Bank Risk Rating
Audit Report
Report Nr. 11/15
September 9, 2015

Distribution:

To:	President & CEO Senior Vice President & Chief Financial Officer Senior Vice President and Chief Risk Officer Senior Vice President, Insurance Vice President & Corporate Controller Vice President, Credit Insurance Vice President, Risk Management Office Director, Financial Institutions Director, Credit Risk Management
CC:	Senior Vice President, Corporate Affairs and Secretary Senior Vice President, Human Resources and Communications Senior Vice President, Business Development Senior Vice President, Financing Senior Vice President, Business Solutions & Innovation Director, Strategic Planning & Stakeholder Relations Principal, Office of the Auditor General Director, Office of the Auditor General

Audit Team:
Ramesh Baddepudi
Mona Ayoub
Adnan Zia

Vice President, Internal Audit
Monica Ryan

Table of Contents

Introduction

As per our FY2015 Audit Plan, Internal Audit performed an audit of the bank risk rating process. The bank risk rating methodology was updated earlier this year. Bank obligors continue to be rated based on the lowest of three external ratings but their rating is now capped by Economic and Political Intelligence Centre's (EPIC) internal country ratings. Bank obligors accounted for approximately $7.8B CAD in notional exposure at March 31, 2015. Approximately 50% of that exposure is concentrated in the following countries (listed in descending order): China, Turkey, Brazil, and South Korea.

Audit Objectives & Scope

The overall objectives of this audit were to review the controls pertaining to bank risk ratings and included an examination of the following areas:

- The methodology for establishing bank obligor risk ratings and its alignment with risk rating policies;
- The establishment and monitoring of bank risk ratings in Insurance and Financing programs;
- Utilization of risk ratings in transactions; and
- Ensuring that approved ratings flow to downstream systems correctly.

The scope of this audit was to evaluate the design and operating effectiveness of controls for establishing and updating bank risk ratings. Excluded from the scope was the process for establishing and approving credit limits. As the new methodology and associated processes were only recently implemented, a sufficient sample of financing transactions had not accrued to perform detailed testing. As such, for financing transactions, we were only able to assess the design effectiveness of the related controls. The testing period for our audit was from January 1st to July 31st 2015.

Internal Audit Opinion

In our opinion the bank risk rating process is ***Well Controlled***[1]. Effective controls exist with respect to the oversight and approval of the rating methodology and its application. Moderate issues were noted and described in the section that follows. Management has agreed to implement the corrective actions no later than Q2 2016 and in a few cases we understand that management has already implemented the corrective actions.

[1] Our standard audit opinions are as follows:

- **Strong Controls**: Key controls are effectively designed and operating as intended. Best in class internal controls exist. Objectives of the audited process are most likely to be achieved.
- **Well Controlled**: Key controls are effectively designed and operating as intended. Objectives of the audited process are likely to be achieved.
- **Opportunities Exist to Improve Controls**: One or more key controls do not exist, are not designed properly or are not operating as intended. Objectives of the process may not be achieved. The financial and/or reputation impact to the audited process is more than inconsequential. Timely action is required.
- **Not Controlled**: Multiple key controls do not exist, are not designed properly or are not operating as intended. Objectives of the process are unlikely to be achieved. The financial and/or reputation impact to the audited process is material. Action must follow immediately.

Audit Findings & Action Plans

1. Use of Country Risk Ratings

A key change in the rating methodology was to move from S&P's sovereign country rating to EPIC's internally developed country ratings as a ceiling. The underwriting system and spreadsheet tool (Deal Compliance Tool) used to monitor the portfolio have not yet been updated to reflect this transition to internal country ratings. As such, there is the possibility that the wrong rating could be applied and/or that the Deal Compliance Tool would not detect a material deterioration in a country rating. Management has agreed to update the configurations to receive EPIC's internal ratings.

During the audit, we noted that a process is not in place to monitor the ratings of bank branches post origination. As a result, several bank branches were in a suspended status despite having active exposure. System configurations do not allow the officer performing the review to consider the location of exposure at the branch level to determine if a local country ceiling should apply to that portion of the exposure. Management has agreed to align the review dates of bank branches with that of the headquarter banks in order for location of exposure in other countries to be considered at time of review. In addition, we understand that the Deal Compliance Tool has already been updated to flag local country exposures.

Rating of Audit Finding - Moderate[2]
Action Owner – Director, Financial Institutions Team
Due Dates - All actions to be implemented by Q1 2016

2. Monitoring of Bank Ratings

The updated methodology designates the Financial Institutions Team (FIT) as the team responsible for assigning bank risk ratings. However, the ongoing monitoring of bank ratings on signed transactions is assigned to FIT for the Insurance program and Credit Risk Management (CRM) for the Financing program. This is creating some duplication of effort between the two teams. Management has agreed to review the activities performed by each team with a view to streamlining the process.

Additionally, FIT's Deal Compliance Tool which is used to monitor their portfolio is a complex spreadsheet. We noted a lack of end-user computing controls supporting this key tool. Specifically, improvements are needed to strengthen design documentation, access controls, version controls and change management. This will help mitigate the risk of errors and provide the appropriate level of oversight to ensure that the tool is producing the results intended. Management has agreed to implement stronger spreadsheet controls.

[2] The ratings of our audit findings are as follows:

- **Major**: a key control does not exist, is poorly designed or is not operating as intended and the financial and/or reputation risk is more than inconsequential. The process objective to which the control relates is unlikely to be achieved. Corrective action is needed to ensure controls are cost effective and/or process objectives are achieved.
- **Moderate**: a key control does not exist, is poorly designed or is not operating as intended and the financial and/or reputation risk to the process is more than inconsequential. However, a compensating control exists. Corrective action is needed to avoid sole reliance on compensating controls and/or ensure controls are cost-effective.
- **Minor**: a weakness in the design and/or operation of a non-key process control. Ability to achieve process objectives is unlikely to be impacted. Corrective action is suggested to ensure controls are cost-effective.

Rating of Audit Finding - Moderate
Action Owner – Director, Credit Risk Management in collaboration with Director, FIT
Due Dates - All actions to be implemented by Q2 2016

Conclusion

The audit findings have been communicated to and agreed by management, who has developed action plans that are scheduled for implementation no later than Q2 2016.

We would like to thank management for their support throughout the audit.