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# Does Your Institution Shine Under the Internal Audit Spotlight?

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# Does Your Institution Shine Under the Internal Audit Spotlight?

**By Salvatore Zerilli**

Internal audit, when properly implemented, is an essential element to assist your financial institution in discovering control weaknesses, regulatory and policy violations, and operational inefficiencies. Such self-scrutiny provides an institution with the ability to take timely, corrective action when needed to maintain its safety, soundness, profitability and integrity.

Salvatore Zerilli

## RISK ASSESSMENT

Proper implementation of an effective internal audit process begins with a comprehensive risk assessment. Financial institutions are not created equally; their mix of products and services and organizational structure vary. A risk assessment should take into account all operational areas specific to the institution, as well as recent regulatory changes, prior regulatory and internal audit issues, and risk appetite. An assessment should be documented to support the creation of the audit universe and plan. The utilization of a cookie-cutter audit plan and a general risk assessment may cause the institution to overlook key operational and regulatory deficiencies.

## AUDIT PLAN EXECUTION

Proper execution of the audit plan is the next critical component of an effective internal audit process. The internal audit department should perform its work in accordance with the *International Standards for the Professional Practice of Internal Auditing*, as promulgated by The Institute of Internal Auditors. The audit methodology should be based on the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and *Control Objectives for Information and Related Technology* (COBIT) from the Information Systems Audit and Control Association (ISACA). Note that in May 2013, COSO released an updated *Internal Control Framework*, revitalizing the guidance and increasing the relevance to the current business environment. Your internal audit department should adopt these changes.

## REGULATORY KNOWLEDGE

The chief audit executive and internal audit staff must possess in-depth knowledge of internal auditing, as well as the banking industry. Recognizing the changing regulatory landscape and the current focus and emphasis of federal and state regulators is essential to optimize the benefits of internal audit. Significant regulatory changes occurred in 2014, mainly resulting from implementation of the Dodd-Frank Act and impacting residential mortgage lending, and numerous others are in the pipeline.

Recent changes include the adoption of Ability to Repay (ATR) and Qualified Mortgage (QM) rules. In addition, complex loan servicing rules amended Regulation X, the Real Estate Settlement Protection Act (RESPA) and Regulation Z, the Truth in Lending Act (TILA). The amendments included nine new key points to be adopted by banks:

1) Periodic billing statements.
2) ARM notice requirements.
3) Prompt payment crediting and payoff statements.
4) Error resolution procedures.
5) Forced placed insurance procedures.
6) Early intervention with delinquent borrowers.
7) Continuity of contact.
8) Loss mitigation procedures.
9) General servicing policies and procedure requirements.

It is important to note that while some of these points have provi-

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sions that exclude small service providers, several caveats embedded within the regulations are applicable to them.

Recent changes were also made to the following: the requirements for appraisals and higher-priced mortgage loans; home ownership counseling; the definitions of the Home Ownership and Equity Protection Act (HOEPA) coverage test and the term "loan originator;" compensation and mandatory arbitration clause restrictions; and single-premium credit insurance financing. Modifications were made to the Flood Disaster Protection Act (FDPA) regulations, stemming from the Biggert-Waters Flood Insurance Reform Act of 2012 and Homeowner Flood Insurance Affordability Act.

The changes above have already been adopted by Congress. Those expected to be implemented in 2015 and beyond include: expanded fields to the Home Mortgage Disclosure Act (HMDA) Loan Application Register (LAR); the combination of the TILA-RESPA disclosures; changes to overdraft fee and capital reporting; and the adoption of the Basel III capital framework.

Your institution's internal audit department should ensure that the changes to the COSO framework and regulatory landscape are integrated into the internal audit process and work programs. Training your audit staff on these changes is critical to the proper execution of the program and the identification of control weaknesses, regulatory and policy violations, and operational inefficiencies.

## BOARD OVERSIGHT

The audit committee of the board of directors requires tools and periodic reports to assist in the oversight of the internal audit process. Internal audit needs to create reports that monitor the department's adherence to timely performance of audit work, the issuance of audit reports upon completion of field work, and tracking of open audit issues across the entire institution.

Federal and state regulators review the comprehensiveness and effectiveness of an institution's internal audit department. Demonstrating that a strong and robust internal audit process has been implemented at your institution assists regulators during their safety and soundness examinations. Regulators will rely on the audit work papers and resultant observations uncovered by internal audit when the overall process is deemed adequate. This reliance, in turn, may limit regulators' need to conduct further review of targeted areas during their examination of your institution.

The internal audit process shines a spotlight on many operational issues at financial institutions. It is preferable, however, to uncover and address concerns through an internal self-reporting function than to be alerted to them via government regulators. The audit committee of the board of directors, as well as management, should leverage the internal audit process to ensure the continued safety, soundness, profitability and integrity of their institution. ■

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