

What it is, why it is important and what lenders need to know to be compliant

The Mortgage Lender's Guide To Internal Audit



Table of Contents

4 Introduction

6 What

What it is

8 Why

Why it is important

10 How

How to comply

12 When

When to conduct

14 Where

Where to find support

16 Who

About MQMR

Introduction

“Given the importance of internal audit in managing risk and ensuring compliance, lenders need to have a clear understanding of this function to ensure it is being properly executed within their organizations.”

Internal audit is a ubiquitous, yet little understood, operational requirement for today's mortgage lenders.

While federal and state regulators, all agencies, investors, etc. have required it as part of their exams, audits and/or due diligence reviews for years, confusion still abounds regarding the particulars of this mission-critical function. Common questions include:

- What exactly is internal audit?
- How is it different from QC/QA?
- What are the minimum requirements to ensure compliance?

Given the importance of internal audit in managing risk and ensuring

compliance, lenders need to have a clear understanding of this function to ensure it is being properly executed within their organizations. This white paper provides an overview of the internal audit function, outlines the importance of the function to mortgage lending operations and provides guidance on what elements lenders need to have in place to satisfy regulatory and agency requirements while adequately addressing risk.



What

Why

How

When

Where

Who

What is internal audit?

According to The Institute of Internal Auditors (IIA), “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.”

To put this into context for mortgage lenders, internal audit is a review process that encompasses all aspects of a lender’s organization. The goal is to evaluate the control activities within a lender’s processes to ensure those processes are working as designed and that all investor guidelines, laws and regulations and industry best practices are being consistently followed. In addition, internal audit is also intended to identify gaps and inefficiencies and uncover potential credit, compliance, operational, financial and/or reputational risks.

Many lenders assume that pre-and post-closing quality control audits can

also be leveraged to meet internal audit requirements. This is incorrect. The primary function of quality control is to ensure that lenders are producing quality loans. Thus, these reviews are only conducted at the loan level and focus primarily on two major areas – credit and compliance. As a result, quality control audits are not nearly comprehensive enough to meet internal auditing requirements and, therefore, should not be used as a substitute for an internal audit program.

What

Why

How

When

Where

Who

Why is internal audit necessary?

Risk mitigation is at the heart of internal audit.

If a lender's processes are not functioning as they should or procedures are not being followed, that lender faces tremendous risk, of which it may not even be aware. This could not only result in possible financial or other regulatory penalties, but could generate a negative public image that impacts both operations and the organization's bottom line.

Internal audit also uncovers inefficiencies and risk within an organization. Consider the following hypothetical:

ABC Mortgage Corp. has a policy in which it only charges for appraisals if a loan closes. As a result, ABC Mortgage Corp. is absorbing the cost of all appraisals conducted for loans that are approved but ultimately do not close. Assuming an average cost of \$500 per

appraisal and a fallout of 700 loans over the course of a year, ABC Mortgage Corp. is spending \$350,00 per year on appraisals for loans that did not result in revenue for the company.

It is this exact type of situation that often goes unnoticed and that internal audit is specifically designed to identify and address. In the scenario outlined above, the policy was more than likely put in place as a customer service measure but still resulted in harm to the organization in its execution. Identifying the true cost of this policy to ABC Mortgage Corp. helps the organization re-evaluate the policy to find a solution that addresses both concerns.

Of course, internal audit is not just a risk mitigation strategy for lenders. It is also a regulatory imperative.

All Fannie Mae seller/servicers – or those about to submit their application to become approved – must meet Fannie Mae's audit and management control requirements to maintain or achieve eligibility. Additionally, Fannie Mae's Mortgage Origination Risk Assessment (MORA) audit and Freddie Mac's Counterparty Operational Risk Evaluation (CORE) review include an examination of a lender's internal audit program, and every entity under the Consumer Financial Protection Bureau's (CFPB) supervision is expected to have an effective Compliance Management System (CMS), which includes an independent compliance audit component (a.k.a. internal audit). State regulators also include internal audit as part of their review during examinations, as do warehouse and secondary market investors in their due diligence review of lenders.



What

Why

How

When

Where

Who

How do lenders comply with internal audit requirements?

As with any law, regulation or guideline, lenders want to understand what is required of them to comply.

In the case of internal audit, the definition of compliance is not as crystal clear as it might be with other regulatory requirements. In addition, given its comprehensive nature, internal audit can quickly evolve into a massive financial and operational undertaking, which many lenders may not be equipped to manage. However, there is some direction available to lenders on the base-level requirements for internal audit.

Fannie Mae explicitly states that its seller/servicers must establish an independent reporting structure for delivering findings directly to senior management and/or the board of

directors and provide a risk assessment, a minimum 12-month audit plan and internal audit policies and procedures, alongside evidence of “on-going audits.”

Rather than specify the exact number of internal audits it expects lenders to conduct annually, Fannie Mae refers its seller/servicers to the standards set by the IIIA, which state that audit frequency should be determined by the results of the company’s annual risk assessment. Given the lack of specificity on internal audit frequency, most lenders default to Fannie’s unofficial MORA audit results, which include all of the internal audit requirements outlined above plus copies of the two most recent audit reports.



What

Why

How

When

Where

Who

When should lenders conduct their internal audits?

Most often, lenders interpret the requirement for an annual internal audit risk assessment as guidance that a yearly internal audit is adequate. This is also incorrect.

The purpose of the annual risk assessment is to identify the operational areas and functions to be audited as part of the organization's on-going audit plan and determine the necessary audit frequency throughout the year to adequately address the risk in those areas and functions. Thus, a one-time comprehensive audit does not fulfill the regulatory requirement for on-going internal audit, nor does an annual risk assessment replace the need to conduct other audits throughout the year.

In a perfect world where lenders had unlimited operational and financial resources, the ideal frequency for conducting on-going internal audits would be four to six times per year, or more depending on the complexity of the organization, covering a multitude of areas. Alternatively, lenders may want to break up larger audits into smaller, targeted audits conducted more frequently throughout the year.

However, not every lender has the budget for that kind of frequency, and even in periods where volumes are up,

that frequency can still be challenging, given how disruptive these audits can be to everyday operations. If resources are limited, the on-going audits can be defined by the top areas identified during the risk assessment, to provide the most meaningful and cost-effective results.



What

Why

How

When

Where

Who

Where should lenders look for internal audit support?

Although regulators require an independent reporting process for internal audit, lenders can choose to conduct this process internally.

However, there are considerable drawbacks to this that lenders must consider. First, internal audit requires significant internal resources. Most lenders that conduct this process in-house have a dedicated team of internal auditors that do nothing else. Given the requirements for independence from other related internal functions, lenders must be willing to financially invest in building a team that cannot be used for any other function.

Internal audit is also a highly specialized form of auditing that requires a particular kind of training to execute it effectively. While quality control auditors are highly skilled professionals in their own right, it would be difficult to transition someone with this skill set into an internal auditing role and have that individual be immediately successful. Thus, lenders need to source personnel that have previous auditing experience, which can be challenging in certain markets, or train individuals that are already familiar with risk and controls to be able to perform these kinds of audits.

Lastly, right-sizing internal audit requires an acute understanding of the intricacies of this critical function. Auditors also need a keen eye for risk mitigation and a healthy dose of experience in satisfying regulators' requirements and desires. The best of the best lenders do not simply do the bare minimum, but instead embrace internal audit as a way to advance their organization, strengthen operations, reduce risk, enhance efficiencies and improve their bottom line.

Given these challenges, many lenders choose to outsource to MQMR.

Conducting more than 2,000 mortgage operational reviews annually, MQMR leverages the collective insights gleaned from these reviews to help lenders develop an internal audit strategy that adequately addresses their unique levels and areas of risk while complying with internal audit requirements. Our thorough reviews of numerous Fannie Mae MORA and Freddie Mac CORE exam findings have yielded an extensive list of basic requirements and key elements to ensure lenders' internal audit programs are GSE-compliant.

Outsourcing to MQMR does not just provide lenders with a cost-effective, scalable solution for mitigating risk and meeting regulatory and agency requirements for internal audit. When conducting this function internally, the scope of lenders' findings is limited to only that which they are or are not doing. Because MQMR audits such a wide variety of organizations, it has amassed a wealth of knowledge on common issues, trends, best practices and more. By working with MQMR, lenders can reap the benefits of the collective knowledge at MQMR's disposal to improve their own operations.

Whether lenders choose to outsource or internalize this function, internal audit plays a key role in lenders' risk mitigation strategy.

By gaining a more fulsome understanding of what this entails, why it is important and what is required to execute it compliantly, lenders can begin to build an internal audit program that adequately addresses the unique risks to their organization while simultaneously satisfying regulatory and agency requirements.

What

Why

How

When

Where

Who

About Mortgage Quality Management & Research, LLC

MQMR helps its clients climb higher by bridging the gap between risk and compliance through its suite of risk-related services.

MQMR provides mortgage compliance consulting throughout the origination process, conducting internal audit risk assessments and ongoing internal audit support, servicing QC and subservicing oversight to master servicers, and filling the void of meeting vendor management oversight requirements.

With 2,000+ operational reviews of mortgage companies, subservicers, document custodians, and vendors annually, MQMR prides itself on being the mortgage industry partner of choice for audit, risk and compliance.

To learn more, visit mqmresearch.com, subsequentqc.com, and hqvendormanagement.com.





MORTGAGE QUALITY
Management & Research

www.mqmresearch.com

info@mqmresearch.com