

# Internal Audit Report for 2019

## 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 2019 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 2019.

## 3. IMPLEMENTATION OF THE ANNUAL ACTION PLAN

In 2019, the Internal Audit of the NLB successfully completed **46 planned audits** of various areas of operation of the Bank and the Group, **18 branch inspections** and was involved in a **strategic project as advisor**. There were 709 working hours used for consulting the management and other employees. For objective reasons, 3 audits were postponed until 2020.

## 4. MAJOR AUDIT FINDINGS

### **Risk management**

In 2019, 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.

The bank has started to rely extensively on internal statistical models to make business decisions and meet regulatory requirements. The capabilities of staff in Modelling and Validation team are strong. The development phase is well planned and well executed, however validation phase can be improved. Furthermore, the Bank is in starting phase of setting general Concept of Model Risk management.

The Policy for the Introduction of new and substantial changes of existing products has been implemented on a Group level. Furthermore, NLB Group Risk Standards were renewed for the purpose of retail product only.

### **Lending process**

The lending process is constantly upgrading and optimising. Key controls in the process and segregation of duties are established. In order to maintain and increase the competitiveness, on line products on retail and corporate segments are in place. Some improvements in lending process for on-line loans for corporate have been recommended.

The consumer portfolio is constantly growing. The quality of portfolio is high and overall portfolio monitoring is well performed. However, special attention and monitoring for new approvals used for repayments of existing debts and possible simplification of the current consumer loans offer were recommended.

In addition, for the Bank's new strategic focus, the Cross border financing, the documentary framework has been prepared.

The loan collateral management is constantly upgrading and improving. The valuations of assets provided as collateral are regular updating. Nevertheless, some possibilities for improvements are in AnaCredit reporting and in documenting the appraisals selection process. In further, 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 is steadily decreasing. Proactive work out is in place; therefore the strategic goals were outperformed. At the expense of reducing the NPL portfolio, the Bank has to manage the significant volume of off-balance-sheet receivables, which are subject to intense collection procedures. Additionally, a comprehensive renewal of the end to end collection process is ongoing.

### **Information technology management**

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 complexity of IT which the Bank is starting to address systematically.

### **Information security**

In the area of cyber security, during the few years 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. The Bank carried out penetration testing and analysed gaps in cyber security. The main challenges are timely implementation of ever growing security measures and on-going provision of expertise in the rapidly developing area of cyber security.

### **Data management**

The quality of data used in ECB reporting system has significantly improved. The local DWHs and validations have been implemented. The Chief Data Officers (CDOs), data owners and data governance process were introduced in all subsidiary banks. On the Group level key Data Quality Indicators have to be defined and regular Data Quality reporting and monitoring system should be established.

### **Management of strategic projects**

In order to monitor the implementation of projects, the Bank presented updated strategy and reduction of the strategic project portfolio. Strategic projects roll out was in general according to expectations with some deviations and where needed, re-plan was introduced to maintain bank's internal resources and still deliver projects' benefits. The Bank also introduced a modern project portfolio management tool.

### **Business continuity**

The Bank's business continuity plans have been set up and are regularly tested. Methodology of the business impact analysis and recovery plans were updated according to the new threats.

### **Development process**

IT development process has been started to be renewed and elements of agile methodologies are being introduced. Special focus at the renewal of the development process was on business analysis, as a key phase of the development process, and on defining controls, roles and responsibilities to ensure even better-quality results.

### **Other**

In 2019, we carried out audits in other areas of the Bank's operations. We have primarily identified progress in the field of performing individual provisions, central vault operations and cash handling in branches. ICAAP process has been significantly upgraded in line with ECB Guidelines. Measures to reduce operational risk related to personal accounts are continuously adopted and show results. The Bank ensure compliance with financial market regulation and quality of input data on financial instruments. Further strengthening of the function is planned.

## **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 performing special work at the NLB d.d. Payments were paid out in line with the Remuneration Policy of Key Personnel, which is aligned with the Slovenian Banking Act, as well as EBA Remuneration 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 2019 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 25 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 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 are executed within the deadlines set.

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

In 2019 the following activities were carried out:

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