Internal Audit:
Regulatory Requirements for Your Mortgage Operations

As a result of the 2008 financial crisis and ensuing global recession, the emphasis and expectations of the internal audit function for a bank, credit union, or mortgage company has never been greater. To assist those who originate and/or service mortgages, the following overview should help you better understand what is required, how best to structure the internal audit function over mortgage operations, and answer some of the common misunderstandings and questions regarding the internal audit function.

Regulatory Expectations

Regardless of who has supervision authority over you – the Consumer Financial Protection Bureau (CFPB), Office of the Comptroller of the Currency (OCC), the FDIC, the Federal Reserve, the Conference of State Bank Supervisors, the National Credit Union Administration (NCUA), or other state regulators and the government-sponsored enterprises (GSEs) – all expect companies to have an independent audit function commensurate with their size and the complexity of services offered. While they understand that it may not be practical for all companies to have a wholly in-house audit function and many will therefore need to utilize third-party providers, that does not relieve you from responsibility in the eyes of the regulators and/or GSEs.

The CFPB expects organizations they supervise to have an effective Compliance Management System (CMS) that includes both auditing and monitoring components. Fannie Mae assesses a company's internal audit function through a Mortgage Origination Risk Assessment ("MORA") review. Fannie Mae has recently cited several mortgage operations for not having a sufficient independent internal audit function and required management to promptly provide corrective action plans as a result.

So the importance of having an internal audit function to satisfy the regulators is clear, but how do you develop and implement an effective function over your mortgage operations? While there are several off-the-shelf templates available for core financial services areas, you would be hard-pressed to find templates that address mortgage operations, mortgage servicing, and the various mortgage business models. Originating and/or servicing mortgages is a heavily regulated industry, and the various requirements of all the agencies, federal laws, state specific requirements, and other regulations (i.e. Servicing Standards, RESPA, TRID, etc.) further add to the complexities of an internal audit function over mortgage operations. Organizations must ask themselves if they have the resources and expertise to handle this function internally, or if it instead makes more sense to outsource. An organization can answer this question only after considering factors such as the size of the mortgage operations, growth strategies, ability to find qualified audit employees, and more.

Internal Audit Process

Internal audit is a process of assessing risk, identifying controls that mitigate the risks, testing internal controls for their adequacy, effectiveness and adherence, and ensuring corrective action steps are developed and implemented as needed. An effective internal audit function typically includes the following steps:

1. **Conduct a company-wide risk assessment.** Through review of a company's policies and procedures, prior examination reports, and discussions with functional area managers, risks should be identified for the auditable areas. Further, mitigating controls for those risks should be outlined, as well as assigning an overall or residual risk rating. The audit plan should be developed or adjusted to ensure higher risk areas are audited on a more frequent basis than lower risk areas. Risk assessments should be conducted at least annually or when the risk environment changes (i.e. structural changes within organization occur, new product or origination channels offered, regulatory changes occur, turnover of key personnel, etc.).

2. **Develop a multi-year audit plan.** Based on the risk-assessment, a multi-year audit plan should be developed to assess whether controls are in place and operating as intended, that identifies the frequency an area will be audited, and should be approved by the Audit Committee. Approval should be evidenced in meeting minutes. The developed audit plan should be reassessed as risks and operational changes occur.

3. **Execute the audit plan.** Through methods such as personnel interviews, policy and procedure reviews, and transactional testing, the audits should be executed and audit reports written and provided to management. Any trends or gaps identified should include input from functional managers for root cause determination and to develop and ensure corrective actions are implemented.

A common finding of regulators is that the audit function reports to compliance. The internal audit function must be independent of operational processes and totally free from influence of the business units, and should report directly to the Audit Committee. No personnel conducting the audit should have any involvement or responsibility in the areas under audit.

Key Mortgage Functions to Include in your Audit Plan

Mortgage operations typically involve two distinct areas: loan origination and servicing. While not all organizations have loan servicing platforms today, trends show more and more organizations developing in-house servicing platforms as interest rates increase (improving the MSR values) in order to provide a natural hedge against mortgage originations and to maintain customer relationships.

When developing internal audit programs for mortgage originations, the following areas should be risk-assessed and incorporated:

- Organizational Structure and Governance
- Origination Channels (retail, broker, correspondent)
- Underwriting and Appraisal
- Closing/Post-Closing/Funding
- Pre-Funding and Post-Closing Quality Control
- Compliance
- Secondary Marketing/Capital Markets
- Marketing/Advertising
- Technology and Business Continuity
- Training
- Vendor Management
- Customer Complaints/Dispute Resolution

When developing internal audit programs for mortgage servicing, the following areas should be risk-assessed and incorporated:

- New loan set-up/ Loan Boarding
- Cash Management/Payment Processing
- Payoff Processing
- Collections
- Foreclosure
- Bankruptcy
- Loss Mitigation
- Escrow Administration (tax, hazard insurance, flood/wind insurance, loss drafts, MI)
- Special Loans (i.e. ARMs, balloons, SCRA, HELOC, assumptions, etc.)
- Customer Complaints/Dispute Resolution
- Research and Release
- Claims
- Call Center Operations
- Training
- Vendor Management
- Compliance
- Quality Control

In developing internal audit programs in the areas above, there are several considerations that should be taken into account. While not an inclusive list, the following may influence the risk assigned, depth of the testing, and/or frequency of the audits:

- Turnover of key personnel
- Past QC findings or trends
- Regulatory examination findings
- Size and age of mortgage operations relative to core banking offerings
- Growth strategy
- New product offerings, origination channels, GSE licensure

Benefits of an Effective Internal Audit Program

Many view internal audit as a necessary evil. However, in addition to ensuring regulatory compliance, there are many benefits of having an effective internal audit function:

1. **Assessment of a company's control environment.** An internal audit function enables a company to assess and evaluate their control environment and identify potential strategic, credit, operational, reputational and compliance risks. Management may then take necessary steps to either accept or mitigate these risks based on their risk appetite.
2. **Identification of process and procedural gaps.** Through review and testing of operations, internal audit helps to identify areas needing further controls developed, identifies procedures not being followed or being misinterpreted, as well as areas that may have outdated policies and procedures in place.
3. **Increases efficiency and productivity of operations.** Since internal audit is independent of operations, opportunities are often identified to enhance operational efficiencies, cost reductions, or identifying ineffective procedures not operating as intended.
4. **Ability to sell loans to GSEs.** Without an effective internal audit function, organizations risk jeopardizing their approval status and thus their ability to sell loans to the agency.
5. **Mitigates compliance errors.** An effective internal audit program should identify compliance errors that are occurring and assist functional areas in developing further controls, policies, and/or procedures to prevent the reoccurrence of those errors. By taking a proactive approach, internal audit can help prevent future errors which could lead to costly penalties, reputational damage, and litigation.

Conclusion

Organizations need to be realistic about how they view the audit function and the purpose the function serves within the overall company framework. Embracing the internal audit function ultimately reduces risks within an organization, but only if management is willing to invest in it, stand behind it, and support its importance. In addition, an effective internal audit function must be comprised of employees (or third-party providers) who possess the requisite knowledge, skills, and internal audit experience, as well as have specific expertise in mortgage operations – and of course, be independent of operational processes and have no involvement or responsibility in the areas under audit. Without qualified internal audit personnel, an organization will never fully benefit from the value internal audit may provide, nor will it be able to fully mitigate the operational and regulatory risks inherent in the post-crisis mortgage origination and servicing environment.

About Richey May & Co, LLP

As a certified public accounting firm with over 25 years of experience serving lenders across the country, Richey May has developed a suite of services to satisfy the independent internal audit requirements of the CFPB and GSEs for companies who originate and/or service mortgages. Whether through a co-sourcing collaboration with your existing internal audit team, or as your outsourced third-party internal auditors, our mortgage industry professionals provide the expert guidance you need to maintain compliance, reduce risk and improve efficiencies. More information can be found on our **website** or contact us directly at **info@richeymay.com**.

Disclaimer: *The information contained within this article is provided for informational purposes only and is not intended to substitute for obtaining accounting, tax, or financial advice from a professional accountant.*