



AuditOne Advisory

From Bud Genovese, CEO

Focus on Loan Losses Spreads to Entire Internal Audit Program

The general economic slowdown has triggered loan losses and concerns about loan quality at banks across the United States. In turn, concerned bank examiners are looking closely at loans, and an offshoot of this focus is that examiners are also showing a heightened interest in other banking activities of high inherent risk as well as the internal audit coverage of those activities. As a result, a number of banks have experienced difficult examinations of late. What's a bank to do?

First of all, ensure that internal audit resources are appropriately directed toward high risk activities. An annual risk assessment should be performed to identify those areas. For example, when loan quality is declining, it is ever more critical to ensure the institution is complying with the Interagency Guidelines on the Allowance for Loan and Lease Losses as well as Commercial Real Estate Concentrations.

In addition, loan review frequencies may need to be increased. Many institutions are engaging for loan reviews on shorter cycles such as quarterly or semiannually. Since the examiners will be spending more time than usual on lending activities, it is a good idea to increase the frequency of note department audits. Besides the perils of greater regulatory scrutiny, your management, Board and shareholders need to be sure that as your credit portfolio shows signs of stress, your loan documentation, monitoring and other operational functions are all sound and reliable -- to identify problems early on and to protect the bank should things worsen. Also, since more loan files are being reviewed, the incidence of regulatory violations for flood insurance compliance has become even more frequent. Appraisal practices also have come into question.

Spillover from the subprime meltdown has impacted the liquidity condition and the investment portfolio valuations at many institutions. It would behoove a Bank to have these activities looked at by internal audit, before the examiners arrive.

While the examiners are your guest for all those weeks, most likely other deficiencies may be uncovered. For example, many institutions have been criticized recently for call report errors, inadequate wire transfer controls, insufficient documentation or testing of the business continuity plan, weak information security controls, or inadequate governance practices by the Audit Committee.

Last but not least, examiner scrutiny of the BSA Program has not let up. Many aspects of BSA Programs continue to be criticized including, but not limited to customer due diligence procedures, BSA training, and independent testing of the BSA program.

The bottom line is that, now, when risks are on the rise, is the worst time to be cutting back on internal audit. But we certainly appreciate that now is also a time when bottom lines are getting squeezed. All this makes optimizing the audit plan all the more important, to ensure that high risk areas are covered at an appropriate scope and frequency. AuditOne performs functional risk assessments for many institutions to help them make that assessment and optimize their risk management dollar.

Bud Genovese is founder and CEO of AuditOne LLC, a California-based internal audit firm that focuses only on banks and their service providers. Mr. Genovese pioneered the concept of providing comprehensive, affordable, independent internal audit services by gathering wide-ranging, extraordinary expertise within one firm. AuditOne now serves over 130 clients throughout the Western United States, and nationally. Contact Bud Genovese at 408-980-8099 or bud.genovese@audit-one.com