075	757
Balance as at 30 June 2018	140 978	48 775	17 630	3 199	(3 591)	58	61 554	268 603
of which								
revaluation reserve for shares	-	-	-	644	-	-	-	644
revaluation reserve for bonds	-	-	-	2 555	-	-	-	2 555

Budapest, 30 August 2018

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CONSOLIDATED INCOME STATEMENT

	Not audited 1st half of year 2018 MHUF	Reclassified not audited 1st half of year 2017 MHUF
Interest income	42 927	45 281
Interest expense	(6 053)	(10 049)
Net interest income	36 874	35 232
Fee and commission income	38 885	34 970
Fee and commission expense	(9 583)	(8 771)
Net fee and commission income	29 302	26 199
Net gains / (losses) from financial instruments at fair value through profit or loss and from foreign exchange	13 887	9 213
Net realised gains / (losses) from financial assets at fair value through other comprehensive income	-	534
Dividend income	6	8
Other income	4 907	1 263
Other expense	(427)	(763)
Total income	84 549	71 686
Operating expenses	(54 275)	(51 954)
Staff expenses	(17 430)	(16 978)
General administrative expenses	(26 642)	(25 568)
Depreciation and amortisation of tangible and intangible assets	(4 381)	(3 961)
Bank tax	(5 822)	(5 447)
Impairment:	2 235	3 017
Financial assets at amortised cost	2 256	3 188
Other	(18)	(171)
Share in results of associated companies	(3)	27
Profit before tax	32 509	22 776
Income tax expense	(4 749)	(3 875)
Profit after tax	27 760	18 901

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Not audited 1st half of year 2018 MHUF	Not audited 1st half of year 2017 MHUF
Profit after tax	27 760	18 901
Other comprehensive income		
Items that may be reclassified to the profit or loss under IFRS 9		
Revaluation reserve of debt instruments		
First time application impact of IFRS 9	(12 632)	-
Deferred tax impact on the implementation of IFRS 9	1 367	-
Net gain / (loss) from fair value changes	(2 044)	248
Deferred tax impact on fair value changes	221	(27)
Transfer from available for sale reserve to net profit:		
(Losses)/gains on impairment	18	-
(Losses)/ gains on disposal	-	(533)
Amortisation of reclassified assets	-	(279)
Deferred income tax	(2)	88
Cash flow hedge		
Net gain / (loss) from fair value changes	(10 344)	(861)
Deferred tax impact on fair value changes	931	78
Transfer from cash flow hedge reserve to net profit:		
Ineffective part	102	121
Gross amount	(227)	(50)
Deferred income tax	11	(6)
Items that will not be reclassified to the profit or loss under IFRS 9		
Available-for-sale equity instruments		
Net gain / (loss) from fair value changes	348	116
Deferred tax impact on fair value changes	(38)	(13)
Own credit risk adjustments	(50)	62
Deferred income tax	5	(6)
Actuarial result on defined benefit plans	18	58
Deferred income tax	(2)	(5)
Total other comprehensive income	(22 318)	(1 009)
Total comprehensive income	5 442	17 892

Budapest, 30 August 2018

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Chief Financial Officer

CONSOLIDATED STATEMENT OF CASH FLOWS

	Not audited 1st half of year 2018 MHUF	Not audited 1st half of year 2017 MHUF
OPERATING ACTIVITIES		
Profit before tax	32 509	22 776
Adjustments for:		
Interest income	(42 927)	(45 281)
Interest expense	6 053	10 049
Net transfer from revaluation reserve (former available for sale reserve)	18	(812)
Net transfer from cash flow hedge reserve	(125)	71
Depreciation and impairment of property, plant and equipment, intangible assets, available-for-sale financial assets and other assets	4 364	4 145
Share in results of associated companies	- -	(27) (27)
(Profit)/Loss on the disposal of property and equipment	(49)	(46)
(Profit)/Loss on the disposal of investment property	(111)	(50)
Change in impairment on assets valued at amortised cost (former loans and receivables and held to maturity)*	(2 256)	(3 188)
Change in other provisions	(48)	73
Unrealised valuation differences	62 262	5 895
Cash flows from operating profit before tax and before changes in operating assets and liabilities	59 690	(6 394)
Changes in financial assets held for trading	(3 356)	(15 284)
Changes in financial assets at fair value through other comprehensive income (former available for sale)	(32 776)	3 478
Changes in financial assets at amortised cost (former loans and receivables)	(296 801)	(128 888)
Changes in financial assets held to maturity	-	1 609
Changes in other assets	(493)	(17)
Changes in operating assets	(333 426)	(139 102)
Changes in financial liabilities held for trading	25 764	(1 001)
Changes in financial liabilities designated at fair value through profit or loss	(12 976)	(39 614)
Changes in financial liabilities measured at amortised cost	50 229	38 454
Changes in other liabilities	(21 178)	7 798
Changes in operating liabilities	41 839	5 636
Income taxes paid	(4 745)	(3 795)
Interest received	44 329	48 246
Interest paid	(6 697)	(12 601)
Net cash from/(used in) operating activities	(199 010)	(108 009)

* Including also provisions on loan commitments.

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2018 MHUF	Not audited 1st half of year 2017 MHUF
INVESTING ACTIVITIES		
Purchase of securities at amortised cost (former held-to-maturity)	(23 672)	(29 970)
Proceeds from the repayment of securities at amortised cost at maturity	8 707	26 950
Proceeds from the sale of securities at amortised cost	44 918	-
Proceeds from the disposal of a subsidiary or business unit, net of cash disposed	548	-
Dividends received from associated companies	2	27
Purchase of intangible fixed assets	(2 294)	(1 815)
Purchase of property, plant and equipment	(1 370)	(2 442)
Proceeds from the sale of property, plant and equipment	59	524
Proceeds from the sale of non-current assets held for sale and disposal groups	4 177	-
Purchase of investment property	(686)	-
Proceeds from the sale of investment property	536	-
Net cash from/(used in) investing activities	30 925	(6 726)
FINANCING ACTIVITIES		
Dividend paid	-	(38 877)
Net cash from/(used in) financing activities	-	(38 877)
CHANGE IN CASH AND CASH EQUIVALENTS		
Net increase/(decrease) in cash and cash equivalents	(168 086)	(153 612)
Net foreign exchange difference	(14 525)	(9 291)
Cash and cash equivalents at beginning of the period	689 900	607 530
Cash and cash equivalents at end of the period	507 289	444 627

CONSOLIDATED STATEMENT OF CASH FLOWS (continued)

	Not audited 1st half of year 2018 MHUF	Not audited 1st half of year 2017 MHUF
OPERATING CASH FLOWS FROM DIVIDENDS		
Dividends received	2	35
COMPONENTS OF CASH AND CASH EQUIVALENTS		
Cash and cash balances with central banks	248 036	89 776
Loans and advances to banks repayable on demand and term loans to banks < 3 months	417 083	399 830
Deposits from banks repayable on demand and redeemable at notice	(157 829)	(44 979)
Total cash and cash equivalents	507 290	444 627

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.

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

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

Budapest, 30 August 2018

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer

Consolidated Management Report

On 30 June 2018, the consolidated total assets of K&H Bank Group (hereunder “the Group”) stood at HUF 3,221 billion. As a financial institution which offers banking and insurance products alike and has a nation-wide branch network of 206 branches, the Group offers the full range of financial services to its clients.

1. Economic environment

The Hungarian economy kept its growth speed of 2017 in the first half of 2018 as well. There was no substantial change in the structure of the growth either: households consumption and investments were boosting the economy, while construction and services performed outstanding among the sectors. Balanced and wide-based economic growth is expected for the whole year. The country’s external debt has continued to decrease in 2018, but its financing need remained at high level in 1H18 due to the pre-financing of the EU subsidies.

	2017 actual	2018 forecast*
GDP growth	+4.0%	+4.0%
CPI (average)	+2.3%	+2.8%
Investments	+16.7%	+15.0%
Unemployment rate	3.8%	3.5%
Budget deficit (ESA) (in % of GDP)	-2.0%	-2.4%
Debt/GDP rate	73.6%	71.4%
Balance of payments (in % of GDP)	+3.1%	+2.5%

**source: K&H Bank Zrt*

At the beginning of the year, the European Central Bank reduced its monthly asset purchasing program from EUR 60 billion to EUR 30 billion and (following a further reduction to EUR 15 billion from October) the program was announced to be abolished by the end of the year. The FED, which plays the role of the US central bank, raised the base rate by 25-25 basis points in March and June, and it is expected to hike further two more times in this year. The National Bank of Hungary (MNB) kept the base rate unchanged at 0.9% and introduced a new program from January to reduce yields of longer (5 and 10 years) instruments in order to moderate the steepness of the yield curve. But at the same time, the long-end of the yield curve has significantly increased due to the change in the international environment. However, interbank short-term interest rates remained on a low level, well below the central bank base rate, thanks, among others, to the increased forint liquidity.

2. The Strategic Objectives of the Group

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

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

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

We want to be the reference in bank-insurance.

<u>Customer strategy:</u>

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

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

Product strategy:

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

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

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

Strategy on distribution channels:

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

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, the initiatives aimed at digitalization have been supported by 1.5 billion HUF of annual capital expenditures since 2014.

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

3. The Group's consolidated activities

3.1 Balance sheet

The Group's total assets increased by 7.4% in the first half of 2018 compared to 1 Jan 2018[1].

[1] On 1 Jan 2018 the new accounting stardard of IFRS9 became effective impacting both the classification and measurement of financial instruments:
- the full impact of first time application is recorded in the equity as at 1 Jan 2018 (-15.954 mln). The Group will not make use of any transitional arrangements with regard to the impact of IFRS 9 on capital, as it wants to provide full transparency.
- the semi-annual report on 1H 2018 (consolidated statement of financial position) includes comparative information for IFRS9 at the date of initial application (the detailed description of IFRS9 and its implications is available in the Group's consolidated financial statements over 2017). The analysis on the balance sheet is based on comparable basis of IFRS9.

Billion HUF	1 Jan 2018 (IFRS9)	30 Jun 2017 (IFRS9)	variance
Total assets	2 997	3 221	+7.4%
Cash and cash balances with central bank	202	211	+4.6%
Loans and advances to customers	1 287	1 338	+3.9%
Deposits from customers	2 287	2 327	+1.7%
Equity	252	269	+6.5%

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

- Within financial assets measured at amortized costs *loans and advances to customers* increased by 4% in H1 2018: both corporate and retail loan portfolio continued to increase during the period. Volume of government bonds slightly decreased compared to 31 Dec 2017.
- *Deposits from customers* increased by +1.7% in the first half of 2018 mainly driven by retail deposits.

Market share	**30 June 2017**	**30 June 2018**
Corporate loans	9.9%	10.2%
Retail loans	10.1%	10.4%
Corporate deposits	12.6%	12.4%
Retail deposits	9.8%	9.7%
Retail deposits+mutual funds	11.4%	11.3%

- *Shareholders' equity* increased by 16.5 bln (+6%) compared to 1 Jan 2018 as profit of 1H18 (+27.8 bln) was partially counterbalanced by lower cash flow hedge reserves (-9.5 bln) and other revaluation reserves (-1.5 bln). The 16.6% capital adequacy ratio at 30 June 2018 reflects the full impact of IFRS9 without any transitional arrangements.

	31 Dec 2017	30 June 2018
Guarantee capital (bln HUF)	278	293
Capital adequacy ratio (%)	16.4	16.6

3.2 Profit & loss

billion HUF	Jan-Jun 2017	Jan-Jun 2018
Profit after tax	18.9	27.8

The Bank Group's profit for 1H18 (27.8 bln) exceeds significantly the level of the comparable period in last year (18.9 bln). The profit figures of the Group include 4 bln exceptional gains from property and financial instruments transactions[2].

The evolution of the main P&L items in the first half of 2018:

- *Net interest income* increased by 4.7% (1H17: 35.2 bln, 1H18: 36.9 bln), as the negative impact of lower interest rate environment was compensated by the increasing customer loan and deposit volumes.

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

- The 11.8% increase in *net fee and commission income* (1H17: 26.2 bln, 1H18: 29.3 bln) is primarily driven by transactional services and investment services.

- The higher *net gains from financial instruments at fair value through profit or loss* (1H17: 9.2 bln, 1H18: 13.9 bln) is attributable primarily to higher Treasury related income.

- *Other income* was boosted by exceptional gains from property and financial instruments transactions.

- The *operating expenses* of the Group for the first half of 2018 amounted to 54.3 bln (1H17: 52.0 bln), the increase compared to previous year is primarily driven by regulatory fees and higher IT costs (impact of significant digitalization and regulatory investments).

  There was 2.3 bln positive P&L impact from release of *impairment on financial assets at amortised cost*. Portfolio quality remained stable in all segments, NPL rates decreased further.

Non-performing loans ratio	31 Dec 2017	30 June 2018
Retail	13.7% (15.9%)*	14.0%
Corporate & SME	2.2%	1.9%
Total	**7.1% (8.1%)***	**7.1%**

* method change due to IFRS9, comparable figures are in brackets

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

	2017 H1	**2018 H1**	**variance**
Cost / income	72.5%	64.2%	-8.3%
Cost / income *	64.9%	60.2%	-4.7%
Non-interest type income/ total income	50.9%	56.4%	+5.5%
Fee and commission income / total income	36.5%	34.7%	-1.9%
Income */ avg headcount (mln HUF)	39.0	44.8	+15.1%
Expenses* / avg headcount (mln HUF)	25.3	27.0	+6.8%
Operating profit* / avg headcount (mln HUF)	13.7	17.8	+30.3%
Credit cost ratio	-0.5%	-0.3%	-0.1%
Non-performing loans	8.6%	7.1%	-1.5%
Loan / deposit	62.8%	62.7%	-0.1%
Capital**/total liabilities	9.5%	9.6%	+0.1%
LCR	224%	162%	-62%
NSFR	134%	144%	+10%
Capital adequacy ratio	15.1%	16.6%	+1.5%
ROE (based on avg equity)***	18.3%	20.8%	+2.5%
ROA (based on avg balance sheet total)***	1.7%	1.8%	+0.1%

* excluding bank tax and exceptional gains from property and financial instruments transactions
** in addition to equity it also includes subordinated debt capital
*** excluding exceptional gains from property and financial instruments transactions; bank tax included on a pro rata basis

Considering risk, liquidity and capital adequacy ratios K&H Bank (as the 2nd largest bank based on total assets and customer–deposit volumes) is considered as one of the banks with the most favourable financial position in the banking sector.

4. Introduction of the important subsidiaries

Leasing operation

At the end of June 2018 the Leasing operation consisted of three active legal entities next to the leasing operations performed by the bank (three entities were merged with K&H Bank Zrt. in previous years).

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

On 30 June 2018 the **Group's leasing** portfolio stood at 64.3 billion, which represents a 9% increase compared to the end of the previous year. Discontinued retail car financing portfolio reduced by 0.5 billion, which is a 72% reduction compared to the end of 2017, while the actively managed portfolio (truck, real estate, machinery & equipment and fleet portfolio altogether) increased by HUF 5.8 billion (10%) compared to the end of 2017.

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

K&H Fund Management Plc. is fully owned by K&H Bank. The assets managed in investment funds increased from 803 billion in Dec 2017 to 813 billion in June 2018 (meanwhile the total assets managed increased from 969 billion to 978 billion in this period).
Based on market share in total assets managed K&H Fund Management is ranking nr. 3 in the Hungarian Fund Management market.
In the first half of 2018 two derivative closed-end funds and two balanced funds were launched.

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

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

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

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

The K&H Factoring Zrt's main activity is factoring (purchase of receivables, financing, discounting). The company's business activities have started in 2010, (factoring) turnover has been increasing since then (2018 1H: 73.1 bln HUF, +30% yoy). The amount of trade receivables towards debtors was 17.5 billion on 30 June 2018.

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

As from April 1st 2017 the Hungarian National Bank (MNB) implemented a new indicator (Mortgage Financing Adequacy Ratio) to constrain the banking sector level systemic risk of maturity transformation related to the long term HUF retail mortgage loan portfolio. According to the rules, at least 15% (20% from Oct 2018) of the 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). K&H Mortgage Bank was established in January 2016.

The core business activity of Mortgage Bank (refinancing of retail mortgage loan portfolios of K&H Bank Zrt, mortgage bond issuance) started in Q1 2017, the amount of issued mortgage bonds portfolio is 74.5 bln on 30 Jun 2018.

5. Risk Management

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

5.1 Risk management governance model

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

- Overarching company and risk committees are the Board of Directors (BoD), the Risk and Compliance Committee (RCC), the Audit Board (AB), the Supervisory Board (SB), the Executive Committee (ExCo), the Country Team (CT) and the Capital and Risk Oversight Committee (CROC). These committees concentrate on overarching risk management and on monitoring value creation.
- Specialised risk councils (Credit Risk Council (CRC), Trading Risk Councils (TRC), Operational Risk Councils (ORC)) concentrate on implementing a group-wide framework for one particular type of risk and monitoring the associated risk management process. The risk councils are composed of representatives from line management and Value and Risk Management Division.
- Line management and activity-specific committees have primary responsibility for value and risk management on the operational level. Value and Risk Management Division measures risks, economic capital and value creation for all relevant business entities and reports its findings directly to line management and the relevant activity-specific committees.
- Within Risk Management Division the Integrated Value and Risk Department is dedicated to overarch the three existing risk centers of competence (Credit Risk, Market and Liquidity Risk and Non-financial Risks), enhance coordination and report to senior management.

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

5.2 Risk types

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

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

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

  Management reports were further fine-tuned during 2018, and amended with additional information.
  The main conclusions for 2018 are:

- Corporate and SME portfolio quality remained stable with some improvements in risk indicators in the period. Furthermore the performing portfolio continued to increase 2018, while non-performing portfolio further decreased.
- Retail portfolio continued to improve during 2018 driven by the decreasing NPL volume and also the substantial amount of new production. It should also be noted that cures from NPL also contributed to the improving risk metrics, although to a lesser degree.

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

The Bank's large risk portfolio is stable, no significant change can be observed in the past years (the total volume of clients with large risk is at 13% of the total legal lending limit). Evolution of large risk is monitored monthly, and the internal processes of the Bank are created in a way so that no breach of the legal lending limit can be made.

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

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

  Trading risk taking was stable at around 25% of the available VaR limit. There was no limit overrun in the examined period. In March 2018 trading positions were migrated to KBC (phase 1: interest rate positions), during 2019 FX positions will be migrated also (phase 2).
- **Liquidity risk** means the risk of the inability of an institution to comply with net financing requirements. Liquidity risk may be caused by disturbances on the market, credit downgrading, which may result in the constant cessation of certain financing sources. On process level the bank is managing interest rate risk as part of the ILAAP framework through the cooperation of the affected departments. Management seeks to diversify the financing sources and manages assets with due regard to liquidity requirements, maintaining a healthy balance between cash, liquid funds and promptly marketable securities. Short term liquidity risk is measured by the operational liquidity limit which establishes whether there is sufficient coverage for the 30-day cumulative liquidity gap. Structural liquidity is monitored through Basel III liquidity ratios (LCR, NSFR) as well as FFAR (DMM) indicator, FLST indicator and by liquidity stress tests and liquidity early warning signals. The department prepares regular reports to the K&H Bank Capital and Risk Oversight Committee on the various liquidity indicators and limits.

	30 Jun 2017	30 Jun 2018	Regulatory requirement
NSFR (%)	133.9	144.4	n.a*
LCR (%)	224.4	161.9	100
FFAR (DMM) (%)	116.7	100.4	100

* Regulatory limit will be introduced in 2019

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

6. Operating Conditions of the Bank

Capital investments in the branch network:

- During the first half of 2018 the set-up, full or partial reconstruction of 17 branches was started or completed
- 24 cash-in ATM terminals were installed
- By the end of H1 2018, altogether 457 ATMs were serving our customers (including 208 Cash-in ATMs).

The number of branches at the end of June 2018 was 206.

The most important IT development projects in the first half of 2018 were the followings:

- Several project size developments were initiated or completed to align with legal regulations such as: Personal Data Protection Regulation, MIFID2, IFRS FTA accountancy, Domestic HUF Instant Payment, New AML legislation, Regulatory Reporting, PSD2.
- For corporate clients certification renewal related developments for token based user authentication was done
- The “Time to yes 48” project launched by retail lending department aims to support decision making within 48 hours.
- Within the Digitalization programme the following developments were delivered in the first half of 2018:
    - website: the online loan calculator for SME clients went live
    - Mobilbank/MobilePayment: message sending function related developments were delivered
    - Chip card authentication phase out was finished.
    - Biometric Signature: the roll out of the already productive Biometric Signature function was done for the entire branch network
    - e-Portfolio: IT specification and development phase of product level profit&loss calculation has been closed.

Budapest, 30 August 2018

David Moucheron
Chief Executive Officer

Attila Gombás
Chief Financial Officer