

**Corporate Portfolio Management - Commercial Loans  
Final Audit Report  
Report Nr. 19/09  
January 13, 2010**

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## Introduction

As per our FY2009 Audit Plan, EDC Internal Audit performed an audit of Corporate Portfolio Management for commercial loans. Corporate Portfolio Management is the planned and continuous, ongoing monitoring activities done to identify changes in credit risk post origination. It includes the mitigation strategies and tools used to manage these exposures and the measurement and reporting of these exposures to management and the Board. The Credit Monitoring and Review Policy establishes the standards for monitoring EDC's portfolio of credit commitments within the Financing Group and Insurance Group programs, and describes the process for assessing changes in credit risk. The policy has the goal of ensuring that EDC's credit commitments are monitored appropriately and, if post-commitment actions may be required, to outline decision making and reporting responsibility for such actions. EDC's corporate portfolio of credit exposure includes loans, guarantees, credit insurance, bonding and trade finance obligations.

## Audit Objectives & Scope

This report contains the findings for the audit of the commercial loans component of EDC's portfolio. The overall objective of this audit was to review the design effectiveness of the internal controls over the Corporate Portfolio Management process of EDC's portfolio of commercial loan commitments for:

- changes in credit risk post-origination;
- credit risk measurement at the portfolio level for commercial loans; and,
- credit risk mitigation activities (e.g. loans sales, hedging, etc.).

In examining corporate portfolio management for commercial loans, the audit addressed the following risk elements of EDC's Enterprise Risk Management (ERM) framework: lending, measurement, compliance, financial management and reporting, transaction processing, governance, infrastructure/information, portfolio concentration and capital allocation, system, and reputation.

Audit fieldwork was performed during October and November 2009.

## Internal Audit Opinion

In our opinion the Corporate Portfolio Management process for commercial loans portfolio is **Well Controlled**<sup>1</sup>. No major<sup>2</sup> control issues were noted. Some moderate issues were noted and are described in the following section.

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<sup>1</sup> 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.

<sup>2</sup> Our audit findings are ranked 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.

## Audit Findings & Recommendations

### 1. Compliance Monitoring

Asset management produces a quarterly credit risk limit compliance certification report for the Board of Directors. From our walkthroughs, we found that on a monthly basis, there was evidence of the compliance reporting being completed however, there was an opportunity to improve the process for communication of the reports to the VP & Chief Risk Officer (CRO) and the President. There have also been some organizational changes in the group that produces the report that are not reflected in the report documentation. Going forward a checklist will be included in the monthly evidence binder that would outline all final month-end procedures for compliance reporting, which will now include sending the reports to the VP & CRO on a monthly basis and to both the VP & CRO and the President on a quarterly basis. The report should be issued by the Director, Asset Management to reflect the organizational changes in the group.

Rating of Audit Finding - Moderate  
Action Owner - Director, Asset Management  
Due Dates - Q1 2010

### 2. Credit Rating Changes

When a credit rating is changed as a result of obligor reviews and/or ongoing monitoring, these changes are sent with supporting documentation to the Risk Policy officer who then manually updates the Company Index (CI) with the new credit rating. The manual nature of this process creates the risk that an input error could occur. In addition, the risk screen in the CI does not have an audit trail of the credit rating changes and the dates these changes were made. The CI risk screen only displays the most recent credit rating and the associated date.

In the new Asset Management system, this process should be automated and embedded to ensure that once a credit rating change (or watchlist/impaired classification) has been authorized by the Portfolio Manager, the credit rating will be automatically updated. This will eliminate the potential for input error and ensure accuracy in credit ratings and classification.

Rating of Audit Finding - Moderate  
Action Owner - Director, Asset Management  
Due Dates - Q3 2010

### 3. Proactive Credit Risk Mitigation

A Secondary Market Pricing Framework exists for monitoring loan prices for obligors with publicly traded loans. If prices fall below thresholds as defined in the Framework, analysis is initiated by an Asset Manager. IA found that the secondary market pricing analysis is being completed by an Asset Manager but there is no documented second level review and reporting is not done as outlined in the Framework. The risk of not having a more senior person (Loan Portfolio Manager) document their review is that they may not be in agreement with the analysis completed by the Asset Manager. Specifically, in instances where the Asset Manager recommends to hold the exposure, when the Loan Portfolio Manager believes that a reduction in exposure may be necessary and consultation with Risk Transfer is needed.

IA is recommending that the thresholds and procedures established under the Secondary Market Pricing Review Framework be followed and documented as outlined. In addition, consideration should be given to expanding the scope of secondary market pricing analysis to also look at Credit Default Swap (CDS) spreads, equity prices, etc. where applicable.

Under the current process relating to loan sales, Risk Transfer is not getting involved until the later stages of the process and consequently their actions are reactive in nature. Secondary market pricing is a good tool to proactively manage exposures, but is limited to those companies with publicly traded loans. Therefore, consideration needs to be given in engaging Risk Transfer at an earlier stage in order for proactive mitigation to occur.

Rating of Audit Finding - Moderate

Action Owner - Director, Asset Management and Senior Risk Transfer Manager

Due Dates - Q3 2010

#### **4. System Access Controls**

IA found that write access to the risk screen in the CI, where credit ratings changes are made, had been granted to business users and technology/support users who did not require this access. For the majority of these users, access was granted to them in prior roles within the organization, however this access was never suspended when the employee changed roles.

Action was taken immediately during the audit, by Asset Management, to remove access for the business users who did not require it. IA is recommending quarterly review of write access to the risk screen in the CI be performed by the Director, Asset Management.

Rating of Audit Finding - Moderate

Action Owner - Director, Asset Management

Due Dates - Q1 2010

### **Conclusion**

The audit findings and recommendations have been communicated to and agreed by management, who has developed action plans that are scheduled for implementation no later than Q3 2010.

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