

# Internal Audit Report for 2022

## 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 2022 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 2022.

## 3. IMPLEMENTATION OF THE ANNUAL ACTION PLAN

In 2022, the Internal Audit of the NLB successfully completed **69 audits**, out of which **66 audits were planned** and covered various areas of operation of the Bank and the Group, **out of which 21 assignments were branch inspections, 2 audits were conducted as joint audits with local auditor and one quality review in banking subsidiary.** In addition, Internal audit initiated and completed **3 new audits**, and was involved in **several strategic projects**, as advisor. Six planned

audits were postponed due to objective reasons. There were 1,080 working hours used for consulting the management and other employees and 784 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**

Risk management is faced with extensive regulatory reporting and constant changes of regulatory framework, and consequently data availability and data quality challenges, most recently with ESG related requirements.

Comprehensive Model Risk Governance continues to be in the phase of implementation. Governance and procedures in this area were further improved, including establishment of the Validation Unit. The Model Inventory was established on the NLB Group level and plan for up-coming validations is in preparation. The increase of development, usage of models and changes in modelling techniques, subsequently demands reliable and effective processes and controls through the model-life cycle.

On the field of IFRS 9 considerable progress has been made by adjusting the methodologies, updating model development documentation, by a significant improvement and effort in data collection, and by introducing monitoring framework with triggers for adjustments. Some room for improvements were identified in performing data validation.

ICAAP process is established and managed adequately, it has been continuously upgraded and supervisory expectations have been considered. The control of raw data is established via interfaces from subsidiaries to the data warehouse; data quality indicators were set and closely monitored.

Bank regularly monitors capital position on Group level and discusses it on Capital Management Group and ALCO sessions.

The NLB Group Risk Appetite Statement represents the aggregate level and types of risk within the NLB Group. The document is yearly reviewed and approved by the Management Board of NLB d.d. and the Supervisory Board of NLB d.d. The bank regularly measures the Risk Appetite on Group Level.

In quarterly risk reporting, some control weaknesses were noted in data quality and comprehensive compliance with the BCBS 239 Principles.

New method of interest rate measurement is in progress. Allocation of non-maturing deposits as the most important modelled component of EVE calculation has already identified limitations, therefore new model is being developed.

As part of mitigating liquidity risk, Financial Markets performs an in-depth analysis of customers' deposits database as the main source of funding on a semi-annual basis and reports results to ALCO. Based on that analysis Deposit strategy had been prepared and included as an important part of the Funding Plan.

In ILAAP Updates on risk identification process results present an input to Risk inventory together with material risks and risk drivers. Risk inventory as well as risk drivers also present an input for stress test content.

Measurement of FX risk is established for NLB as well as for Group, whereas the daily report for NLB will need to be updated with the new position in gold. The frequency of reporting is monthly to ALCO for NLB d.d. and quarterly on ALCOs of other members of NLB Group. Nominal limits are regularly reviewed. Process for calculation of capital requirement needs some updated controls to ensure proper

mitigation for risk of deficiencies in calculations. FX risk is being proactively managed by implementing changes in methodology and IT tools to ensure a comprehensive approach.

Management of securities' portfolio in banking book assure adequate liquidity management with focus on capital consumption and profitability. Limits are set on the level of individual client, product and on the portfolio level as part of risk appetite framework.

Controls on trading with debt securities and money market instruments are properly established and adequately performed, segregation of duties is effectively implemented. Additional further enhanced anti-money laundering activities for financial institutions should be implemented to contribute to continuous mitigation of AML risks.

### **Lending process**

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

The process of approving loans in the segment of small and medium-sized enterprises is well-established. Since the reorganization in 2021, non-commercial activities including clients' AML due diligence, have taken place in the back office. Profitability credit calculator had been renewed; however, it currently covers only loans and overdrafts. Additionally, improvements are expected in monitoring of new approvals which deviates from credit standards.

Materially important clients are carefully treated and monitored on the Group level. The approval process is well-defined; no major issues were identified. Knowledge of staff and information flow between subsidiaries are good. Data quality will be improved in Register of Clients and Groups.

Project financing is well-defined, supported with clear rules and established process. Project finance team's opinion and control have an important role in granting and monitoring the process and all projects are part of Risk Committee discussions. Regular monitoring of projects and credit drawdowns are ensured by external project supervisors. NLB will improve the supporting documentation and monitoring covenants.

The syndicated lending process is well-organized, roles and responsibilities are properly setup. The experience and expertise of employees involved in the process contributes to smooth, stable business operations in this complex area. Some minor shortcomings have been identified in contractual covenant monitoring.

For the corporate segment, the ESG documentary framework for the loan approval has been adopted, and its implementation and preparation of detailed internal regulatory framework for the business process is in progress.

In retail segment, consumer, housing, and mortgage loan approval processes are continuously improving and NLB puts effort into making the process automatic. The process has been also subject to many additional regulatory requirements and changes. Cooperation between all participants in the process is appropriate and represents good risk management practice. Regular update of knowledge is necessary to avoid mistakes in the process and the knowledge transfer is also important for the new colleagues. Residential real estates are properly assessed and verified. Automation of credit card approval process is in progress yet.

### **Cybersecurity**

Cybersecurity governance framework is comprehensive and effective, however cyber risk assessment methodology should be continuously updated to consider new emerging threats and vulnerabilities not only in practice, but also in the methodology.

Patch and vulnerability management needs to be further expanded, regularly monitored and reported, and supported by automated tools.

### **Outsourcing**

3<sup>rd</sup> party IT service provider audit revealed number of deficiencies in 3<sup>rd</sup> party IT risk management. Recommendations to mitigate those findings had been agreed and follow-up process on action plans implementation defined.

### **Cash management in branches**

21 branches were inspected out of the 23 planned for 2022. 2 more inspections are in progress with field work completed and reports to be issued in January 2023. The focus during branch reviews is on the compliance with cash handling work instructions. In general, there is still room for improvement to perform the related activities in line with the internal regulations which is being supported by constant building of awareness among workers, especially since the fluctuation is relatively high compared to other organizational units of NLB. NLB aims at further improve the cash management in branches.

### **Regulatory compliance**

Regulatory changes are becoming more extensive and demanding. NLB has a decentralized system for ensuring compliance with legislation; Regulatory Monitoring and Prevention department is primarily responsible for identifying and monitoring legislative changes, while individual organizational units (ambassadors) are responsible for implementing the necessary changes and ensuring the compliance with legal requirements.

The introduction of a new information tool for ensuring compliance in the bank is expected soon to ensure a more efficient, automated process.

The complexity of the legislation in the field of financial markets dictates the need for extensive monthly monitoring, but due to organizational and technical reasons, control in this area was not fully carried out.

### **Procurement process**

Procurement strategy was adapted, and the process had been changed including additional set of activities to improve the internal control system, delegation of authorities as well as making the procurement process more efficient. The documentation of selection process and completeness of a central register have also been improved, which are in the scope of the currently ongoing follow-up audit activity.

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

Bank received a letter from in-depth review of the Remuneration Policy by JST. Based on this Letter, Bank prepared action plan and implemented all recommendations but two, for which extension of the deadlines had been granted by JST. By implementing and obtaining confirmation by JST for these two recommendations, the Bank will achieve broad compliance with EBA guidelines.

## **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 2022 in various ways described below.

#### **a. Internal quality review**

- permanent supervision by 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 files.

#### **b. Education and training**

8 out of 30 internal auditors hold various professional licenses awarded by Slovenian and international audit institutions. Of this, there are 6 auditors with an international license in the field of information systems auditing (CISA) 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, ESG, 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 2022. The external provider confirmed overall compliance with all international standards of professional conduct in internal auditing.

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

In 2022 the following activities were carried out:

- internal quality review of internal audit function in N Banka;
- monthly competence line meetings with Heads of Internal Audit departments in subsidiaries;
- competence line meeting was held in Montenegro 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);
- monthly meeting for IT auditors;
- Setup of IT Internal Audit Advisory Team in Serbia.

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