

# Auditing Credit Risk Management

2nd edition

Global Practice Guide

Aligns with the Global Internal Audit Standards



The Institute of  
**Internal Auditors**

FINANCIAL SERVICES

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# Executive Summary

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Credit risk has always been a key concern for financial services organizations, and for many, it may be the most critical risk. After the global financial crisis, regulators and supervisors focused on this risk, emphasizing the need for accurate models that can measure the capital impact of credit activities, the risk associated with leveraged finance, and the importance of managing counterparty risk.

These new requirements and supervisors' expanded expectations give the internal audit function a more relevant and active role in the assessment of credit risk. In addition, an organization's board has direct responsibility for credit risk oversight and governance; thus, the independently positioned internal audit function should provide the board with objective assurance as per the Global Internal Audit Standards™.

This guidance provides internal auditors with baseline information that allows them to test and evaluate the effectiveness of an organization's credit risk management framework and processes.



# Introduction

This guide supports internal auditors in the financial services sector with auditing credit risk. Credit risk is one of the essential **risk** categories of the sector. Regulators across the globe are focused on financial services organizations' credit **risk management** activities. Moreover, regulators and supervisors consider managing credit risk one of the pillars required to maintain a robust and solvent financial sector, which in turn encourages a steady economic condition.

Given the complexity and importance of managing credit risk within a financial services organization, this guidance focuses on the credit risk arising from a financial services firm's lending practices.

After reading this guidance, internal auditors should be able to:

- Understand the importance of credit risk in a financial services context.
- Understand the regulatory environment and requirements related to credit risk.
- Understand the **governance** and risk management processes surrounding credit risk.
- Describe the nature and basis of measurement for key variables used in credit risk assessment.
- Design an audit **engagement** that assesses the appropriateness and effectiveness of the credit risk management framework and the adequacy of the organization's credit profile.
- Apply the Standards and risk-based internal audit techniques to assess and audit credit risk in their organization.

## Note

Terms in **bold** are defined in the glossary in Appendix B.

The Global Internal Audit Standards use certain terms as defined in the glossary. To understand and implement the Standards correctly, it is necessary to understand and adopt the specific meanings and usage of the terms as described in the glossary.

The Standards use the word "must" in the Requirements sections and the words "should" and "may" to specify common and preferred practices in the Considerations for Implementation sections.



# Business Significance: Risks and Opportunities

To properly manage the risks facing their organizations, personnel must understand the terminology associated with risk management, **compliance**, and internal auditing. Credit and counterparty risk can be understood as the positive or negative effect of uncertainty on a financial organization, borrower, or counterparty meeting its obligations in accordance with agreed terms. The basic concept is straightforward: each year a certain percentage of borrowers and counterparties will default. If the probability of default (PD) forecast is lower than the realized default rates, the organization will have additional write-offs, so it is important that the financial services organization generates reasonable and stressed forecasts of their PD risks.<sup>1</sup>

These write-offs may be offset by amounts collected during the organization's collections and recovery processes, so the PD forecast data feeds into forecasting of the expected loss given default (LGD). Multiplying the PD and the LGD and the exposure at default (EAD) results in the total expected loss (EL) for the time period. If the realized loss exceeds the EL, the return on equity (ROE) will be less than the amount forecasted by management.<sup>2</sup> If the realized loss is smaller than the EL, the ROE will be more than forecasted by management. EL can be calculated as a percentage ( $EL = PD * LGD$ ) or it can be calculated in terms of money by multiplying PD, LGD, and EAD. The dollar amount of EAD becomes concrete when calculating the value of an asset at the point of default or over time.

Further, EL can be affected by fluctuations in credit lines. This concept is referred to as the credit conversion factor (CCF). The CCF applies primarily to credit cards or similar loans and credit lines where there is a finite value, but obligors are not paying in regular installments as the balance changes. This makes it impossible to know what will happen within the account over time as the obligor may withdraw funds from the available credit line.

How can EAD be accurately measured if the account goes into default and the amount the obligor owes is unknown? The CCF requires the organization to analyze the obligor's behaviors using historical data to estimate how much of their exposure will convert into losses at the time of default.

The EL calculation becomes:

$$EL = (\text{Withdrawn amount} + CCF * \text{unwithdrawn amount}) * LGD * PD$$

1. "Principles for the management of credit risk," Basel Committee on Banking Supervision, April 2025, <https://www.bis.org/bcbs/publ/d595.pdf>.

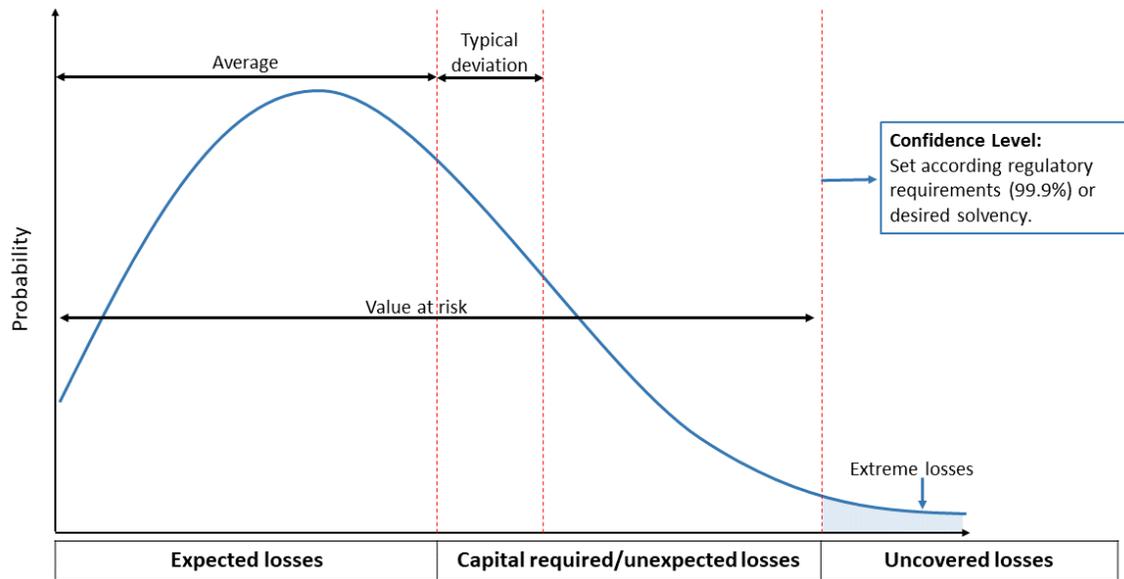
2. "Expected Loss (EL): Overview, How to Calculate, Importance in Credit Risk Management," CFI Education Inc., March 2022, <https://corporatefinanceinstitute.com/resources/career-map/sell-side/risk-management/expected-loss-definition-calculation-importance/>.



A key element in the EL equation is LGD. LGD tools (appraisals, resale statistics, stock prices, futures) are used to assess the value and/or the quality of an asset that the organization holds in exchange for providing funds. Collateral can be hard assets such as cars and machinery, mortgages, commodities, or other types of assets. The higher the value of the security, the lower the LGD and EL.

As shown in Figure 1, capital covers unexpected losses arising from credit portfolios up to a confidence level of 99.9 percent. The confidence level is set by the relevant regulator and/or Basel standards.

Figure 1: Credit Losses



Source: The Institute of Internal Auditors.

While the theory is simple, credit and counterparty risks are multifaceted, with risk impacts that extend into nearly all of a financial services organization’s businesses. Internal auditors working in a financial services environment should understand that credit risk is managed by a complex web of **controls** that include both subjective decision-making processes and objective data.

According to the relevance of credit risk in a financial services organization’s balance sheets, the widespread manifestation of this risk could jeopardize the viability and the sustainability of the organization. For example, a credit problem in a portfolio of loans, if left undetected and unmanaged, can grow into a crisis that could impact the **capital adequacy** and **liquidity** of a financial organization.

The IIA Global Practice Guides [“Auditing Capital Adequacy and Stress Testing for Banks”](#) and [“Auditing Liquidity Risk Management for Banks”](#) provide a complete discussion of credit risk and its effect on capital adequacy and liquidity in financial organizations.



# Key Regulations Related to Credit Risk

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The following are commonly recognized regulations impacting credit risk. Internal auditors should consider the designated regulations relevant to their organization's industry and location.

## Basel Framework Capital Requirements

There are two acceptable approaches to determining LGD values per the Basel Framework:

1. The Foundation Internal Ratings Based (FIRB), in which institutions are allowed to model only a specific set of parameters and must use prescribed calibrations for certain asset classes.
2. The Standardized Approach, in which regulators prescribe risk weights for various asset classes. Usually, this approach necessitates a greater allocation of capital.

Organizations may choose which method to use by asset class; however, certain asset classes are excluded. Most organizations use a single method for the entire portfolio, rather than picking and choosing by asset class.

Generally, internal auditors should monitor their organization's capital ratios and confirm they stay within the requirements. Some internal audit functions may analyze collateral, foreign exchange, and other factors, and recalculate the organization's ratios themselves to confirm they agree with the organization's reporting.

## Risk-Weighted Assets

Risk-weighted assets (RWA) are an estimate of risk that determines the minimum level of regulatory capital a bank must maintain to deal with unexpected losses.<sup>3</sup> The concept of RWA is simple, but calculating it for a financial organization of any size is a challenge.

Banks are required to hold capital in proportion to the risk level associated with the assets on their balance sheets. However, there are many specifications regarding how to classify assets and regulatory adjustments to be made based on numerous factors. Furthermore, the criteria may vary depending on the bank's status of phasing in the framework's requirements. To add to the complications, starting balances for both on- and off-balance sheet exposures, along with applicable risk weights, form the foundation for estimating post-stress-testing capital ratios. Deficiencies or inaccuracies in these starting balances will compound throughout the capital planning process.

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3. "Basel III: Finalising post-crisis reforms," Basel Committee on Banking Supervision, December 2017, <https://www.bis.org/bcbs/publ/d424.pdf>.



Here is a simplified example of the RWA concept:

Cash and high-quality investment-grade sovereign bonds are deemed to exhibit little, if any, credit risk. Therefore, banks could assign them no risk scores and reserve no capital. Conversely, a subprime mortgage that is 90 days past due on its payments may require a capital reserve of 50 percent or more of its anticipated cash flows.

To calculate RWA, banks must perform this evaluation process for the entire asset side of the balance sheet and sum up the capital required based on the assigned risk weightings. That sum is the minimum required capital level for that bank.

In addition to the widely accepted Basel capital requirement, two regulations impacting credit risk are Current Expected Credit Losses (CECL) issued in the United States by the Financial Accounting Standards Board (FASB) and International Financial Reporting Standard Nine (IFRS 9) issued in Europe. Both regulations affect the way financial services firms must calculate estimated losses and their associated capital charges and reserves.

## CECL

The impairment model required by FASB is based on actual losses incurred. Investments or loans are recognized as impaired when there is no longer an assumption that future cash flows will be collected in full under the originally contracted terms. Under CECL, financial services firms are required to use historical information, current conditions, and reasonable forecasts to estimate the expected loss over the life of the investment or loan.

According to FASB, the reasoning behind the implementation of CECL is that it “aligns the accounting with the economics of lending by requiring institutions to immediately record the full

## Audit Consideration

Internal auditors should verify their organization is documenting the process it will use or is using to comply with CECL and/or IFRS 9 including models used and model risk management activities implemented including model validation and vendor management activities.

In addition, internal auditors should understand the rationale of the hypothesis management used to develop compliance processes so they can evaluate the effectiveness of the entire process.

More information may be found in The IIA’s [“Third-Party Topical Requirement”](#) and Global Practice Guides [“Auditing Model Risk Management, 2nd Edition”](#) and [“Auditing Third-party Risk Management.”](#)

## Additional Resource

The BCBS [“Guidance on credit risk and accounting for expected credit losses”](#) includes the 11 principles around which credit risk supervisory guidance should be structured.



amount of credit losses that are expected in their loan portfolios, providing investors with better information about those losses on a timelier basis.”<sup>4</sup>

## IFRS 9

IFRS 9 is similar to CECL in that it focuses on future expected losses. IFRS 9 uses 12-month expected losses for Stage 1 and lifetime expected losses for Stage 2 and 3, as shown in Figure 2: Overview of the Impairment Requirements.

IFRS 9 requires the organization to recognize the instrument when the contract is finalized, at its fair value, and classify the assets by their cash flow characteristics, including:

- Amortized cost if the asset is held within a **business model** whose objective is to hold assets to collect contractual cash flows; and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
- Fair value through other comprehensive income if the asset is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.
- Fair value through profit or loss if the asset is not held in a business model consistent with one of the first two categories.<sup>5</sup>

Similar to securities accounting rules in which securities are held either to maturity or as “available for sale,” assets must be reclassified if the entity changes its business model for managing that asset.

Under IFRS 7, entities are encouraged to provide detailed disclosures about credit risk by class of financial instrument, which may include insights into credit quality, aging profiles, and any renegotiated or collateral-backed assets. These disclosures are not just about compliance – they aim to help users of financial statements better understand the nature of credit exposures and how those exposures are being managed over time. By offering this level of transparency, organizations can foster greater confidence in their financial reporting and risk management practices.<sup>6</sup>

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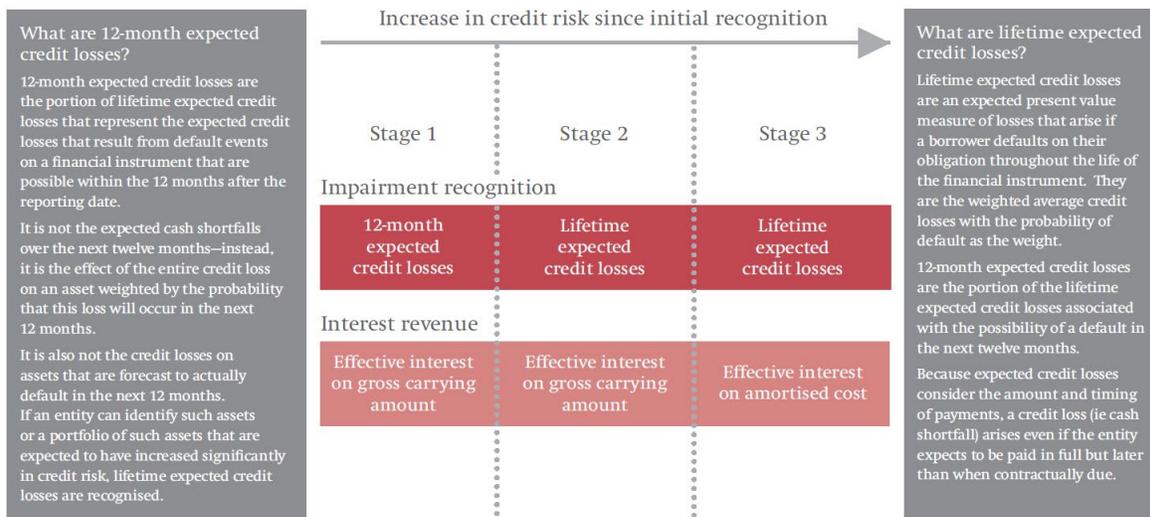
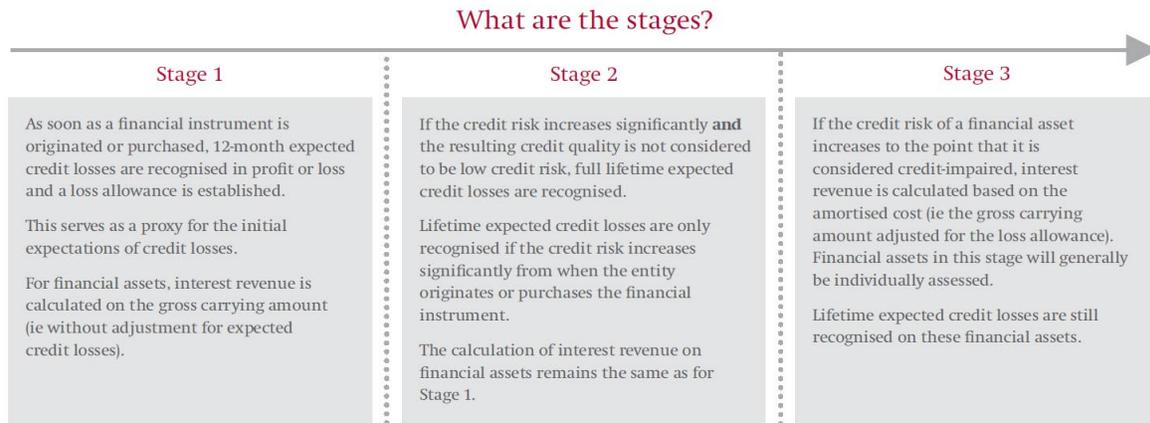
4. “Financial Instruments—Credit Losses (Topic 326)—Purchased Financial Assets,” FASB, May 2025, [https://www.fasb.org/projects/current-projects/financial-instruments%E2%80%94credit-losses-\(topic-326\)%E2%80%94purchased-financial-assets-401651](https://www.fasb.org/projects/current-projects/financial-instruments%E2%80%94credit-losses-(topic-326)%E2%80%94purchased-financial-assets-401651)

5. “IFRS 9 Financial Instruments,” IFRS Foundation, May 2024, <https://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/>.

6. “IFRS 7 Financial Instruments: Disclosures,” IFRS Foundation, May 2024, <https://www.ifrs.org/issued-standards/list-of-standards/ifrs-7-financial-instruments-disclosures/>; “IFRS 7 – Financial Instruments: Disclosures,” Deloitte, August 2023, <https://www.iasplus.com/en-ca/standards/part-i-ifrs/international-financial-reporting-standards/ifrs7>.



Figure 2: Overview of the Impairment Requirements



Source: IFRS 9 Financial Instruments, July 2014, 16-17. <https://www.ifrs.org/-/media/project/fi-impairment/ifrs-standard/published-documents/project-summary-july-2014.pdf>. Appendix E provides detailed copyright information.

## Credit Ratings

Agencies such as Experian and TransUnion numerically rate the creditworthiness of borrowers, including individuals, corporations, governments, and other types of entities. Each agency has its own model for calculating credit ratings, and although the results for entities rated may be close, they are rarely the same. Some credit agencies will provide weights of various criteria considered in generating a credit score; however, for any borrower, the most important factor in determining the credit score is timely bill payment.

Similar to credit ratings for borrowers, bond issuers are evaluated for creditworthiness but using different criteria. Moody's, Standard & Poor's, and Fitch are the world's three main bond rating agencies. The major criteria used to rate bonds is the issuer's financial ability to make interest payments and repay the loan in full at maturity. This rating also affects the **yield** the issuer must



pay to entice investors. Lower rated bonds will pay a higher yield corresponding to the higher risk involved in lending the issuer funds. Generally, bonds are categorized into investment-grade (higher ratings) and high-yield (lower ratings). High-yield bonds are also referred to as non-investment grade or junk bonds.

Studies have shown that lower rated bonds have a higher probability of default and do so more rapidly than investment-grade bonds. Ratings agencies typically issue annual reports illustrating defaults across a variety of industries.<sup>7</sup>

Most financial services firms will have their own processes for rating the creditworthiness of their corporate and retail clients. Ratings published by agencies are only available for companies that have issued publicly traded debt, which would exclude many small and mid-sized companies.

For financial services firms managing credit risk, this data indicates that lower credit ratings for borrowers and/or lower credit ratings for bonds generate higher risk levels, requiring more capital (reserves) held against losses than higher ratings would. Conversely, instruments with higher ratings have lower capital requirements.

Risk increases with time even for borrowers with good credit and investment-grade bonds, and markets are not immune to unexpected risks. Indeed, the global financial crisis of 2008 illustrated the weakness of relying solely on credit ratings to value credit portfolios and reserves. As a result, financial services firms should implement additional measures to monitor the economic health of their borrowers and bond issuers, such as using more than one bond rating agency to manage credit risk.

## Counterparty Credit Risk

“Counterparty credit risk (CCR) is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

An economic loss would occur if the transactions or portfolio of transactions with the counterparty has a positive economic value at the time of default.

Unlike a firm's exposure to credit risk through a loan, where the exposure to credit risk is unilateral and only the lending bank faces the risk of loss, CCR creates a bilateral risk of loss: the market value of the transaction can be positive or negative to either counterparty to the transaction. The market value is uncertain and can vary over time with the movement of underlying market factors.”

Source: BIS, “CRE – Calculation of RWA for credit risk, CRE50 – Counterparty credit risk definitions and terminology,”

last updated 5 July 2024

Counterparty credit risk is associated with the risk of derivatives investing, which is beyond the scope of this practice guide. However, internal auditors should be familiar with the concept.

7. “Default, Transition, and Recovery: 2018 Annual Global Corporate Default and Rating Transition Study,” S&P Global Ratings, April 2019, <https://www.spglobal.com/ratings/en/research/articles/190409-default-transition-and-recovery-2018-annual-global-corporate-default-and-rating-transition-study-10924218>.



# Credit Risk Governance

All financial services organizations should have a defined credit risk management framework. The **board** is responsible for monitoring the credit risk management framework and the governance structures that surround that framework. Standard 9.1 Understanding Governance, Risk Management, and Control Processes states, “The **chief audit executive** must understand the organization’s governance, risk management, and **control processes**.” It is important for internal auditors to understand the governance structures and processes associated with credit risk management.

Credit **risk strategy** or strategies, policies, and processes should be reviewed by the highest-level body charged with governance, such as a board of directors, annually at a minimum. The credit risk strategy should not contradict remuneration policies.<sup>8</sup> In larger organizations, the credit policies may be tailored for different regions and/or customer types. For example, policies for retail customers might be different from those for large warehouse organizations.

The board may create the credit risk strategy and revise it annually, with smaller units reviewing the strategy and policies more frequently. For example, geopolitical issues may necessitate more frequent reviews. When governments change, it can have an impact on the country’s economy, triggering ripple effects for organizations doing business there. In this case, organizations doing business in affected areas may wish to review their credit strategy and policies quarterly.

## A Global Example

In Mexico, by regulation, financial organizations must have a risk management committee, a credit committee, and an audit committee.

One large financial organization based in Mexico City has a risk management committee that meets monthly, covering all risks with the first, second, and third lines. The committee combines the risk management and credit committees into a single entity, covering credit risk.

The audit committee, which meets quarterly, should have members who are external and independent.

Both committees receive risk reports. The risk management committee approves certain strategies, policies, and transactions, while the audit committee approves others, depending on established criteria for escalation and/or delegation of authorities.

Source: Eguía, Borbolla, and Perez, “Banking Regulation 2026: Mexico,” last updated 9 December 2025.

8. “Principles for the management of credit risk,” Basel Committee on Banking Supervision, April 2025, <https://www.bis.org/bcbs/publ/d595.pdf>.



Most financial services organizations have a credit committee that reviews the credit risk management framework, capital strategy, risk aggregation, and concentration limits. They may also be responsible for setting credit risk limits. The credit committee may be the body responsible for reporting on credit risk to the board. Credit committees should meet frequently – perhaps once per week and more often if events merit more attention.

Financial services organizations may also have an asset/liability committee (ALCO). The ALCO should review the capital plan, monitor conformance to the organization’s stated **risk appetite**, and oversee decision-making related to managing assets and liabilities. This oversight includes evaluating and reacting to changing market conditions and ensuring the adequacy of liquidity and capital resources. In smaller financial services organizations, such as local banks or credit unions, these duties may be covered by a credit committee made up of senior lending officials, the chief loan officer, the CEO, CFO, and others, as appropriate. Alternatively, the senior executive team in total may perform these duties. In both cases, the audit committee (known as the supervisory committee in credit unions) monitors the committees/teams.

Risk management (the second line) plays a key role in managing credit risk.<sup>9</sup> For larger corporations, each line of business (retail, commercial) may have their own risk management committees that meet regularly to discuss all types of risk including credit risk.

These committees may have external considerations when setting limits, including but not limited to:

- Limits from the bank or regulator(s) related to their capital requirements.
- Limits on exposure to shareholders or other parties.

In general, the risk management function recommends the risk appetite, targets, and limits related to credit risk that are consistent with the organization’s **risk profile** and strategy to the board. Front office activities should ensure that approved credit risk requirements are fulfilled. Risk management can then perform its challenge and monitoring responsibilities, positioning the

## Audit Consideration

Internal auditors should verify the existence of a clear exception process for violations of credit risk limits, review whether information on exceptions performance is sufficient, and verify that the organization uses the information to take corrective actions.

Further, the credit committee, another second line function, or other relevant personnel, should regularly review exception reports and communicate significant exceptions to executive management and the board as necessary.

Internal auditors should verify whether the exception process for violations of credit risk limits is clear, monitored, and communicated.

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9. “The IIA’s Three Lines Model (An Update of the Three Lines of Defense),” The Institute of Internal Auditors, July 2020, <https://www.theiia.org/globalassets/documents/resources/the-iias-three-lines-model-an-update-of-the-three-lines-of-defense-july-2020/three-lines-model-updated-english.pdf>.



internal audit function to provide assurance on the efficiency and effectiveness of the credit risk management processes.

## Risk Appetite

In the Global Internal Audit Standards, risk appetite is defined as the “types and amount of risk that an organization is willing to accept in the pursuit of its strategies and objectives.” The risk appetite framework forms the basis of capital policies and governs the strategies and processes the organization uses to meet its objectives. BCBS defines the risk appetite framework as “the overall approach, including policies, processes, controls, and systems, through which risk appetite is established, communicated, and monitored.”<sup>10</sup> This definition includes the interaction between capital preservation and funding costs as well as interactions between credit, market, operational, and systemic risks.

Once the board and senior management have determined the organization’s risk appetite, the business will then translate, in quantitative terms, the annual budgets and targets within the limits of the risk appetite, and the liquidity, capital, and efficiency plans established. They may be considering a strategy that includes increasing placements in the retail sector, for example. They may perform new evaluations on sectors of the economy in which the risk profile has changed.

Credit risk is quantified using two main metrics: expected loss and economic capital. The expected loss reflects the average value of the estimated losses (the cost of the business) and is associated with the organization’s policy on provisions, while economic capital is the amount of capital necessary to cover unexpected losses (if actual losses are higher than expected losses). These risk metrics influence risk decisions that optimize profitability by impacting business strategies and operational decisions such as approving individual loans, price setting, assessing nonperforming loans, and more.

Once this analysis is completed, the business may allocate their portfolio according to their parameters and needs, such as sector, region, country, etc. This comprises the organization’s proposed risk appetite. From there, the risk management committee, or other appropriate governing body, will set the credit risk limits for the organization, thereby forming the operational part of the organization’s risk appetite.

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10. "Consultative document, Guidelines, Corporate governance principles for banks," Basel Committee on Banking Supervision, January 2015, <https://www.bis.org/publ/bcbs294.pdf>.



# Credit Risk Management

In financial services organizations, credit, once granted, is subject to a process including measuring and monitoring performance of the loans, various credit administration and servicing processes (depending on the product) and collections, if the borrower fails to meet their obligations on time. Figure 3 depicts the process.

Figure 3: Credit Risk Management Process



Source: The Institute of Internal Auditors.

**Credit Granting Process** – The granting criteria comprise creditworthiness measures. The criteria should be well defined in the credit policy and include the target market, understanding of the borrower and counterparty, purpose and structure of the credit, and source of repayment. The borrower must be classified as being able to repay the loan. The source of repayment should focus mainly on the borrower’s cash flows rather than the collateral. The collateral used or pledged as a guarantee if the debtor fails to repay the credit must be of a nature and value consistent with the borrower’s request for funds.

This process, referred to as underwriting, entails the organization’s ability to determine the borrower’s creditworthiness. Questions to help determine this vary depending on unique circumstances and may include inquiries such as, “Is it a commercial credit in which machines are purchased to generate some return? Or is this an individual consumer loan to buy a car?” Each scenario will have different underwriting requirements. Loans may be secured by several options, including securities, property, and money held in an account.

The granting process should include in addition to approving new credits, the amendment, renewal, and refinancing of existing credits. All extensions of credit must be made on an arm’s-length basis. In particular, credits to related companies and individuals must be authorized on an exception basis, monitored with particular care, and other appropriate steps taken to control or mitigate the risks of non-arm’s length lending.

“Exception to policy” loans should have an appropriate approval process in place and differentiated monitoring to assess performance. Approval can be obtained at an individual credit manager, credit committee, or board credit committee level depending on the amount involved. When auditing financial statements, external auditors often examine samples of those types of loans.



**Loan File Maintenance and Review Process** – Once a credit is granted, it is the responsibility of the business unit, often in conjunction with a credit administration support team, to ensure that the credit is properly maintained. This includes:

- Verifying that all required documentation for the loan file is properly retained at underwriting and approval.
- Keeping the credit file up to date.
- Obtaining current financial information.
- Sending renewal notices.
- Preparing various documents such as loan agreements.

**Credit Servicing Process** – Servicing loans can take many forms; however, collecting borrowers' payments and applying them to the contract's accounts is the main focus. For many types of loans, servicing can include:

- Paying taxes, insurance, or other fees for the borrower.
- Creating escrow accounts to hold the money until it is required.

**Collections Process** – Also known as recovery, this is a key part of credit risk management and entails a significant degree of specialization. Recovery includes activities geared toward reducing the consequences of loss events, before such events occur (arrear management or early nonpayment management), and also after such events occur (recovery of nonperforming loans, recovery of written-off loans, and management of foreclosed assets and execution of guarantees). Thus, in its preventive management phase, recovery management relates to prior monitoring processes, to anticipate the default event and with it take the most appropriate corrective measures for each situation. Collections personnel should anticipate the deterioration/arrear to establish strategies or measures to avoid nonpayment.

**Credit Risk Measurement and Monitoring Processes** – After a loan is approved and the risk is included in the portfolio, a continuous monitoring process of risks assumed is required. Financial organizations must anticipate situations in which risk levels may be increased and corrective measures and actions might have to be taken. BCBS encourages banks to “develop and utilize an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size, and complexity of a bank's activities.”<sup>11</sup>

**Asset Valuation and Loan Loss Reserves (LLR)** – The correct accounting valuation of assets for credit risks can be made by two valuation criteria:

1. Amortized cost: This is the difference between the starting amount and the repayment value at maturity, minus the impairment value reduction that would have been recognized either directly as a decrease in assets or by provisions.

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11. "Principles for the Management of Credit Risk," Basel Committee on Banking Supervision, July 1999, <https://www.bis.org/publ/bcbasc125.pdf>.



2. Fair value: This is the value by which the asset can be acquired, the market value being used as a reference, or failing that, by valuation techniques.

The purpose of the LLR is to reflect estimated credit losses within an organization's portfolio of loans and leases. Estimated credit losses are estimates of the current amount of loans with sufficiently high probability of default and the organization's inability to recover the funds given the facts and circumstances since the evaluation date. The LLR is presented on the balance sheet as a contra-asset account that reduces the amount of the loan portfolio reported on the balance sheet.



# The Role of the Internal Audit Function

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Internal auditing helps an organization accomplish its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control processes. The role of the internal audit function is to independently assess the adequacy and effectiveness of the policies, procedures, and processes applied by the organization to manage credit risk. The internal audit function provides assurance on whether management's outcomes, affected by credit risk, align with the organization's mission, strategies, and risk appetite as well as stated policies and procedures and regulatory requirements. The internal audit function also verifies the correctness of the accounting criteria and the adequacy of the LLR.

Depending on the size and structure of the organization, a global internal audit function may reside at the organization's headquarters, while internal audit teams also reside in other key locations where the organization has a presence. Local internal audit teams provide knowledge of unique local practices, regulations, and other valuable insights. The global internal audit function may assist local units by:

- Auditing new accounting policies, rules, and regulations.
- Developing **engagement work programs** for local units to cover products offered at that unit.
- Reviewing the risk universe for all locations to ensure all units are covering risks in the agreed cycle.
- Reviewing and providing comments on policies, including working with compliance, legal, and other stakeholders to obtain and integrate their feedback.
- Reviewing the credit process and helping management by identifying risks and providing comments on the control environment and controls within the credit process.
- Reviewing the internal system for rating credit risk.
- Reviewing the adequacy of the loan loss reserves provision.

In addition to the engagements listed in the internal audit plan, internal audit functions may receive board requests to review certain loan portfolios or other products and processes. The board may also request that the chief audit executive provide comments on the credit policy to assess the adequacy of loan loss amounts. Issues such as these may come from the organization's other risk management functions, such as operational risk, that may trigger the board to request additional work for the internal audit function to perform.



## Change Management

Financial services firms may be affected by change management risks in numerous ways. New products are an obvious source, but so are expansions or modifications to existing products, services, or systems offered or used by the organization. Also, marketing an existing product to a new location may result in additional or different regulatory requirements. A financial services organization may also change the underlying reference security or technical currency of an existing product, thus generating change management risks.

Most financial services organizations rely on the second line (operational risk) for oversight of product development programs, issue and progress tracking, and reporting. The operational risk function may also be in the position to provide credible challenge and escalation of issues as appropriate. Relating to change management, organizations should consider operational risks such as:

- Inadequate infrastructure to support products.
- Inadequate funding.
- Legal risks and ramifications
- Issues with people, processes, or technology.
- Inadequate training.

New products or changes to existing products may also affect the risk of fraud. The organization's second line may require new fraud monitoring processes and/or technologies to avoid losses.

For example, the introduction of instant digital loan products – where customers can apply and receive approval for loans entirely online within minutes – can increase fraud risks significantly. These products typically rely on automated identity verification and minimal manual oversight, making it easier for fraudsters to use stolen or synthetic identities to obtain funds illicitly. As organizations adopt such credit products to meet consumer demand for convenience, the second line may suggest enhancing controls around customer authentication and application screening to mitigate these risks.

Finally, the organization should have an exit strategy planned if a product fails. The potential for risk exposures beyond the normal expected losses should be considered and documented.

The internal audit function may be involved in the process of implementing new financial services products. Some organizations invite many departments from the first, second, and third lines in their product development process to offer opinions on potential risks (for example, risks within the sector, data required, and regulatory issues). At the end of this process, the internal audit function may complete an engagement work program to provide assurance to management and the board that appropriate steps were taken and accomplished according to procedures. The internal audit function would not be involved in determining the product's ultimate suitability for the organization. However, that does not mean that internal auditors cannot or should not identify additional risks not detected during the product development process.



# Planning and Performing the Engagement

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## Gather Information

The chief audit executive or a designated engagement supervisor should be involved in various meetings throughout the organization regarding strategic planning, capital planning, and other types of risk, including credit risk. Internal auditors attending these meetings should be aware of information related to credit risk. According to Standard 14.1 Gathering Information for Analyses and Evaluation, information must be relevant, reliable, and sufficient. This information will also help internal auditors identify how the organization retains credit-related risk information (Standard 9.1 Understanding Governance, Risk Management, and Control Processes).

Large global financial services organizations often have multiple business lines that are exposed to credit risks. Smaller organizations, insurance companies, and other types of financial services-related businesses may have a limited selection of credit products, but the risks associated with those products remain largely the same. Examples of major business lines organizations may engage in include, but are not limited to:

**Retail** – Is the division of the organization that deals directly with individual customers; also known as consumer banking or personal banking. Institutional branches are part of the retail organization along with other entry channels such as phone apps and internet-based banking sites.

**Wholesale** – Refers to banking services between merchant organizations and other financial organizations. Wholesale banking deals with larger clients, such as major corporations and other organizations, are in this category. Services may include currency conversion, working capital financing, inventory financing, and large trade transactions, among other types of services.

**Private Banking** – Focuses on providing personalized financial advice and management of the investment portfolios of high-net-worth individuals (HNWI). Private banking often includes loans secured by liquid items such as bonds, deposits, and investment funds.

**Small and Medium Enterprises (SME)** – Includes the funding of small and medium-sized organizations (any entity, regardless of its legal form, which carries out economic activity), and represents a major part of the business finance market in which capital for different types of firms is supplied, acquired, and priced. Credit approval is usually granted through a mix of models and underwriter judgment.

**International Lending** – Financial organizations that engage in granting credit internationally must have adequate policies and procedures for identifying, measuring, evaluating, monitoring, reporting, and controlling or mitigating country risk and transfer risk in their international lending



and investment activities on a timely basis. The monitoring of country risk factors should incorporate (i) the potential default of foreign private sector counterparties arising from country-specific economic factors and (ii) the enforceability of loan agreements and the timing and ability to realize collateral under the national legal framework.

**Syndicated Loans** – Some financial organizations participate in loan syndications or other such loan consortia. Some organizations place undue reliance on the credit risk analysis done by the lead underwriter or on external commercial loan credit ratings. All syndicate participants should perform their own due diligence, including independent credit risk analysis and review of syndicate terms prior to committing to the syndication. Each financial organization should analyze the risk and return on syndicated loans in the same manner as directly sourced loans.

Credit risk information can be gathered from any of these business lines. However, the scope of this guide is structured around loans to retail customers for clarity and simplicity.

Once internal auditors have identified the departments, functions, and roles in the organization that are relevant to managing credit risk, they should gather relevant documentation to support the preliminary risk assessment and plan the audit engagement.

The following elements can help internal auditors understand the level of credit risk the organization is willing to accept in the pursuit of its stated objectives:

- Internal audit charter, policies, **risk appetite statement**, and other mandate information for the governance entities responsible for establishing the credit risk management strategy, policies, and procedures.
- Policies and procedures regarding all phases of the credit process from granting to collections. A good place to search for this information would be personnel associated with loan review.
- Results of modeling for credit risks (PD and LGD), and results of monitoring the power of differentiation from credit risk models.
- Assessment of the sufficiency of loan loss reserves (EL and EAD) for nonperforming loans.
- Reports containing the results of stress testing various shocks to the credit portfolio.
- Evolution of capital allocation for credit risk management.

Internal auditors should also ask for related escalation protocols to understand what happens when a loan is approved outside of typical parameters or as an exception to policy.

## Risk Assessment

Credit risk assessments can be conducted top down and bottom up. A bottom-up credit risk assessment in a large organization would be performed locally with results rolled up to the corporate level. Corporate-level internal auditors may identify high-risk portfolios based on ratios (nonperforming loans, cost of credit) to assist them in evaluating the risk assessment results



passed up to them from local internal auditors, but they may take the final decision on what risks to cover. Smaller organizations may be able to conduct credit risk assessments from the top down, starting with the board’s credit risk strategy and ending with risk assessments on key products.

Depending on the size and business model of the financial services organization, sources of credit risk may be aligned with product examples as shown in Figure 4.

**Figure 4: Sources of Credit Risk**

- Loans
- Banking book
- Trading book
- Acceptances
- Banking transactions
- Trade financing
- FX transactions
- Off-balance sheet
- Financial futures
- Swaps
- Bonds
- Equities
- Options
- Extension of commitments and guarantees
- Settlement of transactions.

Source: The Institute of Internal Auditors.

Appendix D provides a list of sample credit risks.

The ultimate scope and objectives of an engagement should inform how the preliminary risk assessment is focused and performed.



## Planning the Engagement

To satisfy Standard 13.3 Engagement Objectives and Scope, some approaches the chief audit executive may consider are:

**Product Audit Engagements** – For many organizations, the largest credit risks exist in the areas of auto, mortgage, and credit cards, so planning an audit approach by product is reasonable.

**Business Line Audit Engagements** – Some internal audit functions may plan their audits around business lines, such as commercial banking, because they are able to get a broad view of the credit risk processes in the business line at a higher level than a product audit would allow. Further, procedures vary between business lines, so internal auditors should not assume two business lines are identical.

**Specific Credit Risk Audit Engagements** – If market events or the organization’s credit portfolio performance warrant a different approach, internal auditors may choose to audit a specific credit risk, such as concentration risk. Internal auditors may analyze the controls related to concentration risk in a cross-section of products and business lines.

**Credit Risk Process Audit Engagements** – The internal audit function may design an audit engagement regarding portfolio management that covers credit approval processes for a selection of products, depending on volume. Another approach is to audit loan impairment provisions, wherein internal auditors would cover retail and include the different portfolios depending on the volume and/or their risk levels. A further example is to conduct a review of nonperforming loans that could consist of examining how a local unit deals with the accounting and the portfolio valuation (marking to market).

### ***Objectivity, Competency, and Resourcing***

To accurately and completely examine credit risk in an organization, internal auditors should ensure they are objective (Principle 2 Maintain Objectivity, Standard 2.1 Individual Objectivity) and that the appropriate technical skills are employed (Principle 3 Demonstrate Competency and Principle 4 Exercise Due Professional Care). The most common way internal auditors or second-line personnel may have their objectivity impaired regarding credit risk is if they are involved with loan reviews, or the development, implementation, or validation of any relevant models.

## Audit Consideration

Financial organizations may have many entities auditing various aspects of credit risk. The internal audit function, regulators, credit risk review functions, compliance, and others may frequently request the same information.

The internal audit function should attempt to coordinate as much as possible with other entities to avoid audit fatigue.

Standard 9.5 Coordination and Reliance and the [Global Practice Guide “Coordination and Reliance: Working with Other Assurance Providers”](#) offer information and approaches to coordinating with others during an engagement.



Internal auditors' objectivity may be impaired if they are part of a team developing a new product, particularly if their duties on that team overlap from being an observer to participating in product design. If this situation occurs, the auditors involved should not be part of the audit team if their involvement occurred within the past year.

Principle 2 Maintain Objectivity, Standard 2.1 Individual Objectivity states, "Internal auditors must maintain professional objectivity when performing all aspects of internal audit services. Professional objectivity requires internal auditors to apply an impartial and unbiased mindset and make judgments based on balanced assessments of all relevant circumstances. Internal auditors must be aware of and manage potential biases."

The "Considerations for Implementation" section of Standard 2.2 Safeguarding Objectivity says a conflict of interest can create an appearance of impropriety that can undermine confidence in the auditor, the internal audit function, and the profession.

Standard 2.3 Disclosing Impairments to Objectivity states, "If objectivity is impaired in fact or appearance, the details of the impairment must be disclosed promptly to the appropriate parties. If internal auditors become aware of an impairment that may affect their objectivity, they must disclose the impairment to the chief audit executive or a designated supervisor. If the chief audit executive determines that an impairment is affecting an internal auditor's ability to perform duties objectively, the chief audit executive must discuss the impairment with the management of the activity under review, the board, and/or senior management and determine the appropriate actions to resolve the situation." This standard outlines further parameters that must be considered when assigning auditors to an assurance or advisory engagement.

Standard 13.5 Engagement Resources indicates that the chief audit executive should assess the skills of the internal auditors periodically to ensure that the internal audit function has the appropriate skills to evaluate the activity under review.

Large financial services organizations may also have a credit review function that resides within the lending unit. If so, the chief audit executive must decide whether that work can be relied upon. If the executive chooses to or is required to rely on other service providers, as noted in

## Evaluating Management's Self-Assessment Results

One large bank reports on issues identified by management or the internal audit function. When internal auditors perform the engagement, they first ask for any management self-identified issues, and they validate those under four criteria:

1. Timeliness.
2. Adequate risk assessment.
3. Reasonable action plans.
4. Issues escalated to an appropriate governance forum.

If management's self-identified issues pass these four criteria, the internal auditors credit management. The two ultimate grades given include:

1. The control rating.
2. Management action grade.

On issues and corrective actions that are accepted, internal auditors may do some testing but not complete testing. They may also seek evidence of progress on actions noted.



Standard 9.5 Coordination and Reliance, he or she should carefully consider the **competency**, objectivity, and due professional care of the other providers, as well as clearly understand the scope, objectives, and results of their work. Ultimately, the chief audit executive retains the responsibility for ensuring adequate support exists for the conclusions reached by the internal audit function, even if that includes work contributed by others.

During planning, internal auditors perform an engagement risk assessment (Standard 13.2 Engagement Risk Assessment) and document information in engagement workpapers. This information becomes part of the engagement work program, established to achieve the engagement objectives (Standard 13.6 Work Program), and is retained according to the requirements of Standard 14.6 Engagement Documentation.

The process of establishing the engagement objectives and scope (Standard 13.3 Engagement Objectives and Scope) may produce any or all of the following workpapers:

- Process maps.
- Summary of interviews.
- Preliminary risk assessment (risk and control matrix and heat map).
- Rationale for decisions regarding risks included in the engagement.
- Criteria used to evaluate the activity under review, including criteria to evaluate management’s self-assessment results (required for assurance engagements, according to Standard 13.4 Evaluation Criteria).

## Performing the Engagement

### *Evaluating Credit Risk Governance*

Generally, within credit risk life cycle processes, the greatest responsibility for credit approval and recovery is assigned to the first line, while monitoring is typically developed by the second line. However, this does not exempt the first line from carrying out process controls that allow it to correct deviations with budgets and meet the organization’s risk appetite. A comprehensive work program for credit risk should focus on both the first line and the second line as well as the higher credit risk governance committees mentioned in the “Credit Risk Governance” section of this document.

Some important considerations should be confirmed as part of Standard 13.6 Work Program:

- Credit risk committees, whose activities must be documented, will be of particular relevance to demonstrate that the second line is appropriately supervising the first line. Know your customer (KYC) rules are an important component of auditing the credit risk processes. The objective of KYC is to ensure credit is granted to a known customer who is not subject to sanctions or associated with criminal activity. The purpose of the loan must be known, and the customer, as represented in the application, must exist.
- Credit risk decisions are taken within individual and committee mandates, as prescribed by the authorities delegated to them from the organization’s highest-level body charged



with governance, such as board of directors, supervisory board, or board of governors. Those responsible for making risk decisions (individuals and committees) should be provided with relevant and updated information from any appropriate risk assessments. Material risk decisions may be subject to challenge by the second line.

- To have greater efficiency in the decision-making process, financial organizations may distribute the responsibilities from the main credit committees to an analyst. Distributing responsibility is often based on materiality, so lower-risk/amount operations can be authorized directly by salespersons or loan officers, with the support of a scoring mechanism that requires the more risk-exposed loans to be approved by higher-level committees.
- Committee structures also may vary. Depending on the size of the financial organization, it may be necessary to create different committees with varying levels of approval power. There may also be cases in which the board itself participates in the decision approval involving the highest risk.
- There should be evidence that committees are executing their oversight functions of credit policies and monitoring portfolios by effectively challenging actions taken by the first line, as appropriate. This requires them to monitor the portfolio's performance to identify deviations that may require action.
- Board members will assess if the risk committee is effectively monitoring whether strategic goals are being met within the risk appetite of the organization.
- The internal audit function should confirm the sufficiency of capital allocated for credit risk.

### ***Overall Segregation of Duties***

One key control that should be in place throughout the credit processes is segregation of duties. The client contact should be separate from the back office that determines the criteria and approval. Figure 5 illustrates the concept.

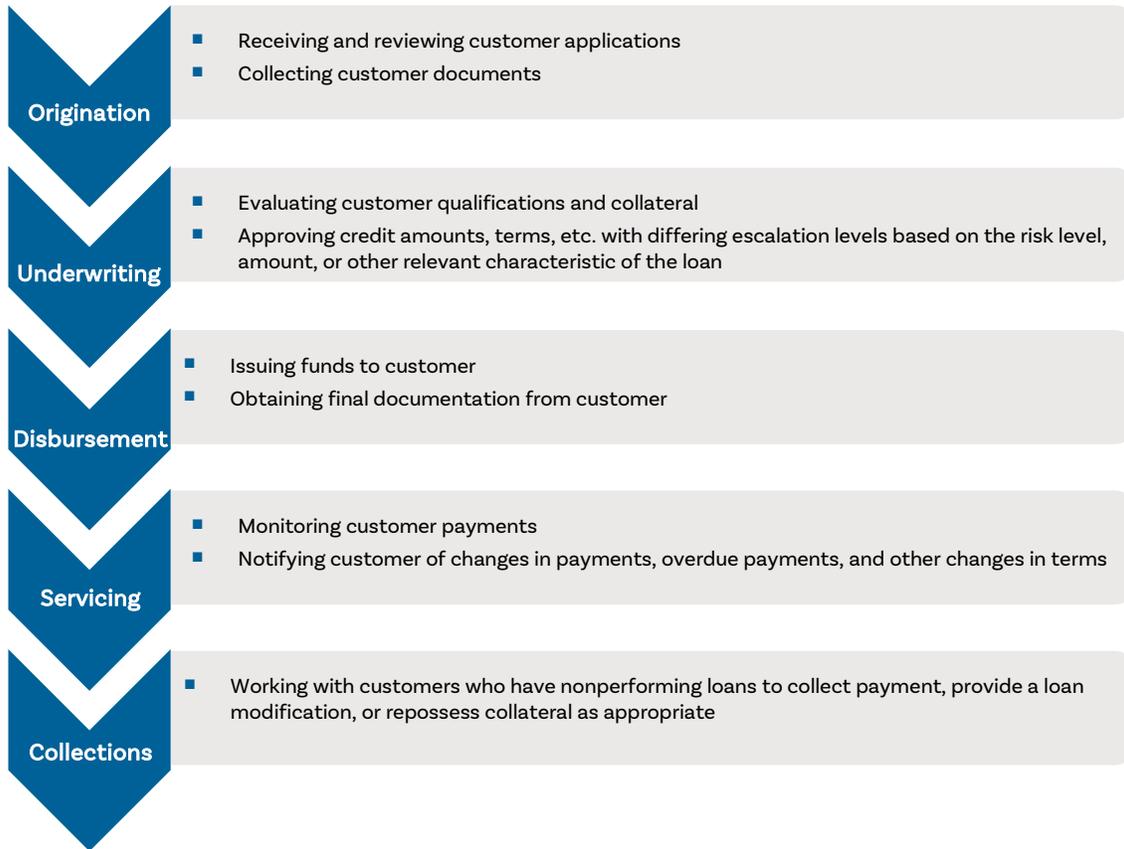
Good practices include:

- Credit officers should have approval limits on a loan-by-loan basis, and their compensation should consider not only the volume of loans but also the performance of their portfolio to encourage approval of loans to customers with the ability to pay.
- No employee should have the power to both originate and approve a loan.
- No employee from sales or credit-granting functions should know the criteria used for the credit risk modeling and auto-approval program.
- No credit manager should have the ability to approve loans of all sizes and risk levels.
- Appropriate escalation protocols should be in place to prevent an individual from exposing the organization to outsized credit risks without checks and balances. Internal auditors may want to review job descriptions of personnel in these areas to confirm they



reflect proper segregation of duties. (Standard 14.1 Gather Information for Analyses and Evaluation)

Figure 5: Segregation of Duties



Source: The Institute of Internal Auditors.

### ***Credit Granting***

In performing an internal audit engagement on the credit-granting process, internal auditors should review the underwriting criteria and scorecards the organization uses, to determine applications to pursue and what information should be passed to and requested by underwriting. In organizations that operate branches, the first check on creditworthiness lies with the loan originator, with the organization's scoring systems as a secondary check.

In digital channels, some organizations use scorecards in which borrowers are rated high risk (red), medium risk (yellow), or low risk (green). Green loans may be processed by an auto-approval program in which the applicant's creditworthiness is evaluated by an algorithm. Such loans would not reach an employee until the approval stage or even the servicing stage, given there are no issues requiring intervention.

The credit-granting process must involve the approval of loans outside of the credit policy and standards. The organization should set limits for different types of exposures, and internal auditors should verify that limits are reasonable and that portfolio performance is in line with the



organization's risk appetite. To accomplish this, internal auditors may select a sample of exceptions and walk through how they were handled, from identification to approval, to the point when the loan was disbursed and passed to servicing. Internal auditors should verify that deviations from credit policy are tracked, monitored, and reported.

Internal auditors should also review the data in the loan system and the source documents. Internal auditors may take a sample of loans and validate important figures and documents are complete, relevant, accurate, and timely, and if the PD and LGD are adequately set based on the credit risk policy. This activity should include a review of the valuation of collateral to verify the correctness of the loan-to-value (LTV) ratio. They may also sample loans, looking at the output of financial models used to make sure the results are reasonable (Standard 14.2 Analyses and Potential Engagement Findings).

### ***Loan File Maintenance and Review***

Some regulators may require a loan review function that provides senior management with an independent view of the quality with which the lending function is performing their duties. This function may reside in the second or first line. This review is to ensure business units are adhering to credit risk policies and procedures and reviewing the adequacy of the internal control environment.

However, even in this situation (and certainly if no loan review function exists), internal auditors should be doing some level of loan file review in engagements focused on credit risk. Most internal audit programs covering loan file review are straightforward with similar steps, such as:

- Reviewing any loan file review work done by the second line (this could be loan file review personnel, compliance personnel, etc.).
- Verifying the file is complete in terms of required documentation.
- Reviewing the balances, fees, payments, and other monetary changes to the loan to confirm the system is calculating these sums according to the agreed terms of the loan.
- Analyzing the portfolio profitability versus the cost of credit.
- Reviewing the risk classification or risk scorecard of the borrower and the portfolio in which the loan resides, if appropriate.
- Double-checking that provisions associated with the loan are calculated accurately.

### ***Credit Servicing***

Auditing of credit servicing, especially mortgage servicing, may be handled by departments such as customer care, accounts receivable, and the credit back office. However, if the internal audit function plans to perform testing on credit servicing, key areas to focus on include collateral registration in the systems, payment posting, and fee practices.

#### **Resource**

Information for organizations that outsource loan servicing may be found in The IIA Practice Guide [“Auditing Third-party Risk Management.”](#)



Internal auditors can approach this by reviewing a sample of servicing records from the servicer's primary system. If issues are discovered, internal auditors may review primary documentation (such as applications, statements, and copies of payment records) to determine their origin. If consumer complaints or document reviews indicate potential violations of compliance rules or regulations in these areas, auditors may consider expanding their sample to determine if the errors or rule violations are systemic or isolated to one loan type or borrower population.

### ***Credit Collections***

Many organizations may have a collections department. Internal auditors may select a sample of nonperforming loans and review the status of the accounts with the appropriate personnel. For loans listed as "repossessed," internal auditors should confirm the disposition of the collateral. Internal auditors can also assess if repossessed collateral has been inventoried, monitored, and converted into money as soon as possible while minimizing the credit loss.

As with any engagement focused on credit risk, internal auditors should obtain exception reports and note any uncollected fees, judgments, or other monies due to the organization. Any waived fees should be documented with proper approval according to the organization's policies and procedures. Uncollectible loans should be correctly listed on delinquency reports and charged off within a reasonable amount of time. Any legal procedures should also be examined to ensure the organization is following its own policies and procedures regarding litigation of bad debt. This information should be reported to management; internal auditors should check that management reporting is complete and accurate.

Revenue recognition and loan loss reserves are other areas to consider in the credit risk assessment. Many organizations use data analytics to gather samples of nonperforming loans, check provisioning, and ensure assets are allocated to the appropriate accounts and listed correctly on aging reports. The "Asset Valuation and Loan Loss Reserves" section on page 15 provides more information on asset valuation and loan loss reserves.

Financial services firms use varying criteria to categorize their loans as performing or nonperforming. According to international standards, nonperforming exposures are loans that

### **Nonperforming Exposures and Forbearance**

BCBS has developed guidelines for common definitions for the two most important terms assessed – "nonperforming exposures" and "forbearance."

The definitions are based on commonalities in existing definitions, aiming to provide clarity in terminology and guidance on quantitative and qualitative criteria for credit categorization.

In addition, the definitions help improve the identification and monitoring of nonperforming exposures and forbearance, as well as promote consistency in supervisory reporting for these two key categories of asset quality.

Source: Basel Committee on Banking Supervision.  
*Guidelines: Prudential treatment of problem assets - definitions of non-performing exposures and forbearance.*  
<https://www.bis.org/bcbs/publ/d403.pdf>



are 90 days past due, but there are different criteria (180 days) in the IRB approach for retail and public sector exposures.

Internal auditors should be aware of the nuances that can be present in loan categorization frameworks. Further, the definition of default does not cover all circumstances in which a loan may be nonperforming. The regulatory definition of default only covers cases of distressed loan restructuring in which the organization loses money (a loan may be nonperforming prior to this stage), and accounting standards for recognizing impairment may differ based on national guidance.

Forbearance is an important concept to understand because granting forbearance measures to a counterparty will not automatically move the nonperforming loan to performing status, but it can be an additional input for moving a performing loan to nonperforming status. According to BCBS, “Forbearance is a concession granted to a counterparty for reasons of financial difficulty that would not be otherwise considered by the lender. Forbearance recognition is not limited to measures that give rise to an economic loss for the lender.”<sup>12</sup> Forbearance is not the same as commercial renegotiation or refinancing. Forbearance should not be used to avoid categorizing loans as nonperforming when they meet the criteria of a nonperforming loan.

### ***Credit Risk Measurement and Monitoring Process***

According to BCBS, “The basis for an effective credit risk management process is the identification and analysis of existing and potential risks inherent in any product or activity.”<sup>13</sup> Organizations should have a thorough understanding of the risks involved with individual borrowers and how the combination of borrowers in a portfolio may be affected by risk as well.

The complexity of the work program for credit risk measurement and monitoring will depend to a degree on the size of the organization, the complexity of their lending portfolios, and the products offered. Larger organizations may have internal software that monitors credit risk, anti-money laundering, and other related activities. Internal auditors in these organizations

### **Variations According to Accounting Frameworks**

Under IFRS 9’s Appendix A, “impaired exposures” are those that are considered “credit impaired.” Under the U.S. Generally Accepted Accounting Principles (GAAP), “impaired exposures” are those exposures for which credit losses are measured under ASC Topic 326 and for which the bank has recorded a partial write-off.

Under IFRS 9, the identification of an exposure as nonperforming does not necessarily influence the impairment stage in which this exposure is allocated for accounting purposes. Under the U.S. GAAP Current Expected Credit Loss model, the identification of an exposure as nonperforming is not intended to affect the estimation of credit losses.

Source: [IFRS, “IFRS 9 Financial Instruments,”](#) accessed 17 December 2025

12. “Guidelines, Prudential treatment of problem assets – definitions of non-performing exposures and forbearance,” Basel Committee on Banking Supervision, April 2017, <https://www.bis.org/bcbs/publ/d403.pdf>.

13. “Principles for the Management of Credit Risk,” Basel Committee on Banking Supervision, July 1999, <https://www.bis.org/publ/bcbssc125.pdf>.



sometimes have access to customized software that alerts them to transactions meeting specific criteria.

Effective credit risk measurement and monitoring programs should include both quantitative and qualitative factors. Subjective measures such as collateral quality, unpaid taxes, economic changes, and scoring agencies can all affect a borrower's worthiness. Therefore, organizations should have a well-designed risk rating system to monitor the credit risk exposure in different portfolios. In very small organizations, monitoring the risk ratings of individual borrowers may be adequate. In larger organizations with complex portfolios, more detailed and sophisticated risk rating and monitoring systems may be used to monitor risk exposure per individual borrower but also capital allocation to strategies, pricing of credits, and profitability of transactions and relationships.

All these risk ratings should be compared to the organization's stated risk appetite and **risk limits**. Internal auditors should perform walkthroughs or tests to verify that limit breaches are brought to the attention of the board and/or senior management promptly and that they are resolved within the organization's stated policies and procedures.

### *Analytical Techniques/Models*

In many cases, models are used in decision-making to accelerate the processes and to ensure homogeneity in the application of defined strategies and their measurement. Consequently, the model management process includes:

- Identifying the modeling needs and the availability of correct and sufficient data for that purpose.
- The construction of these models and their validation by pertinent specialized functions.
- Continuous evaluation of the suitability of models used in applying strategies to ensure they continue to fulfill the target for which they were developed, and, if not, to activate the corresponding actions to modify and adjust them.

Some internal audit functions may lack the necessary in-house skills to effectively audit credit risk models. Chief audit executives in this situation may check to verify that all policies, procedures, and other documentation related to the models are complete and updated. They may also take a sample of loans and examine the output of the models to provide assurance that the results are reasonable. Other options include seeking external assistance from qualified third-party providers.

### Audit Consideration

For some models, local regulators may require internal auditors to test specific risk aspects to provide assurance the models comply with regulatory expectations.

### Additional Information

It is beyond the scope of this practice guide to provide detailed information on each model used in credit risk management. References are provided in Appendix E. General information on auditing models is provided in The IIA's Global Practice Guide [“Auditing Model Risk Management 2nd Edition.”](#)



Organizations using models may use a great variety of them. Regardless of the size and scope of the organization’s modeling activity, a complete and updated model inventory should guide the internal audit function. If the organization has a model validation function, internal auditors may review their activities to confirm the validators are following the approved governance protocols, policies, and procedures. Some internal audit functions may choose to replicate the model validator’s work on a subset of their monitoring activities.

In organizations with resources skilled in auditing models, their procedures are likely to rely on metrics to manage the volume of data. For example, if there is a concentration of alarms in a portfolio, internal auditors may examine the incident and re-review the model validation. Internal auditors should collaborate with the organization in these situations because there may be sound reasons for a portfolio to deviate from its usual boundaries.

## Reporting

To satisfy Standard 15.1 Final Engagement Communication, after completion of an engagement, internal auditors must develop a final communication that includes the engagement’s objectives, scope, recommendations and/or action plans if applicable, and conclusions. According to Standard 14.5 Engagement Conclusions, “Internal auditors must develop an **engagement conclusion** that summarizes the engagement results relative to the engagement objectives and management’s objectives. The engagement conclusion must summarize the internal auditors’ professional judgment about the overall significance of the aggregated engagement findings.”



# Appendix A. Relevant IIA Standards and Guidance

The following IIA resources were referenced throughout this practice guide.

## Standards

Principle 2 Maintain Objectivity

Standard 2.1 Individual Objectivity

Standard 2.2 Safeguarding Objectivity

Standard 2.3 Disclosing Impairments to Objectivity

Principle 3 Demonstrate Competency

Principle 4 Exercise Due Professional Care

Standard 9.1 Understanding Governance, Risk Management, and Control Processes

Standard 9.5 Coordination and Reliance

Standard 13.3 Engagement Objectives and Scope

Standard 13.5 Engagement Resources

Standard 13.6 Work Program

Standard 14.1 Gathering Information for Analyses and Evaluation

Standard 14.5 Engagement Conclusions

Standard 14.6 Engagement Documentation

Standard 15.1 Final Engagement Communication

## Topical Requirements, Global Guidance, and Other IIA Resources

Practice Guide “Auditing Capital Adequacy and Stress Testing for Banks, 3rd Edition,” 2025.

Practice Guide “Auditing Liquidity Risk Management for Banks, 3rd Edition” 2024.

Practice Guide “Auditing Model Risk Management,” 2018.

Practice Guide “Auditing Third-party Risk Management,” 2018.

Practice Guide “Coordination and Reliance: Working with Other Assurance Providers,” 2025.

Practice Guide “Foundations of Internal Auditing in Financial Services,” 2019.

“Third-Party Topical Requirement,” 2025.

## Other Resources

IIA Position Paper, “The IIA’s Three Lines Model: An update of the Three Lines of Defense,” 2020.



# Appendix B. Glossary

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Terms identified with an asterisk (\*) are taken from the “Glossary” of The IIA’s Global Internal Audit Standards.

**board** – Highest-level body charged with governance, such as:

- A board of directors.
- An audit committee.
- A board of governors or trustees.
- A group of elected officials or political appointees.
- Another body that has authority over the relevant governance functions.

In an organization that has more than one governing body, “board” refers to the body/bodies authorized to provide the internal audit function with the appropriate authority, role, and responsibilities.

If none of the above exist, “board” should be read as referring to the group or person that acts as the organization’s highest-level governing body. Examples include the head of the organization and senior management.

**business model**<sup>14</sup> – How an entity manages its financial assets in order to generate cash flows.

**capital adequacy** – Having sufficient capital to run an organization’s business while still absorbing the risk and volatility of its credit, market, and operational threats.

**chief audit executive\*** – The leadership role responsible for effectively managing all aspects of the internal audit function and ensuring the quality performance of internal audit services in accordance with Global Internal Audit Standards. The specific job title and/or responsibilities may vary across organizations.

**competency\*** – Knowledge, skills, and abilities.

**compliance\*** – Adherence to laws, regulations, contracts, policies, procedures, and other requirements.

**control\*** – Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved.

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14. “IFRS 9, Financial Instruments – part,” ACCA Global, August 2025, <https://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/strategic-business-reporting/technical-articles/ifrs9-pt1.html>.



**control processes\*** – The policies, procedures, and activities designed and operated to manage risks and increase the likelihood that established objectives and goals will be achieved.

**engagement\*** – A specific internal audit assignment or project that includes multiple tasks or activities.

**engagement conclusion\*** – Internal auditors’ professional judgment about engagement findings when viewed collectively. The engagement conclusion should indicate satisfactory or unsatisfactory performance designed to accomplish a specific set of related objectives. See also “assurance services” and “advisory services.”

**engagement work program\*** – A document that identifies the tasks to be performed to achieve the engagement objectives, the methodology and tools necessary, and the internal auditors assigned to perform the tasks. The work program is based on information obtained during engagement planning.

**governance\*** – The combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives.

**liquidity** – The ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses.

**risk\*** – The positive or negative effect of uncertainty on objectives.

**risk appetite\*** – The types and amount of risk that an organization is willing to accept in the pursuit of its strategies and objectives.

**risk appetite statement** – The articulation in written form of the aggregate level and types of risk that a financial organization is willing to accept, or to avoid, in order to achieve its business objectives. It includes quantitative statements as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity, and other relevant measures as appropriate. It should also address more difficult to quantify risks such as reputation and conduct risks as well as money laundering and unethical practices.<sup>15</sup>

**risk limit** – Specific quantitative measures or limits based on, for example, forward-looking assumptions that allocate the bank’s aggregate risk to business lines, legal entities as relevant, specific risk categories, concentrations, and as appropriate, other measures.<sup>16</sup>

**risk management\*** – A process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organization’s objectives.

**risk profile** – Point-in-time assessment of a bank’s gross risk exposures (before the application of any mitigants) or as appropriate, net risk exposures (after taking into account mitigants) aggregated within and across each relevant risk category based on current or forward-looking assumptions.<sup>17</sup>

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15. Robert Waters, “[Understanding Risk Appetite](#)” blog.

16. Central Bank of the United Arab Emirates (CBUAE), “[Market Risk Standards](#),” *CBUAE Rulebook*.

17. CBUAE, “[Market Risk Standards](#).”



**risk strategy** – The organization’s plan to achieve its mission and vision and apply its core values.<sup>18</sup>

**senior management\*** – The highest level of executive management of an organization that is ultimately accountable to the board for executing the organization’s strategic decisions, typically a group of persons that includes the chief executive officer or head of the organization.

**stakeholder\*** – A party with a direct or indirect interest in an organization’s activities and outcomes. Stakeholders may include the board, management, employees, customers, vendors, shareholders, regulatory agencies, financial institutions, external auditors, the public, and others.

**workpapers\*** – Documentation of the internal audit work done when planning and performing engagements. The documentation provides the supporting information for engagement findings and conclusions.

**yield** – Cash, usually expressed as a percentage, investors receive from investment instruments; may be added to the security’s principle or paid directly to the investor.<sup>19</sup>

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18. [ISO 31000:2018 Risk management -- Guidelines](#).

19. Chen, “[Yields in Finance: Formula, Types, and What It Tells You.](#)” *Investopedia*.



# Appendix C. Acronym Guide

Acronym	Expansion
ALCO	Asset/liability committee
AML	Anti-money laundering
BCBS	Basel Committee on Banking Supervision
CAE	Chief audit executive
CCF	Credit conversion factor
CCR	Counterparty credit risk
CECL	Current expected credit losses
EAD	Exposure at default
EC	Economic capital
EL	Expected loss
FASB	Financial Accounting Standards Board
F-IRB	Foundation internal ratings based
GAAP	Generally accepted accounting principles
HNWI	High net worth individuals
IIA	The Institute of Internal Auditors
IFRS	International Financial Reporting Standard
LGD	Loss given default
LLR	Loan loss reserves
LTV	Loan-to-value (ratio)
PD	Probability of default
RAS	Risk appetite statement
ROE	Return on equity
RWA	Risk weighted assets
S&P	Standard & Poor's
SA	Standardized approach
SME	Small and medium enterprise



# Appendix D. Sample Credit Risks

Risk	Description
<b>Concentration</b>	<p>The institution will incur significant credit losses stemming from a concentration of exposures to a small group of borrowers, to a set of borrowers with similar default behavior, or to highly correlated financial assets. Common subcategories of concentration risk are:</p> <ul style="list-style-type: none"><li>• Single-name concentrations (including a client or group of connected clients as defined for large exposures).</li><li>• Sectoral concentration.</li><li>• Geographical concentration.</li><li>• Product concentration.</li><li>• Collateral and guarantees concentration.</li></ul>
<b>Counterparty</b>	<p>The risk exposure that may arise from total or partial breach of the financial obligations contracted with the entity. It is a bilateral credit risk, as it may affect both parties of the transaction, and it is uncertain, since it is conditioned by the behavior of markets.</p>
<b>Country</b>	<p>The risk exposure incurred in transactions in which the debtor resides in a country other than that of the lending unit, due to circumstances other than the normal commercial risk.</p>
<b>Sovereign</b>	<p>The risk of default associated with lending to states or entities guaranteed by them, understanding that legal actions against the borrower or party ultimately obliged to pay may be ineffective on grounds of sovereignty.</p>
<b>Cross Border</b>	<p>Foreign creditors or individuals in a country are unable to repay debts due to downturns in the value of the currency or currencies in which they are denominated.</p>
<b>Collections</b>	<p>Third parties used in collections (repossession firms) misrepresent the law, the credit agreement between the institution and the borrower or the institution's policies. Illegal foreclosures.</p>

Source: Adapted from European Banking Authority, Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP), December 19, 2014.

<https://eba.europa.eu/sites/default/documents/files/documents/10180/935249/4b842c7e-3294-4947-94cd-ad7f94405d66/EBA-GL-2014-13%20%28Guidelines%20on%20SREP%20methodologies%20and%20processes%29.pdf>



# Appendix E. References, Additional Reading, Permissions

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## Permissions

Figure 2: Overview of the Impairment Requirements was sourced from IFRS 9 Financial Instruments, July 2014, p 16-17. <https://www.ifrs.org/-/media/project/fi-impairment/ifrs-standard/published-documents/project-summary-july-2014.pdf>.

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