Loans Provisioning
Audit Report
Report Nr. 18/15
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Introduction

As per our 2015 Audit Plan, Internal Audit performed an audit of the loans provisioning process. The loans allowance represents an estimate of probable credit losses on loans, loan commitments and loan guarantees. This estimate is based on an incurred loss model and includes both collective and individual loans loss allowances. The loans loss allowance balance was $1.5B as at September 30, 2015 and is an area where significant estimates are used. The key factors relevant to the loans provisioning calculations are: the loan exposure amount, i.e. Exposure at Default (EAD), Loss Given Default (LGD) and Probability of Default (PD).

Audit Objectives & Scope

The overall objective of this audit was to review controls surrounding the provision methodology and the related calculation tools. As such, the audit included an examination of:

- ✓ Procedures governing the loans provisioning process;
- ✓ Compliance with IFRS. This was mainly from a methodology perspective; presentation and disclosures in period-end financial statements was not in scope;
- ✓ Factors in the determination of individually impaired loan allowance and collective allowance;
- ✓ Integrity of data inputs - source and flow of data used in the provision;
- ✓ Manual adjustments; and
- ✓ End User Computing (EUC) controls.

The scope of the audit was to evaluate the design and operating effectiveness of controls over the loans provisioning process. The determination of LGD and PD, which are model-driven inputs, were scoped out of the audit, since these topics were covered in other recent audits.

The testing period for our audit was from October 1, 2014 to September 30, 2015.

Internal Audit Opinion

In our opinion the loans provisioning process is ***Well Controlled***[1]. We found that key controls pertaining to the loans provisioning methodology and related activities are effectively designed and operating as intended. Moderate issues were noted and are described in the section that follows. Management has agreed to implement corrective actions no later than Q2 2016.

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[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. Loans Provisioning Procedures

A monthly loans provisioning procedures guide and an impaired provision rates guide containing key procedural information for the month-end loans provisioning process are updated on an as-needed basis by individual team members for their own reference. However, there was no evidence of review or validation by the process owner, roles and responsibilities of individual team members are not set therein and some sections require updates to reflect what is currently applied in practice. For instance, there is room for clarification of the current practice in using the Weighted Average Term to Maturity (WATM) as a proxy for the Loss Emergence Period (LEP) used in calculating the loans provision. Review and approval of the procedures documents is important to ensure validity and completeness of the documents, supporting training and process continuity. Management has agreed to implement a process for their procedures documents, to be updated annually or sooner, where required, and the process owner reviewing and approving these documents.

Rating of Audit Finding - Moderate[2]
Action Owner – Francis Mensah (Director, Corporate Accounting)
Due Dates - All actions to be implemented by Q1 2016.

2. Review of Loans Provision Calculations and Underlying Inputs

At each month-end, a checklist of review items is performed by a manager to verify the loans provision (LP) calculations, as well as the underlying inputs used in determining the loans provision figures. The completion of the reviewer checklist used to verify the final LP data set is a key control in ascertaining the accuracy, completeness and integrity of the loans provision calculations and inputs. During audit testing, one of four monthly sample selections of the checklist was found not to have evidence of management review. Based on further inquiry, we confirmed that the review was performed but not documented using the checklist. Management has agreed to enhance the existing process and document evidence of review and approval of the final LP data set upon completion of the manager checklist.

Additionally, as part of the review of the loans provision calculations and underlying inputs, reconciliations are performed monthly to agree loan exposure data in the LP data set to the source database. Although no unreconciled items were noted in our testing sample, we noted an instance where there was no evidence that the monthly reconciliation has been reviewed. Management has agreed to assign the reviewer of the loans provision calculation and inputs to also provide evidence of review of the exposure reconciliations.

[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.

Finally, EDC engages in active risk management by entering into a number of risk mitigation transaction agreements with third-party financial institutions to reduce its exposure with certain obligors. These insurance agreements effectively transfer the risk exposure to the third-party insurer. Within the context of the loans provisioning process, adjustments for Unfunded Risk Participation and Risk Mitigation Insurance (URP-RMI) are calculated manually by the Loans Accounting team as the provisioning system is not currently configured to integrate such data in the LP data set. In testing URP-RMI workbooks manually prepared to calculate URP-RMI adjustments per obligor, it was noted that there is no evidence of review of the manual adjustments by a second person. We confirmed that these adjustments are reviewed as part of the loan allowance calculation; however, no explicit evidence of URP-RMI adjustment review is maintained. Management has agreed that the review checklist will be extended to include a specific check on URP-RMI manually calculated adjustments to ascertain their accuracy. In addition, we understand that efforts have been initiated by management to configure automated data feeds such that URP-RMI data is integrated directly into the loans provisioning data set.

Rating of Audit Finding - Moderate
Action Owner – Francis Mensah (Director, Corporate Accounting)
Due Dates - All actions to be implemented by Q4 2015.

3. General Guidelines and Principles Used in Determining Aerospace Collateral Valuations

During the audit, we were able to verify that for Loan Provisioning amounts and inputs related to aerospace accounts, the RMO-Aerospace team had sufficient supporting documentation, including valuations data from a third party consultancy firm “Ascend”. Ascend specializes in pricing aircrafts and helicopters. We noted however, that there are no documented guidelines on the valuation methodology or key criteria outlining the principles used by the Aerospace team for judgments and assumptions made in areas such as aircraft valuations and repossession costs. Such guidance is necessary to ensure consistency, training and also forms basis for estimates and assumptions. Management has agreed to create documented guidelines and valuation principles to explain the thought process and type of judgments required in assessing aerospace collateral values.

Rating of Audit Finding - Moderate
Action Owner – Yves L’Heureux (Director, Credit Risk Management)
Due Dates - All actions to be implemented by Q2 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 Q2 2016.

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