

# Internal Audit Report for 2023

## 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.

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 2023 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 2023.

## 3. IMPLEMENTATION OF THE ANNUAL ACTION PLAN

In 2023, the Internal Audit of the NLB successfully completed **91 audits**, out of which **23 assignments were branch inspections, 66 audits were planned audit reviews** covering various areas of operation of the Bank and the Group, **4 audits were conducted as group audits, 5 as joint audits with local auditors and 3 quality reviews in different banking subsidiaries.** Five planned audits were postponed due to objective reasons, and 2 audit assignments had been deleted from the plan. Increased amount of time had been spent on non-planned activities, mainly related to the Group-wide

implementation of Internal Audit IT workflow system supporting all activities. In addition, Internal audit was involved in **several strategic projects**, as advisor and consulted the management and other employees.

#### 4. MAJOR AUDIT FINDINGS - 2023

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 duties and constant changes of regulatory framework, and consequently data availability and data quality challenges.

In the field of IFRS 9 additional progress has been made resulting in better quality of models, better data collection process, model representativeness for NLB Group members, and in internal validation functions. Some remaining weaknesses were identified in data quality for modelling purposes.

The share of the Stage 2 client's portfolio is stable and relatively low, in comparison with the peers. The process and rule framework for detecting early increase of credit risk is adequate. The bank is expected to continuously review the approaches and to implement the necessary improvements, if needed, to ensure sound staging assessment processes in order to timely recognise any significant increase in credit risk, thus, preventing undue delays in the transfers to Stage 2.

In climate and environmental risk assessment and management, important improvements have been made by defining methodologies for transition and physical risk assessments, upgrading the collateral valuation process, and collecting data. Additionally, Net Zero portfolio decarbonisation targets have been published while the process of defining sector limits is in progress. ESG risks are in regulatory focus and further improvements are expected.

ICAAP process is established and managed adequately, it has been continuously upgraded and supervisory expectations have been considered. Risk identification process should be further improved and documented within NLB Group members.

Bank regularly monitors current and forward-looking perspective capital positions, and they are being discussed on different management levels.

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 and the Supervisory Board of NLB d.d. The bank regularly monitors the Risk Appetite on NLB Group Level.

Management of **interest rate risk** exposure in NLB Group is decentralized, based on centralized methodological approach defined by NLB, d.d.. Deviations from defined approach in NLB Group members need to be eliminated (final decision for core deposit allocation of banking members is concluded by NLB on expert judgement basis to balance open-closed positions). There is also room for improvement in the development of monitoring and reporting activities using the new IT application.

##### 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, variety of instructions and required credit documents make the process complex.

Documentary transactions are carried out centrally and volume/number of transactions is growing. Management has a positive attitude in searching business efficiencies and new opportunities, also supporting group members in issuing letters of credit. Guarantee business has seen significant growth

in recent years as well, with low default rate. The process is well established; however, several manual controls are still applied. The user experience of stakeholders in the process is very good.

The process of approving loans to micro corporate needs improvements in terms of optimisation due to the limited application support of T24 system, which does not provide an efficient process automation. The documentary framework for approving loans to micro corporate is in place and further improvements are in progress.

Regarding ESG area for corporate segment, the documentary framework and lending process has been upgraded. For comprehensive support and collection of ESG data, an IT tool has been introduced. Additionally, several trainings and workshops have been organised, to increase the knowledge and expertise of all parties in the lending process.

In retail segment, processes are continuously improving and NLB d.d. puts efforts into streamlining the process by automatization, including credit card approval process.

### **Cybersecurity**

A cybersecurity governance framework is comprehensive and effective. However, it should be continuously updated and upgraded, including the strategy to reflect considerably fast changes in the NLB Group and on the market.

### **Outsourcing**

NLB invested huge efforts to establish a sound outsourcing process during the past years. More focus on intragroup arrangements is needed and internal audit activities on 3rd-party IT service providers also revealed some deficiencies in 3rd party IT risk management. Recommendations for mitigating the findings have been agreed upon and follow-up process on implementation of action plans defined.

### **Cash management in branches and Central vault**

As planned, 23 branches were inspected during the year of 2023. The focus of the branch reviews is the compliance with work instructions in cash handling. In general, higher level of compliance was observed when compared to previous years.

Outsourced review organized by Bank Association of Slovenia and performed by PWC in the Central vault of NLB d.d. dealing with cash transport showed good process management.

### **Commercial banking**

A two-tier complaint handling system is in place and is functioning well.

In the area of Acquiring (cards) it would be necessary to develop an enhanced system for risk rating classification of merchants.

NLB is continuously focusing on increasing users' awareness of the use of electronic channels.

### **External communication and relations with investors**

The system of internal controls is very well established in the area of external communication and in providing important information that affects the position of investors.

## **SRB**

The bank consistently follows the guidelines of Single Resolution Board (SRB) in the preparation of documents that are necessary in case of a resolution. However, it is necessary to upgrade internal controls in the area of data quality assurance when preparing the relevant reports.

## **Financial services**

Bank launched a new service Trading with gold that required engagement from many organizational units involved. The process needs to be enhanced by closer monitoring of a new product and mitigating AML risks.

With the implementation of a new NLB Trading platform the Bank improved user experience, automatized processes, lowered the level of mistakes in brokering the transactions and improved internal control system. The process of account blocking at user's request in case of suspected abuse should be comprehensively established. Minor deficiencies in relation to client data exchange and internal data access management need to be mitigated.

NLB d.d. started to closely monitor the profitability of derivatives. Client identification process in trading has room for improvement. Also risk of managing the effects of binding, yet unrealized derivatives as hedging transactions in loan agreements should be mitigated. Due to limitations imposed by the regulation on small trading book, which limits the growth of the derivatives portfolio, the Strategy for Investment banking and Custody needs to be updated.

## **Procurement process**

In procurement process some additional control activities have been set to improve the system of internal control. The IT application for procurement has been upgraded. Development in Datawarehouse by budget availability is ongoing. Periodically review of contracts is in progress.

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

Based on the letter from the in-depth review of the Remuneration Policy, JST assessed that all recommendations have been implemented. Regulator constantly monitors and asks whether the bank is operating in accordance with the EBA directive and guidelines.

In the field of remuneration, the bank had adopted 3 internal acts in which the EBA guidelines and local Slovenian legislation are applied. Remuneration payments for all employees and SB members are in accordance with internal acts.

## **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 2023 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 on different activities (assignments, trainings, administration, etc);
- 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**

13 out of 36 internal auditors hold various professional licenses awarded by Slovenian and international internal 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 2023 the following activities were carried out:

- 3 internal quality reviews of internal audit functions in subsidiaries;
- monthly competence line meetings with Heads of Internal Audit departments in subsidiaries;
- competence line meeting was held in Slovenia 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;
- Group and joint audit according to the Group Internal Audit Plan;
- 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);
- co-ordination of IT internal audit activities; and
- monthly meeting for IT auditors.

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