

Internal Audit Report for 2021

1. THE PURPOSE OF PREPARING THE REPORT

According to Article 281a. of the Companies Act, Article 164 of the Banking Act and Article 10 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 164 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 2021 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 2021.

3. IMPLEMENTATION OF THE ANNUAL ACTION PLAN

In 2021, the Internal Audit of the NLB successfully completed **70 planned audits** of various areas of operation of the Bank and the Group, **out of which 25 assignments were branch inspections, 1 joint audit with local auditor in banking subsidiary** and was involved in **several strategic projects** as advisor. Seven planned audits were postponed due to objective reasons. There were 1,688 working hours used for consulting the management and other employees and 648 hours spent on non-planned activities.

4. MAJOR AUDIT FINDINGS

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

Risk management

ICAAP process is considered as matured and is being continuously upgraded in line with ECB Guidelines. The Bank regularly monitors capital position and discusses it on Capital Management Group and ALCO sessions.

Individual provisioning process is sound with proper segregation of duties, supported by IT application, and timely recognition of provisions.

Risk management is faced with extensive regulatory reporting and constant changes of regulatory framework, and consequently data availability and data quality challenges. In regulatory reporting and data quality, some room improvements, or possibilities to automatize relevant processes have been identified.

The process of Forbearance status change is not operating in optimal manner and additional manual controls are to be in place. Due to COVID moratoriums, the extension of the observation period is expected.

Established Early Warning System (“EWS”) for private individuals needs some alignments with the methodology. Activities for retail EWS implementation in NLB Group members are in progress.

ILAAP process has been supplemented by many improvements taking into account regulator’s recommendations. A bank made a big effort on key areas highlighted by regulator; key documents and methodologies as well as reports have been either updated or submitted according to regulatory expectations. Further improvements are in progress and will be included in the next ILAAP package in 2022.

No deficiencies were identified in the calculation of traded debt securities and settlement risk as part of RWA for market risk.

Counterparty Credit Risk (“CCR”) and related controls are good and effectively managed; limit system and the exchange of cash collateral are effectively implemented and function properly, regulatory changes in the methodology for RWA were properly implemented, the AML filtering of transactions for banks is effective.

Though CRR regulation had changed the calculation of CCR exposure, the change has not been considered also in calculation of capital requirements for the CVA risk.

Liquidity risk management as a process was supplemented with additional control activities in last years. Management of liquidity risk on the group level is defined by a policy that covers a wide range of liquidity activities. Majority of them are prepared on the Group level, while intraday activities still have some room for improvement on a Group-level; intraday liquidity buffer calculations, reporting of NSFR indicators.

Lending process

The lending process has been constantly upgraded and optimised. Key controls in the process and segregation of duties are established. Nevertheless, many applications are in use in the corporate lending process and manual processing of data is extensive. Furthermore, extensive and complex instructions and credit documents make the process even more complicated.

In retail segment, overdrafts approval process had been upgraded and supported with integrated controls built in the IT application. Nevertheless, some minor improvements in the process have been

recommended, as well as in the credit card approval process aiming at implementing automatic controls.

Monitoring of moratoria and post Covid financing for all corporate segments are adequate. The existing Early Warning System has been upgraded with additional activities identified as prevention for possible deterioration of the client's business due to Covid 19 impact. Committee (WLC) sessions are organized more frequently and adapted to the Covid 19 circumstances. Business units are in continuous contact with clients. Improvements are needed in proper, automatic calculation of retail clients contract obligation.

Retail restructuring process has significantly improved; the team possesses good knowledge of restructuring process and acts on a proactive way in finding opportunities for improvements or boosting the process.

The loan collateral management is constantly upgraded and optimized. Further improvements in control, monitoring and data quality are still expected. Currently, the Bank establishes an overview of all received collateral from a more detailed substantive aspect of risks.

Non-Performing Loan ("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. A comprehensive renewal of end-to-end collection process is still ongoing.

The real estate companies in the NLB Group make a positive contribution to the efficient management of real estate and thus to the reduction of Non-Performing Exposures ("NPE"s) of Group members. Some improvements are needed in the harmonisation with the Group standards.

Data Architecture Model

Weaknesses are the gaps between formal and actual responsibility regarding integrated approach to data architecture models, complex and heterogeneous application landscape related to not yet finalised enterprise architecture, and priority of risks treatment regarding current Datawarehouse in the transition period to new environment. Project on data and information capital results so far represent significant progress towards meeting relevant risk data aggregation and reporting requirements.

IT Security

IT security has considerably improved and is comprehensive, however some improvements are needed in risk assessment, and treatment of risks and measures.

Management of key risks and controls over identity and access management is adequate, additional focus is needed in the area of system passwords and access management in cloud environment.

Cash management in branches

In 2021, 27 Distribution network branches were inspected, a third of their total number. Focus of the inspections was on checking their compliance with the cash handling procedures. Overall, progress has been observed, however there is still room for improvement especially in case of repeating deficiencies.

Others

Though FX trading process takes place in different organizational units, it is well connected by common applications. Automatic as well as manual controls mitigate inherent risks; real-time closing transactions, automatically taking over partly closed transactions from sales by financial markets at the

end of the day. The bank has clearly defined business goals on FX trading as a service for customer from general to lower levels (from budget to KPI on individual dealers/traders).

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

The payments for 2020 were made based on adopted resolution of the Supervisory Board of NLB d.d. from 11th June 2020, that Management Board members will be paid out bonus in amount of 25% of the maximum gross salary and in proportion to the duration of the mandate of each Management Board member in 2020. The method of payment of remuneration, which was adopted by the Supervisory Board, was also taken into account for employees performing special work in NLB.

The basis for such decision of the Supervisory Board of NLB dictated by the circumstances surrounding the COVID-19 epidemic, a letter from the President of the European Central Bank's Supervisory Board dated 15.12.2020, the amount of deferred funds for the payment of bonuses, taking into account adjustment criteria based on KPI and KRI and the Remuneration Policy for Employees Performing special work.

The bank also implemented recommendations from JST / ECB Deep-dive review (including the definition of remuneration policy for all employees).

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 2021 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;
- performed internal quality review of the internal audit maps.

b. Education and training

12 out of 28 internal auditors hold various professional licenses awarded by Slovenian and international audit institutions. Of this, there are 7 auditors with an international license in the field of information systems auditing (CISA, CISM) and/or information security management auditor licence and one auditor with international license Information Security Auditor.

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 were also 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. Next external assessment will be performed in 2022 in all NLB Group member banks.

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

In 2021 the following activities were carried out:

- internal quality review of internal audit function in two subsidiary banks (NLB Skopje and KB Beograd);
- harmonization of Internal audit function in KB Beograd with the Group's internal audit standards;
- monthly competence line meetings with Heads of Internal Audit departments in subsidiaries;
- meeting in Ljubljana with the Heads of Internal Audits in subsidiaries;
- trainings provided for internal auditors of the Group (examples of practical audits);
- regular professional assistance to internal auditors of subsidiaries in performing audits;
- monitoring of reports prepared by the internal auditors in subsidiaries for their management and supervisory bodies (annual action plan, quarterly and annual reports on activities, implementation of audit recommendations).

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