

Internal Audit Report for 2020

1. THE PURPOSE OF PREPARING THE REPORT

According to Article 281a. of the Companies Act, Article 144 of the Banking Act and Article 12 of the Charter of the Internal Audit of NLB d.d., the Internal Audit must prepare the Annual Internal Audit Report and submit it to the Management Board, the Audit Committee, the Supervisory Board and the auditor of the financial statements, while the Management Board must notify the General Meeting of Shareholders about the report and the Supervisory Board's opinion thereon.

With the Annual Report, the Internal Audit informs the Management Board, the Supervisory Board, the Audit Committee, the General Meeting of Shareholders and the auditor of the financial statements about:

- the statement of objectivity and independence;
- the implementation of the Annual Action Plan;
- the major findings of the audits of operations carried out;
- the assessment of compliance of remuneration practices with the remuneration policy;
- the implementation of the Quality Improvement and Assurance Programme.

The report contains all the information specified in Article 144 of the Banking Act.

2. STATEMENT OF OBJECTIVITY AND INDEPENDENCE

The duties of the Director of the Internal Audit and internal auditors in NLB d.d. in terms of ensuring independence and objectivity, avoiding conflicts of interest and reporting on the occurrence of any circumstances that could compromise their independence and objectivity are defined in the Charter of the Internal Audit of NLB d.d.

The Internal Audit's independence has been established since the Internal Audit is a management support service within the organisational structure, functionally separate from other parts of the Bank, and reports directly to the Management Board, the Supervisory Board and the Audit Committee.

In determining the objectives, areas and scope of internal auditing, performance and reporting, the Internal Audit is independent. Persons performing internal auditing tasks do not perform any other tasks in the Bank that could give rise to conflicts of interest and compromise their objectivity. Likewise, they have no direct responsibility or authority to decide on the activities they are auditing.

The Director and internal auditors are objective in their work and without prejudice. Any potential threats to independence and objectivity are managed at the level of an individual auditor, engagement, and functional and organisational responsibility. If independence and objectivity are compromised, the Director of the Internal Audit must disclose such information to the Management Board, the Supervisory Board and the Audit Committee as soon as possible.

In accordance with the Code of Ethics of Internal Auditors and the Charter of the Internal Audit of the NLB, the Director of the Internal Audit states that **the Director of the Internal Audit and the internal auditors of the NLB operated independently in 2020 and that no circumstances arose in the course of their activity that would compromise their objectivity.** To this end, the Director and all internal auditors signed a statement confirming their independence and objectivity in 2020.

3. IMPLEMENTATION OF THE ANNUAL ACTION PLAN

In 2020, the Internal Audit of the NLB successfully completed **50 planned audits** of various areas of operation of the Bank and the Group, **2 unplanned audits**, **32 branch inspections** and was involved in **several strategic projects** as advisor. Four planned audits were postponed due to objective reasons. There were 1,592 working hours used for consulting the management and other employees and 440 hours spent on non-planned activities.

4. MAJOR AUDIT FINDINGS

All findings and recommendations issued by Internal Audit had been addressed, the responsible areas had prepared action plans to mitigate the related risks.

Risk management

In the area of legal entities, the bank has a well-established credit rating approach for each segment: micro, medium and large. The rating system is upgrading with the aim to assure automate and up-date credit rating assessment to all clients. With regards to automation of creditworthiness assessment the statistical rating models for micro corporate are in use. As the validation of the statistical model showed certain shortcomings, it is planned to be replaced. Furthermore, certain inconsistency of business rules between models and methodological frameworks have been identified.

Established Early Warning System for corporate clients is sound and appropriate monitoring is in place. Improvements are needed in comprehensive monitoring of clients with lower exposure.

ICAAP process has been continuously upgraded in line with ECB Guidelines.

Lending process

The lending process is being constantly upgraded and optimised. Key controls in the process and segregation of duties are established. Nevertheless, many applications are in use in the SME lending process and manual processing of data is extensive. Furthermore, extensive and complex instructions and credit proposals make the process even more complicated. In some parts, authorization rules are to be clarified.

The quality of housing and mortgage portfolio is good. The Bank has successfully implemented the requirements of the Regulation on macroprudential restriction on household lending since November 1, 2019, which is fully supported by IT application.

The monitoring, recording and reporting of the exemptions and deviations from credit policies and procedures, according to the EBA Guidelines on loan origination and monitoring, has room for improvement.

Cross Border financing portfolio includes material and complex transactions demanding close cooperation with all relevant stakeholders within decision-making and control processes, including all core members (front office, credit risk). Limits are defined in Risk Appetite and monitoring performed by Global Risk. The concept is well-defined, but still some improvements were recommended.

Due to ad-hoc changes regarding Covid-19 pandemic situation, the ZIUPOK Act was passed on the 28th of March 2020 as response measure to outbreak for those businesses and private individuals effected by the crisis and faced by liquidity shortages and difficulties in timely payment of their financial and other commitments. The bank has set the process, rules, segregation of duties and responsibilities for managing the new situation. Improvements are needed in the area of monitoring, IT support, reporting processes and credit process ownership-related tasks.

The loan collateral management is constantly upgraded and optimized. Further improvements in comprehensive collateral IT support and more effective management is also envisaged. Currently, the Bank establishes an overview of all collateral received from a more detailed substantive aspect of risks. Furthermore, Basel II eligible collateral is properly obtained, documented, recorded and reported.

NPL management

The Bank has established an adequate system of monitoring and regulatory reporting on reducing the volume of NPLs at the level of the entire Group. The share of NPLs is steadily decreasing. Proactive

workout is in place. For lowering the NPL, sale of individual or package receivables is also used. In the process of selling receivables key controls have been implemented. Special care is needed to assess these transactions from AML risk perspective. Additionally, a comprehensive renewal of end to end collection process is still ongoing. Some improvements have already been incorporated into the process. The update of NPL Strategy with Covid-19 impact is currently in preparation.

Cyber security

Cyber security infrastructure, processes and organization have been significantly improved during the last two years. In the time of infrastructure implementation, set of functionalities and alarms have been implemented. Security infrastructure needs further adjustments, continuous upgrade of functionalities, as well as optimisation of security processes. An independent sector "Information security management of the NLB Group" was established, which will have a positive impact on the Cyber security.

IT Security (Identity and access management)

Identity and Access control management for applications and cloud services need further improvements. All important system- and application passwords have to be kept in the safe. Passwords need to be changed regularly. Monitoring of external provider accesses has room for improvement. Identity and Access management for cloud services has to be included in central administration of users (CAU). Physical access control management to the IT premises is adequate.

Cash management in branches

28 branches were inspected and 4 additional branches in the Distribution Network were revisited. Focus of inspections was made on the compliance with cash handling procedures. Overall, additional progress has been observed, however, there is still room for improvement in cash management processes. In this sense a joint presentation of main findings to all heads of branches was made by Internal Audit in January 2021.

Others

IA performed audit assignments in other areas of the Bank's. IA has primarily identified progress in the field of process of individual impairments and provisions recognition, in flagging high risk exposures for RWA calculation. The Bank broadly ensures compliance with financial market regulation and quality of input data on financial instruments. Further strengthening of the function is planned.

The bank is aware of and adequately manages risks related to the Covid-19 situation and has ensured the effective transition of many employees to work from home. In this way the infections in business premises are managed well. Due to new way of working, certain administrative problems have occurred, but new IT solutions were successfully and promptly implemented.

NLB Custodian Bank approached to supplement description of activities on ensuring that a value of assets are calculated in compliance with Act, regulations and the investment fund's rules or instruments of incorporation. Regular controls began to be established over access to the main custodian application for outside providers.

Within market risk credit spread risk has been upgraded by economic calculation, its stress scenarios are system validated. The process and the key controls for FX derivatives trading for the bank's account are transparent and appropriately documented.

5. ASSESSMENT OF COMPLIANCE OF REMUNERATION PRACTICES WITH THE REMUNERATION POLICY

Remunerations of the Management Board members and employees performing special work in NLB Group were not paid out, which is in line with the ECB published letter, addressed to the Chairpersons (on 28.7.2020) and decision of Banka of Slovenia (Official Gazette RS, no. 49 on 11th April.2020).

6. IMPLEMENTATION OF THE QUALITY ASSURANCE AND IMPROVEMENT PROGRAMME

The Internal Audit has adopted the Quality Assurance and Improvement Programme with the aim of ensuring compliance with the professional and ethical rules of internal auditing and in order to constantly improve the efficiency and effectiveness of its operation. The programme was implemented in 2020 in various ways described below.

a. Internal quality review

- permanent supervision of the Director of the Internal Audit over the work of internal auditors;
- continuous professional supervision and directing the work of internal auditors by expert managers;
- weekly monitoring of the progress of individual engagements in order to improve the efficiency of work;
- regular monitoring of the time spent by internal auditors;
- semi-annual and annual assessment of the attainment of the objectives of the internal auditors and the Internal Audit as a whole;
- measuring the satisfaction of the management of the audited units with the work of the Internal Audit.

b. Education and training

12 out of 27 internal auditors hold various professional licenses awarded by Slovenian and international audit institutions. Of this, there are 5 auditors with an international license in the field of information systems auditing (CISA, CISM) and/or information security management auditor licence.

Much of the time was spent by internal auditors on professional training and upskilling in the context of various training courses organised by the Slovenian Institute of Auditors (SIR), the International Institute of Auditors (IIA), International Institute of Auditors of Hungary, the ISACA (Information Systems Audit and Control Association), the Bank Association of Slovenia (BAS) and other competent institutions. They improved their knowledge in the following areas: information systems and information security management, information and personal data protection, novelties in banking regulations with an emphasis on risk management, international accounting standards, prevention of fraud, abuse and money laundering, corporate governance and others. They also were acquainted with international trends in the field of auditing and improved their communication skills.

c. Implementation of the recommendations from the external quality review

The last external assessment of the quality of work of the NLB's Internal Audit was conducted in 2017. The external provider confirmed overall compliance with all international standards of professional conduct in internal auditing. Comparative analysis has shown that the quality of the internal audit function is above the average of the international banking and wider competition. The external auditor also made some recommendations for further improvement of the work. Recommendations were executed within the deadlines set.

d. Supervision over the work of the internal audit departments of the NLB Group members

In 2020 the following activities were carried out:

- internal audit of the quality of the internal audit function in three subsidiary banks;
- few competence line meetings for internal auditors of subsidiaries;
- trainings provided for internal auditors of the Group (modelling, cyber security, etc)
- training on the job of subsidiaries' internal auditors;

- provided professional assistance to internal auditors of subsidiary banks and other companies in carrying out audits;
- control of reports prepared by the internal auditors of subsidiary banks and companies for their management and supervisory bodies (annual action plan, quarterly and annual reports on activities, implementation of audit recommendations).

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