Why Mortgage Companies Should Embrace Internal Audit

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THE HEIGHTENED REGULATORY FOCUS ON THE MORTGAGE INDUSTRY IS DRIVING PUBLIC AND NON-PUBLIC MORTGAGE COMPANIES TO ENHANCE THEIR CORPORATE GOVERNANCE STRUCTURES BY IMPLEMENTING EFFECTIVE INTERNAL AUDIT FUNCTIONS.

Since 2004, NYSE-listed companies have been required to maintain an internal audit function to provide company management and key stakeholders, including the board of directors, audit committee and shareholders, with ongoing assurance of the effectiveness of the company's control environment and risk management processes. While non-public companies, including mortgage companies and other non-bank financial services organizations may have utilized internal audits in managing their businesses, many are just starting to fully develop the function.

After the 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) established the Consumer Financial Protection Bureau (CFPB), and with it, increased scrutiny over mortgage industry compliance with consumer financial laws became the norm. While the CFPB is focused on consumer regulatory compliance, other prudential regulatory agencies and the Department of Justice are focused on strategic, credit, operational and other compliance risks. As mortgage organizations embark on the new normal, it is important for management to understand the state of its control environment and where potential strategic, credit, operational, and compliance risks exist.

Understanding your risks should be reason enough to implement an internal audit function; however, there are other good business reasons to make this investment.

NO SURPRISES – Everyone sleeps better when you know what to expect. Internal audit's mission is to provide independent objective assurance to management and the audit committee regarding the effectiveness of the organization's risk management, control, and governance processes.

UNDERSTAND RISKS – Internal audit should provide management with an understanding of the key risks the company faces.

QUALIFICATION TO SELL TO GSEs– Government Sponsored Enterprises (GSEs) such as the Federal National Mortgage Association (Fannie Mae) require approved sellers and servicers to "have internal audit and management control systems to evaluate and monitor the overall quality of its loan production and servicing.[1]"

OPPORTUNITIES FOR OPERATIONAL ENHANCEMENTS– Private companies with diverse product offerings will find an effective internal audit function will not only assist with improving the control environment, but may also identify operating efficiencies and cost reductions, a desired benefit from any investment.

> Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.
>
> *- The Institute of Internal Auditors*

REDUCE COMPLIANCE ERRORS – Oftentimes, inadvertent operational errors result in technical compliance errors or errors that result in consumer harm. Internal audit's review of operational processes can help to prevent these types of errors which may lead to costly customer remediation or litigation.

All of the regulatory agencies including the OCC, FDIC, Federal Reserve, NCUA and the CFPB require strong internal controls and robust internal audit functions. While they may provide some guidance, the authority on internal audit for organizations across all industries is the Institute of Internal Auditors (IIA). The IIA is an international professional association and the recognized authority and acknowledged leader, advocate, and educator on internal audit. The International Professional Practices Framework provides guidance on internal audit effectiveness. Since publicly traded entities and banks have been required to have an internal audit function, these organizations have long been familiar with the IIA and consistently draw guidance from them.

[1] Fannie Mae Selling Guide, Fannie Mae Single Family, published March 29, 2016, page 5 (Eligibility) https://www.fanniemae.com/content/guide/selling/index.html

INTERNAL AUDIT'S MISSION

The Institute of Internal Auditors (IIA) defines internal audit as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.[2]"

A widely accepted practice of structuring an organization-wide control framework is based on the three lines of defense model. The model assigns duties and responsibilities for controls to segments of the organization as follows:

THREE LINES OF DEFENSE MODEL

1	2	3
The business lines and operations units execute the activities that create and prevent risk. The first line owns and manages risks and controls through policies, procedures, and monitoring processes within the daily operations that help prevent or mitigate risks.	The support functions in an organization including **Finance, Security, Risk Management, Compliance and Legal support management** by providing expertise, process improvements, and a second level of monitoring of business line and operations unit activities.	**Internal Audit is a function that is separate and independent** of the first and second lines of defense. It provides assurance to both senior management and the board of directors around organizational activities.
Works collaboratively with the second line to address improvements required to enhance controls and mitigate risks.	The second line is an oversight function operating under the direction of senior management.	The third line independently reviews all activities within the first and second lines of defense.
The first line reports to senior management.	In many organizations, the second line also reports to the audit committee and/or risk committee of the board.	The internal audit function's primary reporting is to the audit committee of the board with administrative reporting to the CEO.

THE FIRST LINE OF DEFENSE is the operational units or business lines. At this level, management should be able to determine if organizational policies and procedures are being executed correctly by the front line. A process of internal controls, self-monitoring, and correction should be built into the day to day functions to allow department managers and supervisors to ensure duties are being carried out in accordance with company policies and procedures.

THE SECOND LINE OF DEFENSE is typically comprised of the risk management function which includes the compliance function. Generally a management function, the second line provides guidance to the business units on how to design and structure controls to mitigate risks. The second line of defense typically performs ongoing and periodic monitoring, and assists management with control enhancements as needed.

THE THIRD LINE OF DEFENSE is the internal audit function. The audit function is a key element in a sound corporate governance structure and provides independent assurance to the board of directors and executive management about the effectiveness of internal controls and the state of compliance in the company's operations.

[2] The Institute of Internal Auditors – Standards and Guidance – International Professional Practices Framework (IPPF), www.theiia.org.

INDEPENDENCE OF THE INTERNAL AUDIT FUNCTION

An effective internal audit function must be independent of and free from business unit influence and should not perform functions related to the daily operations of the organization. The Chief Audit Executive typically should report directly to the audit committee of the board with unrestricted access to the board of directors and executive management. In many organizations, the Chief Audit Executive reports administratively to the President or CEO.

The internal audit standards of "independence" and "objectivity" may not yet be fully appreciated by mortgage companies that are new to the concept of an internal audit function. Some mortgage companies believe the Quality Control Unit or Compliance Unit is also their Internal Audit function. While both the Quality Control and Compliance units perform tests and provide feedback on performance, they are doing so as part of the first or second line of defense, at management's direction. An Internal Audit unit, in its role as the company's third line of defense, operates independent of the first and second lines. In this example, Internal Audit will actually need to include the Quality Control and the Compliance Units in their audit universe.

STRUCTURE OF THE INTERNAL AUDIT FUNCTION

When deciding how to establish the internal audit function, management has some flexibility as the function should be commensurate with the organization's size and complexity. Some organizations may choose to engage external resources to supplement the function rather than staffing the entire function internally. The cost of the internal audit function grows with a company's size and complexity; and companies should regularly evaluate which audits should be performed internally versus outsourced to a third-party service provider for added oversight and efficiency.

Some additional considerations when establishing an internal audit function include:

Accountability - While the duties of an audit function can be outsourced, accountability for the function and the results remains with management.

Expertise - Auditors must have the requisite knowledge and expertise in the area(s) to be audited.

Training - Training costs to maintain the necessary knowledge and expertise

Independence - The audit function must be free from influence or bias in appearance and in fact. This is not just important if establishing an in-house audit department, but also if using a third party firm. Third party firms should be engaged by the general counsel, executive management, designated Chief Audit Executive or the board rather than the Chief Financial Officer, Compliance Officer or operations manager.

Vendor Management - If outsourcing the function, be sure to evaluate the external resource according to your vendor management program. Keep in mind that they are operating as an extension of your staff and you are ultimately responsible for their actions.

THE INTERNAL AUDIT PROCESS

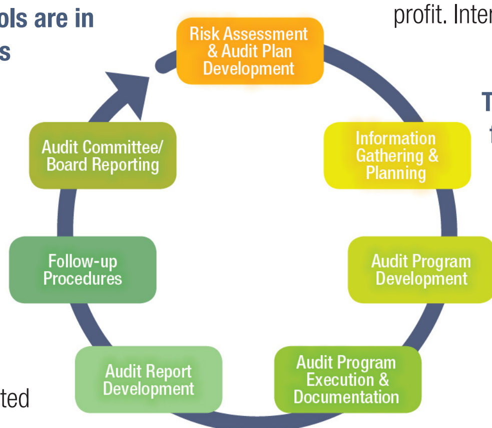
Internal audit is a process of assessing risk, identifying controls to mitigate those risks, testing those internal controls for adequacy and effectiveness, and ensuring appropriate corrective action is undertaken when needed. Key steps in an effective internal audit function typically include the following:

Perform a company-wide risk assessment to ensure all relevant risks have been identified, risk-rated, and properly addressed

A company-wide risk assessment is the initial step in developing a comprehensive risk-based audit plan. While the risks to be assessed will vary by company, typical risk categories to be assessed include strategic, credit, compliance and legal, reputational, financial, and operational risk. Assessing and prioritizing risk(s) should be done at least annually or more often when significant operational or product changes occur.

Non-depository mortgage bankers who sell loans to Fannie Mae are subject to a Mortgage Origination Risk Assessment (MORA) review. In these reviews, Fannie Mae has identified Internal Audit as an issue requiring management's attention. Particular focus is on whether risk assessments performed include the areas of Quality Control, Originations, Closing, Funding, Underwriting, Servicing, and Secondary Marketing, as well as other areas pertinent to Fannie Mae's investor requirements. If internal an audit is an area requiring improvement, be sure to allow sufficient time to properly address all of the components required for an effective internal audit function. Devoting sufficient time to this process will be the difference between an internal audit function that is quickly assembled to avoid criticism and penalties and an effective, worthwhile function designed to add value and improve an organization's operations.

Develop a risk-based, multi-year audit plan to assess whether controls are in place and operating as intended



The risk assessment will support development of a multi-year audit plan. A multi-year approach is recommended as areas identified as lower risk can be audited on a semi-annual or even tri-annual basis. The audit plan should identify the frequency an area will be audited, with higher risk areas audited more frequently and at least annually. The multi-year audit plan should be evaluated and revised, if necessary, at the conclusion of each risk assessment update.

In their MORA review, Fannie Mae has requested the organization's audit plan identifying which areas will be audited, their relative risk ratings, and the timing of audits. To satisfy the MORA requirements, mortgage lenders will need to set aside sufficient time to perform the risk assessment prior to developing the audit plan. Estimating the audit plan without actually performing a comprehensive risk assessment may result in misdiagnosed or unidentified risks that end up costing the organization more in the long run.

Evaluate processes and controls to identify required improvements in the control environment

Audits should assess policies, procedures, practices, and controls and should be completed using a variety of methods including interviewing key personnel, reviewing policies and procedures, and detailed transactional testing. If issues or weaknesses are identified, the auditor should recommend practical solutions to address the root cause of the issue including changes to procedures or controls, additional training, or enhanced monitoring. The internal auditor should be viewed as a partner that has the best interest of organization in mind. The goal of identifying practical solutions to issues and control weaknesses is to reduce risk and create a more efficient organization, resulting in more profit. Internal Audit is more than "checking the box."

Track and follow-up on previously identified control issues to ensure timely and adequate resolution

When issues are identified, it is important that management take the appropriate corrective action to remediate the issue. This could range from making specific transactional corrections, to changing policies, procedures, practices, and retraining personnel if necessary. Internal audit should follow up on prior issues to ensure that appropriate, effective, and sustainable corrective action has been taken.

In the course of its daily responsibilities, including follow up on prior issues, it is imperative that the internal audit function have access to ALL company records. For example, if a mortgage company operates in 20 states and has been examined by multiple state regulators, internal audit should have unfiltered access to and review all of those reports in their entirety. Filtering information for internal audit signals lack of transparency. The purpose of an internal audit function is to provide management with independent and objective assurance that procedures and controls address the key risks a company is facing. Anything short of providing full documentation creates red flags to regulatory agencies and investors.

Report findings to Executive Management, or Board of Directors to ensure they are informed and provide oversight over the remediation process

Audit reports that include the scope, objectives, findings, and management's action plan for correction should be provided to executive management and summarized for the board of directors by the Chief Audit Executive to ensure all key findings are presented to the Board. Executive Management and the board are expected to provide active oversight and ensure appropriate remediation occurs. Meeting minutes should reflect discussion of the internal audit issues reported, related actions taken, and any further action that may be required.

CFPB EXPECTATIONS

Many private mortgage companies are now experiencing a heightened focus on internal audit as a result of the CFPB's regulatory examination activities. The CFPB expects the organizations it supervises, both depository institutions and non-depository consumer financial services companies, to establish and maintain an effective Compliance Management System (CMS) to provide assurance to executive management and the board of directors that compliance policies, procedures, and internal controls are effective. Internal audit is a requirement for an effective CMS. The CMS encompasses how a supervised entity establishes its compliance responsibilities; communicates those responsibilities to employees; ensures that responsibilities for meeting legal requirements and internal policies are incorporated into business processes; reviews operations to ensure responsibilities are carried out and legal requirements are met; and takes corrective action and updates tools, systems, and materials necessary. An effective CMS has four interdependent control components:

1) Board and management oversight;
2) Compliance program;
3) Response to consumer complaints;
4) Independent compliance audit.

When all four components are strong and well-coordinated, a supervised entity should be successful in managing its compliance responsibilities and risks.[3]

As stated in the CFPB Supervision and Examination Manual,

> *"Weaknesses in compliance management systems can result in violations of law or regulation and associated harm to consumers. Therefore, the CFPB expects every regulated entity under its supervision and enforcement authority to have an effective compliance management system adapted to its business strategy and operations. Each CFPB examination will include review and testing of components of the supervised entity's compliance management system. An initial review will help determine the scope and intensity of an examination. The findings of more detailed reviews and transaction testing will determine the effectiveness of the compliance management system and whether enhancements or corrective actions are appropriate.[4]"*

A third line of defense compliance audit is a required component of an effective CMS and one that the CFPB is focused on as it conducts its examinations.

[3,4] CFPB Supervision and Examination Manual – Version 2.0, www.consumerfinance.gov

Conclusion

There are many good reasons why mortgage companies should embrace establishing an effective internal audit function including good corporate governance and meeting regulatory requirements. To take full advantage of this investment, management should ensure the function is comprised of individuals possessing the appropriate knowledge, skills, and discipline to execute the internal audit mission. Most importantly, for the organization to embrace the benefits that internal audit can provide, executive management and board support is imperative. Without that support, internal audit becomes a "check the box" activity whose full value will go unrealized to the organization and likely will not successfully keep it out of regulatory hot water.

AUTHORS

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