



VOLUME 8 NO. 5  
MAY 2011

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**MORTGAGE LENDING**

**MONTHLY FOCUS**

# Mortgage Servicers' Auditing Weaknesses Contributed to Foreclosure Crisis

Ineffective internal auditing was among the litany of industry-wide errors and weaknesses found by the four primary bank regulators<sup>†</sup> after "horizontal" (simultaneous) reviews of foreclosure processing at 14 of the nation's largest mortgage servicers. The on-site reviews, conducted during the fourth quarter of 2010, were prompted by the massive foreclosure experience that reached crisis proportions in 2010, when mortgage servicers plowed through heavy workloads by taking shortcuts and failing to practice ordinary care in processing foreclosures.

The volume was indeed extraordinary. Depending on the size of a servicer's operations, anywhere from 100 to more than 25,000 foreclosure ac-

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**AUDIT PROFESSION**

**HEADLINES**

# "Relationship Acumen" Is Internal Auditor's Essential Skill

The stereotype of the accounting and auditing "type" is someone with great financial acumen and a head for details but not necessarily good communication skills. Regardless of whether this stereotype ever reflected reality, it is no longer adequate in today's business environment. According to a white paper published by the Institute of Internal Auditors (IIA) and The Korn/Ferry Institute, "relationship acumen" is essential for an internal audit leader's ongoing success.

"Soft skills" have not traditionally been thought of as a key component of an internal auditor's skill set. But, according to IIA president and CEO Richard Chambers, good communication and interpersonal skills "are essential to effectively navigating the often rough waters internal auditors must confront."

Chambers was alluding to the role of internal auditors in delivering unwelcome news: "We have found an internal control problem," "I suspect fi-

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## BSA COMPLIANCE

## AUDIT TUNE-UP

# Ensuring Confidentiality of SARs Shared with Affiliates

On January 3, 2011, guidance from the Financial Crimes Enforcement Network (FinCEN) became effective, confirming the ability of depository institutions to disclose Suspicious Activity Reports (SARs) they have filed, or any information revealing the existence of a SAR, to their affiliates. The guidance, among other things, instructs depository institutions to institute internal controls aimed at ensuring that their affiliates, in turn, protect the confidentiality of a SAR's filing or existence.

The new affiliate sharing authority, however, is conditioned on the affiliate also being subject to a SAR regulation. FinCEN issued the guidance after concluding that the sharing of SARs with such affiliates facilitates the identification of suspicious transactions taking place through a depository institution's affiliate, thus making it consistent with the purposes of the Bank Secrecy Act (BSA).

Internal auditors may need to update their audit procedures to make sure the guidance is properly implemented within the institution's BSA compliance program and that appropriate policies and procedures are in place to carry out the law's confidentiality requirements and ensure that affiliates with whom a SAR or information about a SAR is shared will do their part to keep it confidential.

In the guidance, an "affiliate" of a depository institution is defined as any company under common control with, or controlled by, that depository institution.

## Background

Under the BSA rules generally, filers of SARs are barred from notifying anyone involved in a suspicious transaction that the activity has been reported. The purpose of the confidentiality provision is to protect the institution and give law enforcement time to investigate before tipping off the subjects that their activity has been noticed.

FinCEN generally construes this confidentiality provision as prohibiting a depository institution from disclosing a SAR or any information revealing the

existence of a SAR. However, FinCEN carved out exceptions from the confidentiality rule, allowing disclosures of a SAR to: FinCEN; any federal, state, or local law enforcement agency; any federal regulatory agency that examines the institution for compliance with the BSA; or any state regulatory authority that examines the depository institution for compliance with state laws.

In addition, there is an exception from the prohibition against sharing a SAR, or information revealing the existence of a SAR, within a depository institution's corporate organizational structure for purposes consistent with the BSA, as determined by regulation or guidance.

In January 2006, FinCEN released guidance, in cooperation with the federal banking regulators, that explicitly permits a U.S. branch or agency of a foreign bank to share a SAR or information about a SAR with its head office, and also allowing a U.S. bank or savings association to share a SAR with its controlling company (whether domestic or foreign). These authorities were based on the belief that the sharing of SARs in these ways enables head offices or controlling companies to discharge their duty to oversee entities for which they are responsible and to conduct enterprise-wide risk management.

The January 2006 FinCEN guidance deferred taking a position on whether a depository institution is permitted to share a SAR with its affiliates. At the time and pending further deliberation, the guidance directed depository institutions *not* to share SAR information with their affiliates.

The new guidance, effective this year, withdraws FinCEN's earlier position and is based on its conclusion that the sharing of SARs with affiliates that are themselves subject to a SAR rule facilitates the identification of suspicious transactions taking place through depository institution affiliates and is therefore consistent with the purposes of the BSA.

However, even under the new interpretation, FinCEN cautions depository institutions against disclosing a SAR or any information that would reveal the

existence of a SAR if the depository institution has reason to believe the information may be disclosed to any person involved in the suspicious activity.

The box below lists several relevant matters that a depository institution's internal auditor or BSA compliance officer should check with respect to implementation of the new FinCEN guidance. ■

### ADD NEW CHECKS TO YOUR BSA/ SAR PROGRAM AUDIT

An auditor reviewing a depository institution's compliance with the SAR confidentiality provisions and the new FinCEN guidance on sharing with affiliates should check whether specific policies and procedures have been put in place to:

- Ascertain whether the affiliate with whom a SAR, or information revealing the existence of a SAR, is to be shared is itself subject to a SAR rule
- Verify that the reasons for disclosing the SAR, or information revealing the existence of a SAR, are consistent with the purposes of the BSA — that is, to facilitate the detection and investigation of suspicious activity — *each time a decision is made to share*
- Implement specific policies and procedures governing the disclosure of a SAR or information revealing the existence of a SAR to affiliates, making sure the disclosures are made in a manner that protects their confidentiality
- Confirm that any affiliates with whom SARs or SAR information is shared have procedures in place to ensure that the documents or information are not further disclosed to any affiliate of their own, even if that affiliate is subject to a SAR rule (only one level of inter-affiliate sharing is allowed)
- Periodically review compliance with the SAR rules and the institution's compliance with the BSA's confidentiality provisions, including those permitting the sharing of SARs and SAR information with affiliates

## Mortgage Servicers' Auditing

*continued from page 1*

tions occurred each month between January 1, 2009, and December 31, 2010. As a result, the foreclosure processes at each of the servicer operations was geared toward speed and quantity instead of quality and accuracy.

The deficiencies and risks identified by the agencies' examiners were of a nature and pervasiveness that they resulted in unsafe and unsound practices and violations of applicable law, the agencies declared in their April 2011 report, *Interagency Review of Foreclosure Policies and Practices*.

The agencies detected critical weaknesses in the servicers' foreclosure governance processes, document preparation processes, and oversight and monitoring of third-party vendors. These problems were found in varying degrees at all the servicers subject to the supervisory review, representing two-thirds of the entire servicing market.

For these shortcomings, the banking agencies are taking enforcement action against each of the 14 servicers and, in some cases, their parent holding companies. In addition, each mortgage servicer must retain an independent firm to conduct a thorough review of the foreclosure actions that were pending at any time between January 1, 2009, and December 31, 2010. The purpose of the independent review is to identify borrowers who were financially harmed by deficiencies identified in the interagency report and to specify remedies where appropriate.

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### Audit Framework

To ensure consistency among the reviews, the federal bank regulatory agencies used standardized work programs to guide the assessments and to document their findings. The work programs were

organized into review categories. An internal auditor responsible for reviewing and verifying the adequacy of an institution's foreclosure processing policies and procedures may wish to use these categories (summarized in Exhibit 1) as a framework for the audit.

## Common Weaknesses

As a result of the reviews, the agencies identified significant weaknesses in six general areas at all 14 mortgage servicing institutions. Among them were ineffective quality control and audit programs.

The checklist at the end of this article is derived from the list of weaknesses that the agencies detected. This checklist may be used, along with the audit framework categories in Exhibit 1, to design an internal audit program for a financial institution's foreclosure processes.

The checklist may be useful whether an institution engages third-party service providers for some or all processing tasks or does all its own mortgage

foreclosure processing. An awareness of common deficiencies and weaknesses in foreclosure processing gives the internal auditor a head start in knowing what to look for when setting up an audit program, creating audit work papers, and conducting a review.

For more details on the findings of the interagency review of foreclosure processing practices, you may access the report at: [http://www.federalreserve.gov/boarddocs/rptcongress/interagency\\_review\\_foreclosures\\_20110413.pdf](http://www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf) ■

† The Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision conducted reviews at large mortgage servicers under their respective jurisdictions; the Federal Deposit Insurance Corporation is not the primary regulator for any of the largest mortgage servicers, but it participated in the review as the "back-up regulator to protect the interests of the deposit insurance fund" (FDIC press release, April 13, 2011) and to provide resources and support for the review.

### Exhibit 1: Foreclosure Processing Review Categories/Audit Framework

- ▣ *Policies and procedures* — Did the institution adopt adequate controls over the foreclosure process and were they sufficient to ensure compliance with the applicable laws and regulations?
- ▣ *Organizational structure and staffing* — Were staffing levels, staff qualifications, and training programs adequate to the volume and nature of the foreclosure processing work?
- ▣ *Management oversight of third-party service providers* — Was the oversight of foreclosure attorneys, default service providers, and others engaged in supporting the foreclosure process adequate?
- ▣ *Quality controls and internal audits* — Did the institution incorporate quality control processes and procedures in the foreclosure processing work flow? Were internal and external audit reports prepared, including secondary mortgage market agency reports and investor audits?
- ▣ *Compliance* — Were corporate governance, audit programs, and controls in place to ensure regulatory and statutory compliance?
- ▣ *Loss mitigation* — Was the institution in direct communication with borrowers? Were loss mitigation strategies, including loan modifications, considered and discussed with borrowers as alternatives to foreclosure?
- ▣ *Critical documentation* — Did the institution maintain control over critical documents used in the foreclosure process, including implementation of retention safeguards for original loan documentation? Were critical foreclosure documents present in the foreclosure files, and were notes endorsed and mortgages assigned?
- ▣ *Risk management* — Did the institution appropriately identify financial, reputational, and legal risks they were incurring in connection with foreclosures? Were identified risks communicated to the board of directors and senior management? Did the board and senior management provide active risk management guidance to keep these risks in check?

## FEATURED TOOL

## CHECKLIST OF COMMON FORECLOSURE PROCESSING WEAKNESSES

*This checklist summarizes the weaknesses found in the foreclosures processes of mortgage servicers that were subject to the banking agencies' horizontal reviews. You can use the checklist to help identify similar problems or weaknesses that could potentially exist in your institution's foreclosure activities. By looking for specific weaknesses, you can either rule them out or verify that they may be present, allowing your foreclosure unit to take corrective action. Place a checkmark in the box if you detect any of these weaknesses.*

### 1. Foreclosure Process Governance

**General weaknesses:** Foreclosure governance processes were underdeveloped and insufficient to manage and control operational, compliance, legal, and reputational risk associated with the increasing volume of foreclosures. Specific weaknesses include:

- Inadequate policies and procedures to control foreclosure process
- Lack of an independent control infrastructure
- Inadequate monitoring and controls to oversee foreclosure activities conducted on behalf of servicers by external law firms or other third-party vendors
- Lack of sufficient audit trails to track whether information set out in the affidavits (amount of indebtedness, fees, penalties, and so forth) matched the servicers' internal records at the time the affidavits were executed
- Inadequate quality control and audit reviews to ensure compliance with legal requirements, adherence to policies and procedures, and maintenance of a sound operating environment
- Inadequate identification of risks
- Absence of internal communication between senior management and boards of directors regarding potential risks

### 2. Organizational Structure and Staffing

**General weaknesses:** Failure to provide adequate organizational support and staffing to foreclosure units to address the increased volume of foreclosures. Specific weaknesses include:

- Insufficient numbers of qualified employees
- Inadequate training for affidavit signers, notaries, and quality control staff
- Insufficient supervision
- Inadequate manpower to communicate effectively with borrowers
- Inadequate authority to discuss foreclosure alternatives

### 3. Affidavit and Notarization Practices

**General weaknesses:** Preparation of critical foreclosure documents was incomplete and prone to error. Specific weaknesses include:

## CHECKLIST OF COMMON FORECLOSURE PROCESSING WEAKNESSES, CONT.

- Failure of individuals who sign foreclosure affidavits to personally check the documents for accuracy
- Insufficient knowledge possessed by individuals who sign foreclosure affidavits to understand what they attested to by their signatures
- Mistakes in documents that indicate they were executed under oath but no oath was administered
- Improper notary practices that failed to conform to state legal requirements
- Execution of documents in a manner contrary to the notary's acknowledgement and verification
- Inaccuracies in amounts listed on affidavits of indebtedness as compared to amounts on paper files or computerized loan servicing systems
- Failure to accurately complete or validate itemized amounts owed by borrowers in default

### 4. Documentation Practices

**General weaknesses:** Documents were incomplete or contained errors, including errors in recording fees. Specific weaknesses include:

- Discrepancies between actual fees charged and the fees that internal records indicated were charged
- Overcharges and undercharges
- Lack of a clear auditable trail in reconciling foreclosure filings to source systems of record
- Absence of critical foreclosure documents in the foreclosure files

### 5. Vendor Management

**General weaknesses:** Failure to properly structure, carefully conduct, or prudently manage vendor relationships with outside law firms and other third-party foreclosure services providers, thus increasing reputational, legal, and financial risks. Specific weaknesses include:

- Insufficient guidance, policies, and procedures governing initial vendor selection, ongoing vendor management, and termination of law firms that handle foreclosures
- Too much reliance on firms designated as approved or accepted by investors, or too much reliance on existing business relationships between law firms and default management service providers, as opposed to conducting own due diligence
- Too much reliance on informal engagements with law firms, rather than formal contracts, thus forfeiting contractual recourse for liability or performance issues
- Inadequate monitoring of outside law firms for compliance with the institution's standards
- Exemptions of outside law firms from the institution's regular vendor management programs

## CHECKLIST OF COMMON FORECLOSURE PROCESSING WEAKNESSES, CONT.

- Weak monitoring programs that were confined to evaluating responsiveness and timeliness, checking for liability insurance, or determining whether any power of attorney given to the firm remained valid, as opposed to comprehensively assessing the accuracy and adequacy of the law firm's work product, such as legal document accuracy or state law compliance
- Inadequate retention of originals or copies of documents maintained by outside law firms, with too much reliance placed on third parties to retain documents
- Absence of central and well-organized foreclosure files
- Defects in foreclosure documents prepared by outside law firms, such as signatures without the requisite authority to sign and unauthorized changes to format and content of affidavits
- Deficient practices arising from arrangements with default management service providers, including inadequate contracts and insufficient oversight
- Inadequate oversight, management, and supervision of arrangements with Mortgage Electronic Registration Systems, Inc. (provides support to mortgage servicing and foreclosure processing, including mortgage recording and assignment services; can also serve in a nominee capacity)

### 6. Quality Control and Audit

**General weaknesses:** Insufficient quality control procedures resulting in failure to perform foreclosure tasks at a satisfactory level; insufficient internal audits resulting in failure to identify fundamental control issues that led to foreclosure process breakdowns. Specific weaknesses include:

- Failure to ensure accurate foreclosure documentation
- Failure to incorporate mortgage servicing activities into the institution's loan-level monitoring, testing, and validation programs
- Failure to evaluate and test compliance with applicable laws and regulations, court orders, pooling and servicing arrangements, and similar contractual arrangements
- Failure to apply proper controls to prevent foreclosures when intervening events or conditions warrant stopping the foreclosure process (for example, bankruptcy proceedings, situations in which Servicemembers Civil Relief Act applied, or initiation of trial or permanent loan modification programs)
- Failure to perform adequate internal audits, thus:
  - Impeding the ability to identify, address, and internally communicate foreclosure processing risks
  - Offering inadequate support to the institution's risk management processes commensurate with the size and complexity of foreclosure activities
  - Impairing the ability to take sufficient corrective action to strengthen policy and procedural gaps, increase staffing, or improve training
  - Failing to improve documentation procedures, including custody and control of documents and proper notarization

## “Relationship Acumen”

*continued from page 1*

financial wrongdoing may have caused a discrepancy,” “The financial statement needs to be altered,” or “A compliance violation has occurred.” In delivering audit results such as these, an internal auditor must not be seen as a critic but as a partner in management.

To foster this image, a chief audit executive must establish and maintain strong relationships with key stakeholders — executive management and the audit committee of the board of directors — according to the white paper. Management and the board may have conflicting agendas, and meeting both their expectations involves a broad range of communication skills and sensitivities.

The white paper also notes that a savvy chief audit executive is called upon to *observe*, *absorb*, *probe*, and *listen*. These skills were identified after interviewing numerous internal audit practitioners and audit committee members. The internal auditor needs to know how to nurture strong relationships and avoid projecting what the study’s authors called a “punitive image.”

The study revealed that audit committees now have higher expectations for their chief audit executive than previously. An internal audit leader should inspire confidence and “be proactive and get out in front of the curve.” This requires understanding the business and being able to “advocate behavioral change with a positive perspective.”

Trust also plays a key role in every aspect of an internal auditor’s work. Without trust, it is difficult to get people to be candid, tell the truth, and otherwise provide reliable input to an audit.

The white paper identifies six traits that high-performing chief audit executives should possess:

- Positive intent
- Diplomacy
- Prescience (foresight)
- Trustworthiness
- Leadership
- Empathy

Perhaps these skills and traits can be emphasized in business courses and professional education pro-

## May Is International Internal Audit Awareness Month

Internal auditors are promoting their profession this month by explaining the important role that internal audit plays in corporate governance, internal control, and risk management. Who is listening? Stakeholders (executive management and board audit committees), employees, customers, and students.

The observance is an especially good time to let people know that internal auditing is an attractive and dynamic career that puts one right at the heart of the organization and works to keep it strong, sound, and successful.

The Institute of Internal Auditors sponsors International Internal Audit Awareness Month. For more information, tools, and resources, go to: <http://www.theiia.org/theiia/about-the-profession/promoting-the-profession/awareness-month>

grams. Practicing internal auditors may also wish to develop these skills through continuing education opportunities.

The white paper, entitled “The Relationship Advantage: Maximizing Chief Audit Executive Success,” can be downloaded from: [http://www.kornferryinstitute.com/files/pdf1/The\\_relationship\\_advantage\\_Maximizing\\_chief\\_audit\\_executive\\_process1.pdf](http://www.kornferryinstitute.com/files/pdf1/The_relationship_advantage_Maximizing_chief_audit_executive_process1.pdf) ■

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