ANNUAL AUDIT
ROUND-UP

Five Major Audits for Effective Risk Management

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Executive Summary

No one likes the "a" word, but audits are a critical component to mitigate risk in mortgage lending.

Depending on the factors at plan (volume, lending footprint, business model, GSE approval status, etc.), a lender could be required to conduct dozens of audits each year. However, there is a core set of audits that most mid- to large-size lenders are required to conduct each year.

This white paper summarizes the basic facts about these critical reviews to ensure they stay top of mind, thus enabling lenders to effectively insulate themselves from the various areas of risk these audits are intended to uncover.

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Internal Audit Risk Assessment

An internal audit risk assessment identifies hazards that could negatively impact an organization's ability to conduct business. These assessments help identify inherent business risks and provide measures, processes and controls to reduce the impact of these risks to business operations. The results should be used to evaluate the various risk components to identify the operational areas and functions to be audited as part of the organization's ongoing audit plan.

Who Requires It?

Fannie Mae, Freddie Mac, CFPB, bank regulators and select state regulators

How Often Should It Be Conducted?

At a minimum, lenders should be conducting risk assessments annually to ensure the key risks to the organization are being addressed in the audit plan and that the audit plan aligns with the organization's strategies and objectives.

What Resources Are Needed?

Access to management for interviews and internal and external corporate documents such as management meeting minutes, management reports, policies and procedures, operational performance scorecards, training records, consumer complaints and external examination reports, among other things, are necessary to ensure a successful assessment.

Keep in Mind...

- **Risk assessments may vary greatly based on the complexity and size of the organization, as well as auditors' access to and the availability of management, information and documentation.**

- **The keys to a successful risk assessment are open and transparent communication, access to requested information/documentation and timely response to and implementation of the audit plan.**

- **A one-time comprehensive audit does NOT fulfill the GSEs' on-going internal audit requirement, nor does an annual risk assessment replace the need to conduct other audits throughout the year.**

AML Audit

The Bank Secrecy Act (BSA) requires lenders to conduct an independent audit of their AML program to ensure program efficacy and compliance. This is one of a handful of audits that must be performed by someone qualified and independent of the functions being tested. Specific areas of review include:

- AML Compliance Officer Qualifications;
- Board/Executive Management Oversight;
- AML Risk Assessment;
- AML Policies and Procedures;
- AML Training;
- "Red Flags" – detection, prevention;
- Suspicious Activity Reporting (SAR);
- USA Patriot Act Sec. 314 Information Sharing;
- AML Testing and Audit Procedures; and
- Office of Foreign Assets Control (OFAC) Procedures.

Who Requires It?

The BSA requires an independent audit function to test AML programs. Various federal and state regulatory agencies enforce this requirement including the Financial Crimes Enforcement Network (FinCEN).

How Often Should It Be Conducted?

The FFIEC BSA/AML Exam Manual recommends every 12-18 months, which has become the de-facto industry standard.

What Resources Are Needed?

This audit must be conducted by an auditor separate from the lender's AML/BSA Officer or anyone who reports to this individual. The lender should also provide a single point of contact for document and information requests. The Board and/or executive management must receive and review the audit results to demonstrate involvement and proper oversight.

Keep in Mind...

- **With an engaged and responsive lender, this can be completed within 30 days. Audit length will vary depending on the size and complexity of the organization and AML program being reviewed.**

- **The independent AML audit requirement is different from the AML risk assessment. Performing a risk assessment is a requirement of an effective AML Program, as it helps to identify risks particular to an organization.**

- **State examiners are beginning to ask for proof of a company's AML program – beyond the written policy – as part of their exams. Proof of training (i.e. course content and attendance logs), SAR filings, prior audits, risk assessments, etc. should be documented in writing.**

- **An auditor should be able to review and verify a company's AML program off-site, as the full scope of the AML Program should be adequately documented in writing.**

MERS QA Audit

Any financial institution that is a member of the Mortgage Electronic Registration System, Inc. (MERS) and is named as the servicer for an active mortgage identification number (MIN) has to meet certain quality assurance (QA) requirements. The objective of the annual MERS QA Audit is to certify an organization's QA performance against its MERS QA Plan based on the organization's system-to-system reconciliation process, its reject/warning report process and overall adherence to its QA Plan.

Who Requires It?

MERS and (by consent order) the OCC

How Often Should It Be Conducted?

All MERS members must conduct their annual QA Audit by December 31.

What Resources Are Needed?

Lenders need to provide the auditor with Corporate Resolution Management System (CRMS) & quarterly attestations, exception reports, global address lists (GAL), system-to-system reconciliation reports, reject/warning reports, MERS reconciliation export reports, QA Plan, policies and procedures and signing authority agreement.

Keep in Mind...

- MERS QA policies and procedures should include sections for origination, on-boarding, foreclosures, registration, QA, rejects, aging items and root cause. Lenders should review their corporate resolution monthly to ensure it is accurate and up-to-date, and maintain all reports being utilized for at least the last 12 months.

- MERS members with less than 1,000 active MINs as of March 31 of the current year must conduct a quarterly two-way data validation between its system of record and the MERS system. MERS members with 1,000+ MINs must conduct a monthly two-way data validation between its system of record and the MERS system in addition to having a MERS-approved, independent third party perform the annual audit.

- All MERS QA Plans should include, at a minimum, the following: Registration, Reject/Warning, System-to-System Reconciliation, Transfers of Beneficial Rights (TOB)/Transfers of Servicing Rights (TOS), CRMS.

Document Custodian Audit

Document custodians hold the underlying collateral of trillions of dollars of mortgages across the country. As such, many investors, including the GSEs, require that holders of MBS pools audit their doc custodians to monitoring the financial viability and operational capabilities of these entities.

Who Requires It?

Fannie Mae, Freddie Mac, Ginnie Mae and other investors

How Often Should It Be Conducted?

If a Ginnie Mae issuer has more than one document custodian, at least one custodial institution must be reviewed each year, and all must have an on-site review within a three-year cycle.

What Resources Are Needed?

Per Ginnie Mae guidelines and the Department of Housing and Urban Development (HUD) Handbook, document custodian audits must include an on-site review of the custodian's premises and a pool loan-level review. To comply with the Gramm-Leach-Bliley Act (GLBA), the on-site should be divided into two parts – physical security analysis and corporate structure review. The loan-level pool review should consist of a selection of the loan pools being held by the doc custodian to ensure that the collateral file is intact and that it contains all the necessary original documents and endorsements. The auditor must verify that all pools are final certified within 12 months of being issued.

Keep in Mind...

- **The document custodian's availability to host the on-site audit and the number of pools selected for the audit can significantly impact audit length/timing. To minimize this, lenders may want to schedule this audit at the same time each year for each custodian.**

- **These audits should occur as part of an existing and ongoing compliance program and can be triggered by the results of an audit performed by Ginnie Mae. In addition, a lenders CPA firm may ask for the previous year's document custodian audit to ensure compliance with Ginnie Mae requirements.**

- **For lenders approved with Ginnie Mae, guidelines state that issuers may be required to post a letter of credit (LOC) for the pool amount if the pool is not final certified within 12 months. If an issuer is required to obtain a LOC, it could negatively impact the cash position of the issuer, and could eventually result in loss of commitment authority.**

Subservicer Audit

Because regulators and the GSEs hold the master servicer responsible for all loan servicing activity, those that choose to outsource this function to a subservicer must have an oversight policy in place to ensure compliance. The policy should establish the master servicer's servicing QC program which should include an annual audit that covers these key areas:

- Discussion/review of all functional areas, such as servicing departments and their performance, internal audit program, compliance management system, change management, HR strategies, required compliance training, vendor management and IT;
- Discussion of the subservicer's strategy; and
- Review of the subservicer's corporate initiatives over the last 12 months, as well as those anticipated in the upcoming 12 months.

Who Requires It?

Fannie Mae, Freddie Mac and Ginnie Mae, as well as other regulators that require vendor oversight of critical vendors

How Often Should It Be Conducted?

A full on-site audit should be conducted at least annually. Master servicers with a small portfolio may elect to alternate between on-site and remote audits each year. Any interim concerns for high-risk conduct or a significant decrease in performance of the subservicer should trigger an immediate targeted audit.

What Resources Are Needed?

In addition to access to all functional areas and loan files under review, auditors also need an agenda with specifics as to who should attend the kick-off meeting (such as VP of loss mitigation, Chief Compliance Officer, Customer Service Manager, etc.), as well as a script to organize audit questions with a place to record notes.

Keep in Mind...

- **A thorough subservicer audit includes management interviews of all functional areas, discussion of company strategies, corporate structure updates and a site tour, which generally requires multiple days. Some master servicers elect to add desk-side reviews (policies and procedures testing, review of custodial reconciliations, etc.) and/or loan-level testing, which can add more time to the visit but in some cases could be done remotely.**

- **November, December and January are difficult months for conducting this audit due to holidays, vacations and corporate planning.**

Conclusion

While not inclusive of every audit a lender may be required to conduct, this group represents some of the most important and comprehensive reviews used to mitigate risk across a lender's entire organization.

Depending on the factors at plan (volume, lending With careful scheduling of audit timing and the proper marshaling of resourcing – including third-party firms where required/appropriate – lenders can significantly shift their perspective on this mission-critical function, transforming the word "audit" from a frustration-inducing obscenity to a considerable badge of honor.

About MQMR

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.

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