Credit Risk Transfer Financing
Audit Report
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Introduction

As per our 2015 Audit Plan, Internal Audit performed an audit of the Credit Risk Transfer Financing process. EDC engages in primary and secondary risk transfer activities for its Financing portfolio to reduce exposure to losses due to obligor, sector and/or country concentrations and to create capacity to support additional business. Gross loans receivable and financing commitments were just over $68B CAD as of the end of Q1 2015. Within this portfolio, excess concentrations of credit risk at an obligor, sector, and/or country level may be mitigated through risk transfer instruments such as loan default insurance, unfunded loan participations and single name credit default swaps.

Audit Objectives & Scope

The overall objective of our audit was to review the controls surrounding secondary risk transfer activities pertaining to the financing portfolio. This included a review of: the effectiveness of and compliance to the related policies within the Risk and Capital Management Policy (RCMP) and, transactional controls surrounding the execution of loan insurance and unfunded loan participations. Excluded from the scope of our audit were: loan sales, credit default swaps and, the establishment of counterparty credit limits. Controls pertaining to these areas were examined as part of our 2013 audit and have not changed. The testing period for our audit was Q1 2014 through the end of February 2015.

Internal Audit Opinion

In our opinion, secondary risk transfer activities pertaining to the Financing portfolio are ***"Well Controlled"***.[1] Generally, we found that transaction controls surrounding the execution of risk transfer agreements (loan default insurance and unfunded loan participations) are operating consistently. This includes procedures to ensure: the availability under the applicable counterparty (CP) credit limit; availability under the Board approved Portfolio Management Framework budget to cover the cost of the transaction; terms and conditions of the risk transfer agreements effectively mitigate the related credit exposure; and compliance with DOA levels. Overall, risk transfer activities are transacted and reported in accordance with the requirements outlined in the RCMP.

Existing controls surrounding the execution of unfunded loan participations and loan default insurance agreements are mostly manual today. As a result, there is a risk that these controls may not continue to operate consistently if risk transfer volumes continue to increase or, if high transaction volumes within compressed periods continue. Action plans have been developed to implement changes to existing

[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.

business applications to increase the automation surrounding risk transfer activities. In addition, action plans have been developed to implement stronger spreadsheet controls around the management of counterparty positions against limits.

Audit Findings & Action Plans

1. Tools and Infrastructure to Manage Risk Transfer Activities

Existing controls surrounding the execution and ongoing administration of unfunded loan participations and loan default insurance agreements are mostly manual today, particularly during the up front transacting of risk transfer activities. The process is heavily dependent on Excel spreadsheets for the recording, tracking and reporting of CP positions. Additionally, manual notification is required to inform Asset Managers of loans subject to insurance and risk participations. The reliance on spreadsheets and manual effort increases the likelihood that these controls may not continue to operate consistently if risk transfer volumes continue to increase or if high transaction volumes within compressed periods continue to be characteristic of these risk transfer activities. Projects involving existing business applications are currently underway to implement system solutions to facilitate the recording of hedged exposures and administration of policies. Management has agreed to complete the automation through existing business applications, as well as strengthen the controls around the use of Excel spreadsheets.

Rating of Audit Finding – Moderate[2]
Action Owner – VP, Risk Management Office
Due Dates – Q4 2016

2. Positions against Counterparty Limits

Prior to insuring a loan or entering into an unfunded loan participation transaction, the Risk Transfer team engages with Market Risk Management (MRM) to ensure that there is availability under the relevant counterparty limit. Confirmation of the exposure hedged is sent to MRM once the transaction is complete in order to appropriately reflect counterparty exposures in the Reinsurance Exposure Report. While performing our detailed testing, we noted that the availability under the counterparty limit was not always confirmed prior to executing a loan credit insurance or unfunded loan participation transaction. The Reinsurance Exposure Report was identified as a compensating control as it is maintained on an ongoing basis to show the availability under counterparty limits and is used as a reference point by the Risk Transfer team. Generally, we found that controls around this report are operating effectively, however errors in counterparty exposure levels were not always identified on a timely basis.

[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.

Management has agreed to ensure that counterparty availability is consistently confirmed with MRM prior to entering into loan credit insurance or unfunded loan participation transactions and that evidence of the confirmation will be retained. As well, after the execution of these transactions, prompt notification will be sent to MRM to ensure that counterparty exposures are being recorded and reported on a timely basis.

Rating of Audit Finding – Moderate
Action Owner – Director, Risk Transfer & Special Risks
Due Dates – Q1 2016

3. Confirmation of Transacting Authority

Delegation of Authority (DOA) Appendix C-4B requires that Legal Services confirm the legal and documentation risks, transaction authority and transaction execution for all Portfolio Management Framework transactions. Risk Transfer provides Legal Services with the authorized Credit Insurance Authority Memo and a spreadsheet summarizing the proposed insurance coverage by Insurer to facilitate Legal Service's transaction review; source insurance agreements are not provided if the documentation is standard. As part of our detailed testing, we noted that the information presented to Legal Services is not consistent and does not always accurately reflect the final terms of the insurance policies. As such, Legal Services may not have access to the appropriate evidence and definitive terms to support their review and ensure that the proposed Portfolio Management Framework Commitment and Expenditure Commitment are in line with the authorization.

Management has agreed to provide Legal Services with the declarations section of all proposed loan credit insurance policies, in addition to the Credit Insurance Authority Memo and a standardized summary information spreadsheet to ensure an effective review by Legal Services of the Portfolio Management Framework Commitments and Expenditure Commitments under DOA Appendix C-4B.

Rating of Audit Finding – Moderate
Action Owner – Director, Risk Transfer & Special Risks
Due Dates – Q1 2016

4. Credit Risk Transfer Policies & Related DOA

Four policies within the RCMP apply to primary and secondary risk transfer activities: (1) Credit Portfolio Management Policy, (2) Risk Transfer Policy, (3) Management & Board Reporting Policy, and (4) Counterparty Credit Risk Policy.

Additionally, there are two DOA Appendices which apply: (a) Appendix C-4B Portfolio Management Framework, and (b) Appendix G-1 Counterparty Credit Risk Limits (Investment and Hedging).

During our audit, we noted:

- ✓ The delegated authority to approve risk transfer transactions in the Risk Transfer Policy includes the Senior Vice President, Enterprise Risk Management and Chief Risk Officer, however the position is specifically excluded from DOA Appendix C-4B.
- ✓ There is a lack of clarity regarding the completeness of Counterparties listed in the Counterparty Credit Risk Policy and DOA Appendix G-1. Both of these corporate policies make reference to "Reinsurance Counterparties" which is currently being interpreted to include Insurance Counterparties as well as Counterparties to Loan Participation Agreements. Clarification of the term is needed to avoid any misunderstandings.

Our transaction testing did not indicate any issues with regards to the appropriate authorization of Portfolio Management Framework and Expenditure Commitments per DOA Appendix C-4B. As well, our testing indicated the requirements of the Counterparty Credit Risk Policy and DOA Appendix G-1 were being appropriately applied to Insurance Counterparties and Unfunded Loan Participant Counterparties.

Management has agreed to make the necessary changes to the Risk Transfer Policy and DOA Appendix C-4B to ensure consistency with respect to the delegated authority for purposes of authorizing risk transfer activities. Additionally, Management will review the definition of Reinsurance Counterparties and provide clarification by updating the Counterparty Credit Risk Policy and DOA Appendix G-1 where necessary.

Rating of Audit Finding – Moderate
Action Owner – VP, Risk Management Office
Due Dates – Q1 2016

5. Board Reporting

The Risk Transfer Policy of the RCMP and DOA Appendix C-4B set out the quarterly Board reporting requirements in relation to secondary risk transfer activities. It states that all risk transfer transactions must be reported on a quarterly basis as long as the transaction remains outstanding. In our testing of the "Credit Risk Management: Risk Transfer Transactions" quarterly Board report, we noted that risk participation transactions are only reported in the quarter in which they are executed rather than for the period the transaction remains outstanding. Additionally, we observed that risk participation transactions are reported inconsistently from quarter to quarter as sometimes they are listed as loan sales and in others, as participations.

We also noted that the quarterly risk transfer information presented to the Board is primarily quantitative in nature. Additional qualitative information and analysis may better facilitate the Board's understanding and oversight of the risk transfer program. Such analysis could include the reasoning behind undertaking hedging transactions.

Management has agreed to ensure that the information presented in the quarterly Credit Risk Management: Risk Transfer Transactions report is in compliance with the reporting requirements of the Risk Transfer Policy of the RCMP and DOA Appendix C-4B and will augment the annual Portfolio

Management Framework Budget Request to better inform the Board regarding the reasoning behind secondary risk transfer activities.

Rating of Audit Finding – Moderate
Action Owner – Director, Risk Transfer & Special Risks
Due Dates – Q1 2016

Conclusion

The audit findings and action plans have been communicated to and agreed by management, who has developed action plans that are scheduled for implementation no later than Q4 2016.

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