August 26, 2024

Julia Gordon, FHA Commissioner
Office of Housing / Federal Housing Administration
US Department of Housing and Urban Development
451 7th Street S.W.
Washington, DC 20410

Re: Draft Single Family Housing Policy Handbook 4000.1, Appendix 8.0 – FHA Defect Taxonomy for Serving Loan Reviews – 2024 Update

Dear Ms. Gordon,

The Housing Policy Council (HPC)[1] appreciates the opportunity to submit comments on the Draft Single Family Housing Policy Handbook 4000.1, Appendix 8.0 – FHA Defect Taxonomy for Servicing Loan Reviews– 2024 Update (Servicing Defect Taxonomy). We agree with the intent of a Servicing Defect Taxonomy – to improve the consistency and predictability of interpretation and enforcement of the FHA servicing rules. As previously discussed, we believe that uniformly applied rules will reduce FHA servicing costs, which may encourage retention of existing and participation of new lenders and servicers in the FHA program.

We also commend FHA for utilizing its Drafting Table to receive feedback on the Servicing Defect Taxonomy. This is a best practice that contributes meaningfully to more effective policy making.

After careful review, we are concerned that the proposed Servicing Defect Taxonomy will not achieve FHA's key goals without additional clarification and revision. Specifically, we continue to believe that a Servicing Defect Taxonomy that presents clear and unambiguous guidance will best achieve FHA's goals of providing the certainty required to promote full engagement in the FHA Program.

This letter outlines our most significant feedback with FHA's most recent draft of the Servicing Defect Taxonomy:

1. The "Purpose" section of the Defect Taxonomy should more explicitly reflect FHA's intent for the document by leveraging language that FHA has publicly used elsewhere to describe it.
2. Materiality is a key component of how the Taxonomy functions. The Taxonomy fails to commit to a definition of materiality, stating only that it "generally aligns" with how HUD has defined that term. The Taxonomy cannot fulfill its stated function of providing clarity and transparency if such an integral component is left open to subjective interpretation.

[1] The Housing Policy Council is a trade association comprised of the leading national mortgage lenders and servicers; mortgage, hazard, and title insurers; and technology and data companies. Our interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promotion of lending practices that create sustainable homeownership opportunities in support of vibrant communities and long-term wealth-building for families. For more information, visit www.housingpolicycouncil.org.

3. Indemnification is not an appropriate general remedy for servicing errors. At a minimum, indemnification should not be triggered without a causal connection between the servicing error and a future loss event.

We also attach our "Feedback Response Worksheet" submission, which includes our comprehensive and detailed input on the entirety of the Draft Mortgagee Letter.

1. *"Purpose" of the Defect Taxonomy*

The 54 words that currently describe what the purpose of the defect taxonomy is, rather than what it is not, are far less direct than the July 10th press release announcing the proposed policy change. We recommend that some of the language from that press release be used in the purpose section of the actual taxonomy.[2] Specifically, we would like to see the following text from the press release incorporated: "The Servicing Defect Taxonomy is intended to provide clear guidance to mortgage servicers regarding FHA's servicing loan review process, FHA's assessment of the severity of errors or non-compliance with its mortgage servicing policies, and the actions FHA may take in instances of servicer error or non-compliance." Additionally, we believe the purpose section should reiterate Acting Secretary Todman's statement from the press release directly, that the goal of FHA is to provide "clarity and transparency to [mortgagees]" or "clarity and certainty for mortgage servicers".

These additions would establish useful context for stakeholders and serve as a barometer for future assessment of the Servicing Defect Taxonomy, and whether it is achieving its purpose.

2. The Defect Taxonomy Must Clearly Define Materiality

It is reasonable and appropriate for FHA to identify a defect as an error or omission that imposes an "adverse impact" on FHA, a property, or a borrower, but we believe this standard must be accompanied by a materiality threshold. For example, a $1 servicing error may have an adverse impact on FHA but is otherwise immaterial. In fact, when a servicer refunds $1 to HUD after identification of an error, the administrative costs of processing the refund to both the servicer and HUD certainly exceed the amount of the error/refund itself. As a result, immaterial infractions have material consequences. Having a materiality threshold creates consistency in identifying loan level defects and in balancing the risk management and quality assurance processes.

Similarly, we support the concept behind severity tiers. However, we ask that HUD be explicit and unambiguous in stating exactly how the taxonomy will work and emphasize that it will be consistently applied. For example, for Severity Tier 1 and 2, the proposal presents that the Taxonomy only "*generally* align[s] with the definition of Material Finding" in the HUD Handbook. We don't understand what this means and are puzzled that identification of errors would not align *precisely* rather than generally with the Handbook definition. This raises real questions for stakeholders. As written, the definition is ambiguous and fails to provide clarity or transparency. We believe that a simple edit could be made to clarify that a Tier 1 and/or Tier 2 defect occurs when there is a Material Finding, as defined in the HUD Handbook.

[2] See HUD Press Release "HUD Releases Revised Servicing Defect Taxonomy for Stakeholder Feedback" on July 10, 2024.

Additionally, we are deeply concerned with the broad description of what constitutes a Tier 2 violation, which will "require corrective servicing action, financial remediation, and/or other remedy." Without a materiality threshold, this description is incredibly vague and does not provide a servicer with certainty about when a defect will in fact be a Tier 2 violation and whether the defect will result in the significant penalties associated with that determination. Regrettably, the absence of an unequivocal definition gives HUD complete discretion to identify virtually any defect to be a Tier 2 violation, which defeats the purpose of the taxonomy. The vague definition will also generate inconsistent identification of defects and imposition of penalties across the Homeownership Centers as well as between FHA and the Office of Inspector General, which will very likely contribute to disparate treatment of servicers.

Lastly, the definition of a Tier 3 violation covering "certain violations of HUD policy where FHA can determine compliance with federal and/or state laws and regulations that govern servicing generally" and other references to that language should be clarified in the taxonomy. It is currently unclear whether this is related to preemption of state laws, and an example of the applicability of this section would be helpful.

3. Indemnifications as Penalties

As we have mentioned in previous communications on the servicing defect taxonomy,[3] indemnification is not an appropriate general remedy for servicing errors. Unlike origination defects that could render a loan uninsurable or higher-risk than is acceptable, the loan servicing function is unlikely to affect the risk profile or performance of the loan. As a result, it is difficult to justify an approach where the servicer will accept losses on a loan (as prescribed in the indemnification agreement) for a servicing violation that is not directly tied to the actual cause of the losses. Absent any connection between the defect and the losses (associated with some possible future loss event covered by the indemnification agreement) this policy is a troubling departure from the FHA Origination Taxonomy and the Fannie Mae and Freddie Mac servicing representation and warranty framework. Said differently, this proposal doesn't require a causal link between a future loss event and the servicing error in question, and with a loan program that regularly experiences a 10% default rate, this remedy will be disproportionate to the severity of the defect.

Further, as we have stated previously, we question the premise and legal foundation for the FHA determination that the primary remedy of this taxonomy be indemnification. HUD regulations expressly state that failure to comply with servicing requirements set forth in Subpart C, "Servicing Regulations" (which can be found at 24 C.F.R. §§ 203.500 through 203.681) "shall not be a basis for denial of insurance benefits." Requiring indemnification for a violation of the requirements of Subpart C would be functionally equivalent to denying insurance benefits, despite the express contradiction therein. Instead, indemnification is only appropriate where a loan is no longer eligible for FHA insurance, as is the case with the FHA Originations Taxonomy.[4]

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[3] See joint trade letter to FHA on January 28, 2022; also see HPC letter to FHA on May 12, 2022.

[4] See 24 C.F.R. §203.500. The section of the NHA governing the payment of insurance expressly states that "insurance benefits shall be paid ... and shall be equal to the original principal obligation of the mortgage (with such additions and deductions as the secretary determines are appropriate)." (12 U.S.C. § 1710(a)(5)). The NHA also requires that "[a]t least one of the procedures for payment of insurance benefits specified in [sections of the statute governing claim payment upon assignment of the mortgage or conveyance of title to property] shall be available to a mortgagee with respect to a mortgage." (12 U.S.C. § 1710(a)(3)). This language is not permissive, but rather requires that claims must be paid and evidences Congress' intent to provide for the payment of FHA insurance benefits in at least the amount of the unpaid

While we believe the use of indemnification is inappropriate and legally questionable, should HUD preserve loan indemnification as a primary servicing remedy in the taxonomy, the term of the indemnification should start at the date of the error rather than the arbitrary and irrelevant date of when FHA and the servicer sign the agreement (which we acknowledge would generally shorten the indemnification period). This would at least bring some proportionality between the error and the length of the punishment.

Conclusion

As expressed previously, we share FHA's objectives for the Servicing Defect Taxonomy, to enhance FHA's oversight of servicing with a set of transparent rules that will be consistently applied and enforced. With such a framework, servicers will be in a position to calibrate their quality control practices to align with FHA's standards, to minimize servicing defects and to quickly address any errors identified by FHA. Unfortunately, we are not confident that this proposal achieves this objective and urge that FHA address the issues addressed in the attached worksheet.

Thank you for the opportunity to comment on the proposed changes to the Handbook. Should you or your staff have questions or wish to discuss this issue further, please contact Matt Douglas at matt.douglas@housingpolicycouncil.org.

Yours truly,

Edward J. DeMarco
President
Housing Policy Council

principal balance of the loan. While the provisions provide HUD with discretion as to additional amounts that may be included in the claim, the NHA requires payment of a claim. Finally, the NHA includes an incontestability clause, which states that any insurance contract executed by the Secretary "shall be conclusive evidence of the eligibility of the loan or mortgage for insurance, and the validity of any contract of insurance so executed shall be incontestable … except for fraud or misrepresentation." (12 U.S.C. § 1709(e)). Attempting to impose indemnification for failure to meet FHA servicing requirements would terminate, and thus in effect invalidate, an FHA insurance contract for a reason other than fraud or misrepresentation, an action that is not authorized by the incontestability clause.

FHA Single Family Housing Policy Feedback

Draft Handbook 4000.1 Appendix 8.0 FHA defect Taxonomy for Servicing Loan Reviews

Instructions

1. **Provide only one set of comments per company.**
2. **Complete identifying information below.**
3. **If you have a general comment, state "Other" on the page number and provide as much specificity as possible.**

FHA ID Number:	
FHA Relationship:	
Other Relationship:	
Contact Name:	Matthew Douglas
Company Name:	Housing Policy Council
Contact Phone Number:	202-589-1924
Contact Email address:	matt.douglas@housingpolicycouncil.org
	FEEDBACK IS DUE ON MONDAY AUGUST 26TH

Feedback Number	Page Number	Line Number	FeedbackD16
1	1	3	We believe that the purpose section of the document isn't as clear as it should be. To address this, we would recommend that some of the language from HUD's July 10th press release announcing this policy be used in the purpose section of the actual taxonomy. Specifically, we would like to see the following section of the press release incorporated into the purpose section of the policy: "The Servicing Defect Taxonomy is intended to provide clear guidance to mortgage servicers regarding FHA's servicing loan review process, FHA's assessment of the severity of errors or non-compliance with its mortgage servicing policies, and the actions FHA may take in instances of servicer error or non-compliance." Additionally, we think the purpose section should include a goal of providing "clarity and transparency to [mortgagees]" or "clarity and certainty for mortgage servicers" just like Acting Secretary Todman said in the press release. These additions would provide useful context for future stakeholders and serve as a useful barometer in the future for determining whether the Servicing Defect Taxonomy is achieving its purpose.
2	1	21	The taxonomy would be more effective if it could be used by mortgagees to self-report and fix identified defects and harms. However, as currently written servicers can't rely on this for self-identified/self reported issues (based on the two sentences at the end of the purpose section). We think that this is a mistake.
3	2	37	We are concerned that severity tiers 1 and 2 only "generally align" with the definition of Material Finding in the FHA Handbook. We think the better and clearer policy is to remove the phrase "generally" so that the definition is clear to all parties.
4	2	37	We are concerned that alignment with the Handbook definition does not actually say that a Tier 1 or Tier 2 violation must be a material finding. We believe this should be clear that Tier 1 and 2 violations are material findings.
5	2	37	In the context of mortgage servicing, a finding should only be "material" if it has an adverse impact on the property and/or FHA. More specifically, the concept of "adverse impact" needs to have a materiality threshold. A $1 mistake is an adverse impact to FHA but is otherwise immaterial. As a result, immaterial infractions have material consequences. Without this type of materiality threshold, we are simply left to "hope that HUD will be reasonable" which largely defeats the purpose of the taxonomy.
6	2		We are concerned with the description of what constitutes a Tier 2 violation. Specifically, the description is so vague as to be unhelpful. It gives HUD complete discretion to put virtually anything into a Tier 2 violation. This does the opposite of creating consistency between HOC's and between servicers.

7	2	44	We support the policy concept that Tier 3 and 4 Findings do not require a Mortgagee response. However, our members experiences are that FHA does not respond to rebuttals provided by servicers on Tier 3 and Tier 4 findings. In the event that a servicer disagrees with a lower tiered finding and FHA concurs after reviewing the documentation, the finding should be sufficiently removed from the LRS history or at least acknowledged by FHA that an error was not made.
8	2	47-48	With the Tier 3 description, we do not understandwhat is meant by "certain violations of HUD policy where FHA can determine compliance with federal and/or state laws and regulations that govern servicing generally." Without examples, which have largely been removed from this document, this clause just introduces confusion. If this is getting at state or federal preemption-please say that!
9	2	53	We support that mortgagees may rebut any Finding by responding in LRS with supporting information.
10	2	53	This sentence on the rebuttal process could use more details. One potential solution would be to cross-reference existing LRS guidance which provides significantly more details.
11	2	53	FHA should clarify when it is appropriate for a mortgagee to attempt to rebut a finding. Is it limited to only situations when the mortgagee believes that FHA has identified a defect that should not be a finding?
12	3	55	We would recommend that the Remedies section clearly state that it includes a description of all remedies available as part of the process. The document goes out of its way to say what it isn't, but never clearly states what it is.
13	3	59-60	We support that the "purpose of remedies is to mitigate risk to FHA and, if applicable, put Borrowers and/or other affected parties in the position they would have been in absent the violation."
14	3	62	The phrase "alternatives to indemnification may be available in LRS for Tier 2 Findings," coming right after a description of "life of loan indemnification" makes a reasonable reader think that life of loan indemnification is a standard remedy for a Tier 2 violation. We think that is inappropriate and out of proportion with a Tier 2 finding. We also don't believe that is consistent with current HUD practice.
15	3	66	We support the clarity brought by the "mitigation" section.
16	3	72	We support the "financial remediation" section.
17	3	70-71	FHA should clarify when "mitigation" is an appropriate remedy. For example, we think mitigation would be an appropriate remedy when there is a credit reporting issue that can be corrected by the mortgagee.
18	4	87-90	We support the inclusion of the 1-year and 5-year remedies being added to the servicing defect taxonomy.
19	4	88-89	We don't support the term of a servicing indemnification running from the date the agreement is signed by both the Servicer and FHA, but rather should start the date the error was made
20	4	87-90	We believe that 1 year and 5-year indemnification agreements should be limited to a determination that the servicing violation was closely related to the financial harm that FHA would suffer.
21	4	91	The definition for when a 5-year indemnification agreement is allowed is helpful.
22	4	87-90	For the FHA program, we believe that the distinction and monetary difference between a 5-year indemnification and life of loan indemnification is small (the vast majority of FHA loans default withing five years of origination), but the difference between 1 and 5 years is great, and yet the categories don't seem to recognize this.
23	8	121	We recommend changing the labels on the defect area charts to be more descriptive. Instead of "unacceptable" or "deficient" it should read "unacceptable findings" or "deficient findings."
24	8	121	The first bullet in defect Area 1 "FHA is unable to determine compliance because mortgage documents or servicing records were not obtained through servicing transfer and/or retained in the servicing file" is a very broad example of a finding (meaning it is not particularly helpful example to include). Additionally, this finding seems quite harsh to label this a Tier 2 and is much more consistent with a deficient finding.
25	8	121	The second bullet in defect Area 1 "Failure to report servicing transfer or Mortgage Sale to FHA as required " is clear, but inappropriate to label this simple error that is easily correctable (without causing harm to FHA or the borrowers) as a Tier 2 violation and is much more consistent with a Tier 3 "deficient finding" definition.

26	9	124	Under the 4th bullet in Tier 2 "1-Year indemnification is used for general servicing violations that cannot otherwise be addressed with mitigating documentation or corrective action at the loan level," we are concerned with this broad catch-all as an example remedy as it doesn't seem to account for or acknowledge individual facts/circumstances. It is just too harsh a remedy to be appropriate for a catch-all category. It also implies this will be how every situation like this is handled, which could introduce inconsistencies from HOC to HOC (if some retain the current practice where this remedy wouldn't be applied in situations like this).
27	11	132	In tier 3 of the deficient findings section, the phrase "with all applicable laws and rules that govern the servicing activity generally" introduces confusion. If this is about state law preemption (which is what we suspect), then why not specify that?
28	11	134	The first part of the first bullet in Tier 2/Forward "Full payments were not applied in the correct order" is clear, but inappropriate to label this simple error that, for full payments, cause no harm to FHA or the borrowers. Rather, a full payment - by it's nature - satisfies all required elements of a monthly payment and the order in which it is applied is of no consequence. As a result, it is not appropriately classified as a Tier 2 violation and is much more consistent with a Tier 3 "deficient finding" definition.
29	12	135	This section is clear and we understand what the appropriate remedies should be. No recommended changes.
30	14	144	In the first bullet on tier 2 findings, we are unclear where the handbook requires reporting of the "Delinquent Mortgage to the credit bureaus." This goes beyond the FCRA's dictate that we accurately report and seemingly implies an obligation to report, although one does not exist within the FCRA. This should be clearer or eliminated as an example.
31	14	144	The bullet requiring "escrow funds were not disbursed on a timely basis and fees/penalties were improperly deducted from the Borrower's escrow account or otherwise charged to the Borrower as a result" seems duplicative of an example in Defect Area 3 on page 14. If they are supposed to be different examples, the language needs to be clearer to distinguish them.
32	15	147	We believe that the 4th remedy under Tier 2 is too harsh (life of loan indemnification for property related violations). We believe that this finding is an example of potential mortgagee neglect. There are many things that FHA can due in this situation-well short of life of loan indemnification. A fairer opportunity would be giving the mortgagee the ability to make adjustments/repair the property, which should allow servicer to remediate, and/or a lesser indemnification. Lastly, it seems like the 4th bullet point is unnecessary in light of the 3rd one.
33	17	155	For the first finding "loss mitigation review activities were not conducted within HUD-specified time frames", we are unclear what this is referring to. Is this referring to the requirements that you must review by day 90 or must complete within 120 days requirements? We are unclear what policy violation this example is getting at? Does this apply to both/can this be more specific?
34	17	155	In defect area 4, we are unclear about the inclusion of the example of when a "loss mitigation was not processed in accordance with specific FHA requirements, but information in the servicing file supports compliance with all applicable laws and rules that govern the servicing activity generally." If this is about state law preemption (which is what we suspect), then why not specify that?
35	17	155	In defect area 4, we support the inclusion of the example of where "Loss mitigation notifications do not include all required elements". This makes sense when there is no borrower harm.
36	17	155	For the fifth example of a finding "borrower's reason for default, eligibility, credit report, and verbal or financial information was improperly documented ", we think this seems too harsh for Tier 2, a mistake like this should be a tier 3 issue that it is deficient (especially in light of the widespread use of streamline options).
37	18	158	For the 2nd remedy under Tier 2 "FHA will accept a 1-Year indemnification only when the Borrower does not accept the terms of the correct Loss Mitigation Option" there should be an example of an alternative remedy, as almost always this type of loan will be re-pooled into a new Ginnie security when it is not delinquent and is ineligible for most types of loss mitigation (it can't be bought out of a pool if current). This remedy doesn't make sense in light of the standard industry practice, and the Mortgagee may be able to otherwise provide a similar redress to the Borrower without a new Loss Mitigation Option (i.e. principal curtailment sufficient to account for difference in terms). This remedy also seems to require that a Mortgagee offer a Borrower the "correct" Loss Mitigation Option even if the "incorrect" one was more favorable to the Borrower.
38	18	158	The phrase "complete evaluation" which arises three times in the taxonomy, is inappropriate and confusing in light of the move towards streamlined loss mitigation options where there is no "complete" evaluation. This phrase should be eliminated entirely from this taxonomy.

39	18	158	In the 4th bullet of remedies, "FHA will accept a 5-Year indemnification only when the Borrower does not qualify based on the loss mitigation evaluation, or if the Borrower does not accept the Loss Mitigation Option" we are confused how this works. Is this an example of where the borrower was not given the "correct" loss mitigation option? Is this supposed to mean for situations when the borrower did not qualify based on a flawed evaluation? We are very confused by the relation of the timing of the new evaluation compared to the timing of the error. We assume it is to correct what was done at the time the mistake was made, but it could also be read as looking at the options that are currently available to the borrower (previous options may have expired or changed).
40	20	166	In the 4th bullet of findings, "borrower was ineligible for the Home Retention Option received based on non-owner occupancy or vacant property status", we think this should be eliminated as there are now no distinctions for occupancy status for most loss mit options. However, if this is retained it should be limited to when a servicer knew or should have known about the occupancy or vacancy status.
41	21	169	For the 2nd remedy under Tier 2 "FHA will accept a 1-Year indemnification only when the Borrower does not accept the terms of the correct Loss Mitigation Option" there should be an example of an alternative remedy, as almost always this type of loan will be re-pooled into a new Ginnie security when it is not delinquent and is ineligible for most types of loss mitigation (it can't be bought out of a pool if current). This remedy doesn't make sense in light of the standard industry practice, and the Mortgagee may be able to otherwise provide a similar redress to the Borrower without a new Loss Mitigation Option (i.e. principal curtailment sufficient to account for difference in terms). This remedy also seems to require that a Mortgagee offer a Borrower the "correct" Loss Mitigation Option even if the "incorrect" one was more favorable to the Borrower.
42	21	169	For the 6th bullet in the remedy section "for overpaid Partial Claims, remit the overpayment amount to HUD," this example is unnecessary as this is already a clear handbook requirement. Easy place to streamline.
43	23	177	The 2nd bullet, "HUD-approved extension or variance was not obtained as required and servicing records do not indicate a permissible reason or supporting documentation for exceeding HUD-specified time frames" is a simple timeline issue. However, this same timeline issue already has an already embedded penalty involved (curtailments), and thus identifying it as Tier 2 is harsh and unnecessary. We are unclear why this is called out, and how a remedy would even work with this finding.
44	24	180	We strongly agree with the 7th bullet under remedies, "for improperly paid conveyance claims due to incomplete repairs less than $2,500, remit the cost of the repairs to HUD." However, we think it would make more sense (more efficient for both HUD and the mortgagee) to raise this amount to something more in the $5,000 range.
45	GENERAL		We understand that HUD recognizes the need to update/enhance LRS policies to complement the implementation of its final Servicing Defect Taxonomy. This could include consideration of changes to timelines associated with resolving loan-level defects inherited through servicing transfers and the associated indemnification requirements. We welcome the opportunity to further engage with HUD on this topic in the near future.
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