

# Internal Audit Report for 2018

## 1. THE PURPOSE OF DRAFTING 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 produce 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 2018 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 2018.

## 3. IMPLEMENTATION OF THE ANNUAL ACTION PLAN

In 2018, the Internal Audit of the NLB successfully completed **43 planned and 6 extraordinary** audits of various areas of operation of the Bank and the Group. There were 568 working hours used for consulting the management and other employees. For objective reasons, 3 audits were postponed until 2019.

## 4. MAJOR AUDIT FINDINGS

### **Information technology management**

In 2018, the Bank concluded the reorganisation of the IT area and completed recruitment of senior management. IT is adequately managed. The Bank did not witness any major unplanned IT system shutdown that would have a significant impact on its operations (financial, client satisfaction, reputation, violation of regulatory requirements, etc.). Challenges arise mainly in filling all newly emerging vacancies resulting from the introduction of new technologies and methodologies, and owing to the existing age structure of the personnel and the complexity of IT, which the Bank has been simplifying at a fast pace by implementing the adopted IT strategy.

### **Cyber security**

In the area of cyber security, the Bank made significant progress. A cyber security framework has been set up. An Information Security Committee has been established. A security operating centre is operational for the entire Group. A uniform tool for managing incidents and events has also been introduced. In order to increase security, the Bank carried out penetration testing and analysed gaps in cyber security. Challenges arise mainly in the timely implementation of defined security measures and on-going provision of expertise in the rapidly developing area of cyber security.

### **Data management**

Years ago, the Bank joined the data management and data warehouse redesign project. In addition to development, it also provides for smooth operation of the existing environment for the purpose of regular reporting to the regulator and other business needs. However, it is necessary to constantly improve the quality of the data at the Group level. The Bank has already made the first steps in this direction by setting up local data warehouses in the members of the Group and introducing mandatory validation of data prior to their transfer to the NLB.

### **Management of strategic projects**

In order to monitor the implementation of projects, the Bank has selected a globally established good practice. Due to the complexity and the size of the project portfolio, it faces difficulties in managing human resources, interdependencies between projects and setting development priorities, which caused certain delays in projects. The Bank has already started updating the strategy, reorganising the area for strategic development, recruiting additional experts and introducing a modern project portfolio management tool.

### **Process management**

The Bank has in place a business process ownership model. In the last year, it launched a gradual process redesign according to the lean process methodology. The first optimisation possibilities and thus savings have already been recognised, but they will require certain development of information support, which will have to be suitably prioritised in order to actually realise savings.

### **Business continuity**

The Bank's business continuity plans have been set up and are regularly tested. It will be necessary to revise the methodology of the business impact analysis and supplement the plans with the business recovery scenarios for cases when both data centres are down at the same time.

### **Outsourcing**

In the area of outsourcing, the Bank does not record major incidents. With the new European regulation on managing outsourcing, the Bank initiated the modernisation of existing processes, the strengthening of human resources, the updating of the risk assessment methodology and the

formulation of exit strategies. It also updated the regular incident and service level (SLA) monitoring tool.

### **Personal data protection**

The Bank has implemented new European regulations governing the protection of personal data (GDPR). It will be necessary to further strengthen the awareness of responsible handling of personal data at all levels of the Bank and define binding rules for the entire Group.

### **Risk management**

The Bank has implemented an internal model for calculating Group impairments and provisions under IFRS 9. The accuracy of the model has been examined by an external auditor, and its implementation also by the regulator. Model validation and back-tests were performed. In the future, the Bank will have to provide sufficient time series of data.

In 2018, the Bank continuously introduced novelties and improvements in the context of implementing the modified banking regulations and good practices that apply in the European banking area. There are a number of development activities in progress aimed at improving the quality of data at the level of the entire Group and ensuring a higher level of automation of regulatory reporting at the consolidated level. In the future, it will be necessary to upgrade the existing IT support in certain segments, improve documentation on manual procedures and controls, and conduct the missing validations of risk management models. In addition, the compliance function in this area will have to be upgraded professionally due to extensive and complex banking regulations and increasingly stringent regulatory requirements.

### **Lending process**

The lending process has been upgraded and updated for several years, and the optimisation activities continued in 2018 as well. Key controls in the process are established, separated from front office in organisational terms and regularly conducted. The Bank also uses internally developed statistical and expert models for the credit rating of clients. In 2018, it introduced new products at an accelerated pace along with marketing channels in order to maintain and increase its competitiveness.

Significant progress has been achieved in the area of loan collateral management in terms of improving the quality of data, the organisation of internal acts and documents, and regular updating of the valuations of assets provided as collateral. It will be also necessary to improve IT support and optimise the entire process.

### **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 has been steadily decreasing and is in line with the strategic goals. At the expense of reducing the NPL portfolio, however, an increase is seen in the volume of off-balance-sheet receivables written-off, which are subject to intense collection procedures. We proposed a more active pre-court collection and automated transfer of NPLs from the Front Office.

### **Other**

In 2018, we carried out audits in other areas of the Bank's operations. We have primarily identified progress in the field of cash handling and a strong control system in payment transactions, card fraud management, guarantee operations and trade finance as well as accounting of tax on financial services. We proposed procedural improvements and optimisations in the field of procurement, staffing, management of own real estate and restructuring of clients – natural persons. Moreover, we suggested reducing the scope and complexity of internal acts and upgrading some computer support to downsize the necessary the volume manual procedures and controls.

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

In accordance with the banking regulations, the Internal Audit checked remuneration payments to the NLB's Management Board and employees whose work is of a special nature at the NLB. Payments were made in accordance with the Policy on Remuneration of Key Personnel, which is aligned with the Banking Act and the Act Governing the Remuneration of Managers of Companies with Majority Ownership held by the Republic of Slovenia or Self-Governing Local Communities as well as the 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 2018 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**

11 out of 24 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), the ISACA (Information Systems Audit and Control Association), the Bank Association of Slovenia (BAS) and other competent institutions. They perfected 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 got acquainted with international trends in the field of auditing and perfected 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 audit 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 are executed within the deadlines set.

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

In 2018 the following activities were carried out:

- internal audit of the quality of the internal audit function in three subsidiary banks;
- a 2-day expert meeting for internal auditors of subsidiaries;

- 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).

Ljubljana, 15/02/2019

  
Polona Kurtevski  
Director of Internal Audit