



## **Independent Bank, Ionia, MI**

# **Single-Family Housing Mortgage Insurance Program**



Issue Date: September 17, 2013

Audit Report Number: 2013-CH-1007

TO: Charles S. Coulter, Deputy Assistant Secretary for Single Family Housing, HU

FROM: *Kelly Anderson*  
Kelly Anderson, Regional Inspector General for Audit, 5AGA

SUBJECT: Independent Bank, Ionia, MI, Generally Complied With HUD's Quality Control and Underwriting Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final report of our audit of Independent Bank's quality control and underwriting of Federal Housing Administration-insured loans.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 312-353-7832.



September 17, 2013

## Independent Bank, Ionia, MI, Generally Complied With HUD's Quality Control and Underwriting Requirements

# Highlights

Audit Report 2013-CH-1007

### What We Audited and Why

We audited Independent Bank, a Federal Housing Administration (FHA) supervised direct endorsement lender. We selected Independent Bank for review based on its overall compare ratio of nearly 200 percent for loans originated in our jurisdiction<sup>1</sup> for a 2-year FHA performance period.<sup>2</sup> The audit was part of the activities in our fiscal year 2013 audit plan. Our audit objectives were to determine whether (1) Independent Bank's quality control plan, as implemented, met HUD's requirements and (2) Independent Bank complied with HUD's regulations, procedures, and instructions in the underwriting of FHA-insured loans.

### What We Recommend

This report does not contain recommendations; therefore, no action is needed.

### What We Found

Independent Bank's quality control plan, as implemented, generally complied with HUD's requirements. Further, Independent Bank generally complied with HUD's regulations, procedures, and instructions for underwriting FHA-insured loans with the exception of 1 of the 11 loans reviewed. Specifically, it did not ensure that the borrowers' payoff statements were maintained in the FHA case binder and provided to the servicer upon transfer or sale of servicing. Independent Bank was later able to obtain the payoff statements from the settlement agent, and we determined that the loan did not contain material underwriting deficiencies.

<sup>1</sup> For Michigan only. The lender did not originate loans in Illinois, Indiana, Ohio, Minnesota, and Wisconsin during the selected performance period.

<sup>2</sup> Period ending November 30, 2012

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## BACKGROUND AND OBJECTIVES

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The National Housing Act, as amended, established the Federal Housing Administration (FHA), an organizational unit within the U.S. Department of Housing and Urban Development (HUD). FHA provides insurance to private lenders against loss on buyers financing homes. The basic home mortgage insurance program is authorized under Title II, section 203(b), of the National Housing Act and governed by regulations in 24 CFR (Code of Federal Regulations) Part 203. In 1983, HUD implemented the direct endorsement program, which authorizes approved lenders to underwrite FHA loans without HUD's prior review and approval.

Independent Bank, founded as the First National Bank of Ionia in 1864, received approval as an FHA lender on June 2, 1952. In 1973, HUD approved Independent Bank as an FHA-approved supervised direct endorsement lender. On March 11, 1993, Independent Bank became an unconditional direct endorsement lender, which also originates U.S. Department of Veterans Affairs, conventional, and construction loans. Independent Bank also provides financial services, such as retail and commercial banking, investment, and title services.

As an unconditional direct endorsement lender, Independent Bank determines that a proposed mortgage loan is eligible for insurance under applicable programs' regulations and submits the required documents to HUD without its prior review of the origination and closing of the loan. Independent Bank is responsible for complying with all applicable HUD regulations and handbook instructions regarding the late endorsement and underwriting of FHA loans.

According to HUD's Neighborhood Watch Early Warning System,<sup>3</sup> as of January 30, 2013, Independent Bank had originated 1,601 FHA-insured loans with beginning amortization dates between December 1, 2010, and November 30, 2012. Of the 1,601 loans, 27 were seriously delinquent or had claim insurance status. In addition, Independent Bank had a compare ratio<sup>4</sup> of nearly 200 percent for loans originated in the State of Michigan for the 2-year performance period of December 1, 2010, through November 30, 2012.

Our audit objectives were to determine whether (1) Independent Bank's quality control plan, as implemented, met HUD's requirements and (2) Independent Bank complied with HUD's regulations, procedures, and instructions in the underwriting of FHA-insured loans.

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<sup>3</sup> Neighborhood Watch refers to a Web-based software application that displays loan performance data for lenders and appraisers using FHA-insured single-family loan information. The system is designed to highlight exceptions so that potential problems are readily identifiable.

<sup>4</sup> Compare ratio is the value that reveals the largest discrepancies between the subject's default percentage and the default percentage to which it is being compared. The percentages being compared are the percentages of originations that first defaulted during a selected period.

## RESULTS OF AUDIT

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### Finding: Independent Bank Generally Complied With HUD's Quality Control and Underwriting Requirements

Independent Bank's quality control plan, as implemented, generally complied with HUD's requirements. Further, Independent Bank generally complied with HUD's regulations, procedures, and instructions for underwriting the FHA-insured loans reviewed with the exception of 1 of the 11 loans reviewed. Specifically, it did not ensure that the borrowers' payoff statements were maintained in the FHA case binder and provided to the servicer upon transfer or sale of servicing. This condition occurred because Independent Bank needed to improve its procedures and controls to ensure compliance with HUD's requirements. It was later able to obtain the payoff statements from the settlement agent, and we determined that the loan did not contain material underwriting deficiencies.

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#### **Independent Bank Generally Complied With HUD's Requirements**

Independent Bank's quality control plan, as implemented, generally complied with HUD's requirements. Further, Independent Bank generally complied with HUD's regulations, procedures, and instructions for underwriting FHA-insured loans with the exception of 1 of the 11 loans reviewed.

#### **Independent Bank Did Not Ensure That Borrowers' Payoff Statements Were Maintained**

The borrowers' loan payoff statements for FHA case number 262-1705986 were not in the FHA case binder or included in the servicer's file. Further, Independent Bank did not maintain a copy of the loan origination file due to its file retention policy. HUD Handbook 4155.1, REV-5, section 3-1, states that the application package for FHA insurance must contain all documentation that supports the lender's decision to approve the mortgage loan. Further, HUD Handbook 4000.2, REV-3 paragraph 5-8.B, states that upon sale or transfer of servicing, the entire origination file must accompany the transfer.

This condition occurred because Independent Bank needed to improve its procedures and controls to ensure compliance with HUD's requirements. However, this loan closed in 2008, and Independent Bank's current procedures for FHA loans require that payoff letters be included in the binder for refinance loans. As a result of our audit, Independent Bank contacted the settlement agent

to obtain the payoff statements, and we determined that the loan did not contain material underwriting deficiencies.

## **Recommendations**

This report does not contain recommendations; therefore, no action is needed.

## SCOPE AND METHODOLOGY

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We performed our audit work from February through June 2013 at Independent Bank's main office in Ionia, MI, its branch office in Grand Rapids, MI, and our offices located in Chicago, IL, and Detroit, MI. The audit covered the period January 1, 2010, through December 31, 2012, and was adjusted as necessary.

To accomplish our objectives, we reviewed applicable HUD handbooks, regulations, mortgagee letters, and other reports and policies related to the FHA mortgage insurance programs. Further, we reviewed Independent Bank's loan origination and closing files, quality control plan, and quality control documentation. We also reviewed the organization charts, a list of fees, and financial audits for prior years' information. We interviewed Independent Bank's employees.

### Underwriting Review

Using HUD's data maintained in its Single Family Data Warehouse system,<sup>5</sup> we determined that HUD paid claims on 61 loans during the period January 1, 2010, to December 31, 2012, that were originated or sponsored by Independent Bank. These 61 loans closed between September 28, 2007, and February 28, 2011. Of the 61 loans, 34 went into default within the first 12 payments after the loans closed. HUD's Quality Assurance Division selected and reviewed three of the loans, and a postendorsement technical review was completed for one loan. Therefore, we reduced our claims sample to 30. We judgmentally selected 7 of the 30 loans to review for compliance with HUD's underwriting requirements.

Using HUD's data maintained in the Single Family Data Warehouse system, we also determined that 2,465 loans were originated or sponsored by Independent Bank during the period January 1, 2010, to December 31, 2012. Of the 2,465 loans, we excluded 19 home equity conversion mortgage loans and 134 loans that were no longer FHA insured. For the remaining 2,312 loans ((2,465-19)-134), we identified 282 loans that defaulted during our audit period. Of the 282 defaulted loans, the borrowers for 40 loans defaulted on their loans within the first 6 mortgage payments. For the 40 loans, we determined that (1) 3 were included in our sample of loans that went to claim, (2) 2 were under indemnification agreements with HUD, (3) 19 were subjected to a postendorsement technical review, and (4) 2 were reviewed by HUD's Quality Assurance Division. These adjustments reduced our default sample of 40 loans to 14 (40-3-2-19-2). We judgmentally selected 4 of the 14 loans to review for compliance with HUD's underwriting requirements.

In summary, we reviewed 7 loans where HUD paid claims during the audit period and 4 loans that were originated and sponsored by Independent Bank that went into default during the audit period. The conclusion in this audit report is limited to the 11 (7 + 4) loans reviewed. We did

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<sup>5</sup> HUD's Single Family Data Warehouse is a collection of database tables structured to provide HUD users easy and efficient access to single-family housing case-level data on properties and associated loans, insurance, claims, defaults, and demographics.



not conclude on Independent Bank's compliance with HUD's underwriting requirements on its entire portfolio of originated and sponsored FHA-insured loans.

### Quality Control Review

For our review of Independent Bank's quality control program, we obtained Independent Bank's quality control review reports that were completed during our audit period of January 1, 2010, to December 31, 2012. We performed analyses to determine whether Independent Bank complied with HUD regulations for quality control reviews of the following: early payment defaults, frequency of reviews, timeliness of routine quality control reviews, and exception or deficiency follow-up. We identified minor deficiencies in its process that were not included in this report. However, the deficiencies were discussed with Independent Bank during the audit.

We relied on information maintained in HUD's Neighborhood Watch and Single Family Data Warehouse Systems for informational and sampling purposes only. We also relied on data maintained in Independent Bank's system, such as electronic loan files. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes. The testing consisted of comparing data in the electronic files to the FHA case binders. The audit results were based on our review of electronic and supporting hardcopy documentation maintained by Independent Bank.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# INTERNAL CONTROLS

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Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

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## Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objectives:

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Reliability of financial reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

## Significant Deficiencies

We evaluated internal controls related to the audit objectives in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance regarding the effectiveness of the internal control structure as a whole. Accordingly, we do not express an opinion on the effectiveness of Independent Bank's internal controls.

# APPENDIXES

## Appendix A

### AUDITEE COMMENTS AND OIG'S EVALUATION

#### Ref to OIG Evaluation

#### Auditee Comments



**Independent Bank**  
*Soaring above the rest*

August 08, 2013

Anthony Smith, Assistant Regional Inspector General for Audit  
U.S. Department of Housing and Urban Development  
Office of Inspector General  
477 Michigan Ave., Room 1780  
Patrick McNamara Federal Bldg.  
Detroit, MI 48226-2592

Dear Mr. Smith:

We would first like to express our appreciation to the Office of Inspector General for the comprehensive review that was completed of our FHA underwriting and quality control plan. This letter is in response to the findings contained in the OIG Exit Conference presentation dated August 6, 2013. The findings state:

IA. Provide sufficient documentation to show that the loan was current at the time the loan closed or reimburse HUD \$79,581 for the loss incurred on the sale of the associated property.

IB. Implement adequate procedures and controls to ensure that documentation supporting underwriting decisions is maintained.

#### **Comment 1**

**IB Response:** I have attached payoff statements from Countrywide Home Loans dated January 16, 2008 and the cover letters from Able Title that accompanied the payoff remittances. The payoff statements show the following:

- a. First Mortgage: The payoff calculation shows Principal Balance as of January 1, 2008 with interest payable from 01-01-08 through 01-31-08.
- b. Second Mortgage: The payoff calculation shows Principal Balance as of January 1, 2008 with interest payable from 01-01-08 through 01-31-08.

**Ref to OIG Evaluation**

**Auditee Comments**

IB closed the FHA refinance loan on January 25, 2008. The payoff statements document that the borrower was current through January 1, 2008 at the time of closing.

**Comment 2**

Independent Bank procedures require that all files must contain evidence that the borrower was current at time of refinance. I have reviewed our current FHA case binder stacking list and confirmed that the case binder list requires payoff letters to be in the binder for refinance loans.

August 8, 2013  
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We respectfully request that you accept this letter and the attached documentation to clear the audit findings. If additional information or documentation is necessary please contact me at 616-522-1754 or [dcampbel @ibcp.com](mailto:dcampbel@ibcp.com). Thank you.

Sincerely,



Deborah Campbell  
Vice President  
Independent Bank  
230 West Main Street  
Ionia, MI 48846

### **OIG Evaluation of Auditee Comments**

- Comment 1** We reviewed the loan's payoff statements for the borrowers' previous first and second mortgages and revised the audit report accordingly.
- Comment 2** We commend Independent Bank for reviewing its procedures to ensure (1) the requirement for all files to contain evidence that the loan was current at the time of refinance and (2) that its current FHA case binders' stacking list requires payoff letters to be included in the binder for refinance loans. This requirement should mitigate future documentation deficiencies in regard to payoff statements.