



American  
Bankers  
Association®



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Lopa Kolluri, Principal Deputy Assistant Secretary for Housing  
Office of Housing / Federal Housing Administration  
US Department of Housing and Urban Development  
451 7<sup>th</sup> Street S.W.  
Washington, DC 20410

**Re: Draft Update of the FHA Defect Taxonomy for Servicing Loan Reviews to the Single Family Housing Policy Handbook 4000.1**

Dear Ms. Kolluri:

The American Bankers Association (ABA)<sup>1</sup>, the Housing Policy Council (HPC)<sup>2</sup>, and the Mortgage Bankers Association<sup>3</sup> (the Associations) appreciate the opportunity to submit joint comments on the proposed changes to the Defect Taxonomy for *Servicing Loan Reviews* (Servicing Defect Taxonomy) section of the Federal Housing Administration (FHA) Single-Family Housing Policy Handbook. The Associations commend the steps that FHA and the Department of Housing and Urban Development (HUD) have taken to update its servicing and loss mitigation policies and appreciate that FHA has chosen to utilize the Drafting Table to receive feedback on the Servicing Defect Taxonomy.

**Summary of Comments**

The Associations appreciate FHA's efforts to develop a Servicing Defect Taxonomy that will enhance fairness and predictability, reduce FHA servicing costs, promote retention of existing FHA servicers, and encourage new lenders and servicers to participate in the FHA program. However, the proposed Taxonomy will not achieve these goals without critical clarifications and revisions. The draft proposal lacks sufficient detail or clarity regarding defects that could result in enforcement action, severity tiers, and appropriate remedies.

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<sup>1</sup> The American Bankers Association (ABA) is the voice of the nation's \$23.3 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard \$19.2 trillion in deposits and extend nearly \$11 trillion in loans.

<sup>2</sup> The Housing Policy Council is a trade association comprised of the leading national mortgage lenders and servicers, mortgage and title insurers, and technology and data companies. HPC advocates for the mortgage and housing marketplace interests of its members in legislative, regulatory, and judicial forums. 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](http://www.housingpolicycouncil.org).

<sup>3</sup> The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets, to expand homeownership, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,300 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies, and others in the mortgage lending field. For additional information, visit MBA's Web site: [www.mba.org](http://www.mba.org).

The proposed Servicing Defect Taxonomy is simply too important for the long-range success of the FHA program to rush. A detailed, balanced, and holistic Servicing Defect Taxonomy that presents clear and unambiguous guidance will best achieve FHA's goals of achieving certainty and clarity for program participants. Thus, we urge FHA to consider the development of the Servicing Defect Taxonomy as a long-term project during which it will continually work with stakeholders in the same iterative process that FHA used to develop the Originations Defect Taxonomy.

### **Section-by-Section Feedback**

#### ***1. "Purpose" Section of the Defect Taxonomy on Page One<sup>4</sup>***

The Associations support FHA establishing a Servicing Defect Taxonomy. However, it is critical that the Taxonomy provide servicers with a clear and detailed framework that they can rely upon when analyzing servicing defects. To achieve FHA's goals, the Servicing Defect Taxonomy must, at minimum:

- Explain when loans will be subject to review under the Taxonomy;
- Specify how FHA will characterize the severity of any particular defect;
- Differentiate severity levels between defects with ongoing customer impact and isolated defects with no material impact to the Fund or homeowners;
- Explicitly state the appropriate corresponding remedy; and
- Explain how the Taxonomy will be used during post-claim audit reviews, enforcement activity, and existing controls.

FHA's current proposal does not yet meet these minimum requirements. Indeed, rather than providing clarity, the current proposal raises significant questions about how the taxonomy will work.

#### ***2. "Defect Areas" Section of the Defect Taxonomy on Page One***

The Associations support the concept of using "defect areas" as an organizing tool for the Servicing Defect Taxonomy. This is consistent with current practice and makes sense to continue to use as a framework. However, the "Defect Area" section of the Defect Taxonomy fails to address basic questions that are fundamentally necessary for the Taxonomy to function, such as:

- What is the definition of a defect?
- When does an issue rise to the level of a defect?
- What is a material inaccuracy? Is there a numeric threshold that could be used to determine a material inaccuracy?

For consistency, we would encourage HUD to incorporate references to HUD's Quality Control section of the Handbook to define materiality. Additionally, the Taxonomy should include concrete examples of the

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<sup>4</sup> For ease of reference, we provide page numbers from the .pdf version of the Servicing Defect Taxonomy published on the HUD website/Drafting Table.

type of errors that rise to the level of “defect”, and even more specifically, provide examples of defects where there is a material harm based on the “Material Finding” definition set forth in the Handbook.<sup>5</sup>

Again, without addressing these deficiencies, the Taxonomy will not meet FHA’s goals of improving the program to retain and attract participants.

### **3. “Sources and Causes” Section of the Defect Taxonomy on Page One**

Making the “Causes” identical for all of the defect areas is unhelpful to servicers and makes the document more difficult to understand and utilize. We urge FHA to parallel its Originations Defect Taxonomy and develop narrowly tailored causes for each specific defect area.

Additionally, policy/FHA Handbook references which the Servicing Defect Taxonomy labels as “Sources” for each Defect Area are duplicative and lack requirement- or provision-level specificity, which is likely to lead to confusion or uncertainty as to which piece of a particular handbook section is covered by each defect area. Policy references to “Sources” are also missing from some of the Defect Areas. For example, Defect Area 6 includes foreclosure and claims but foreclosure and claims handbook sections are not included; Defect Area 3 includes property inspection, repairs and preservation but only property inspection handbook sections are included. For the Servicing Defect Taxonomy to be effective, we urge FHA to mirror its Origination Defect Taxonomy by specifically linking each Defect Area to particular servicing activities and requirements.

Lastly, FHA should group similar or related activities into one defect area to the extent possible as opposed to following the layout of the Handbook to determine the appropriate breakdown of the defect areas. For example, payoff statements and payoff disclosures go hand in hand but are currently split between two different defect areas under the proposed taxonomy. This increases the likelihood that auditors will write up multiple findings for the same underlying servicing activity, rather than determining the root cause of the defect, a shortcoming that is contrary to the stated objectives of the taxonomy.

### **4. “Severity Tiers” Section of the Defect Taxonomy**

The Associations support the concept behind severity tiers. We acknowledge FHA’s characterization that the Taxonomy formally establishes the existing Quality Assurance Division servicing review practices, including remedies and materiality designations, as a permanent foundation for FHA’s quality assurance procedures. However, additional clarity is needed to help servicers fully understand the severity tiers, since this information has not previously been shared with stakeholders. To be blunt, we ask that HUD be explicit and unambiguous to take the mystery out of the process – to be of value, servicers need to know how exactly how the taxonomy will work and that it will be consistently applied. Optimally, the Taxonomy should also clearly account for the fact that many servicing issues can be, and are, resolved through mitigating actions throughout the course of the loan servicing lifecycle, since

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<sup>5</sup> We understand and think it appropriate that these would only be examples, and not an all-inclusive list, but still feel that these examples are needed for clarity and understanding.

servicing is a fluid activity with multiple decision/inflection points, whereas loan origination fundamentally culminates in an approval which could be based on errors that may not be mitigated after the loan has been closed and insured.

Additionally, servicers need clarity on the difference between missing documentation that leads to an unacceptable finding versus a deficient finding. The parameters around this are much clearer in the Originations Defect Taxonomy than in the proposed Servicing Defect Taxonomy.

For Tier 3 and Tier 4 findings, we request at least one example in each defect area of the type of findings that would reasonably receive this classification.

Lastly, the Associations encourage HUD to create a binding timeline for the process, so that there is a reliable conclusion to the activity and efforts of responding to and resolving findings.

### **5. *“Remedies” Section of the Defect Taxonomy***

A properly functioning Defect Taxonomy should include FHA’s characterization of the severity of a particular defect along with the appropriate and specific corresponding remedy. Unfortunately, the current Defect Taxonomy proposal doesn’t include the necessary clarity or detail to achieve this goal.

The Associations recognize how challenging it would be to identify a specific remedy for every defect, but the current framework makes little effort to explain how the particular facts and circumstances surrounding a defect influence the remedy. To illustrate, for all of the following examples, it is not clear to our members how the Taxonomy would work:

- There is a clear defect, but there is no harm to the Fund (e.g., property wasn’t repaired timely but is otherwise in conveyance condition; or escrow holdbacks were applied later);
- There is a clear defect, but it is unclear whether there is a harm to the borrower (e.g., borrower wasn’t reviewed for loss mitigation timely but otherwise qualified for a home-retention option preventing foreclosure);
- There is a clear defect and a harm to the Fund, but the current FHA process already remedies the situation (e.g., claims curtailments or withdrawal of the claim); or
- There is a defect and harm to the Property, but FHA’s Mortgagee Compliance Manager will reconvey the property (e.g., a code violation that needs to be remediated before FHA can accept the property)

Without clarity on these common scenarios, the Defect Taxonomy is unlikely to enhance either fairness or predictability.

Another issue with the current proposal is that the remedies identified are too limited and are overly reliant on life of loan indemnification. We strongly reject the premise that the primary remedy should be loan indemnification. In fact, 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.” See 24 C.F.R. §203.500. Requiring indemnification for a violation of the provisions set forth in this Subpart of HUD regulations

would be functionally equivalent to denying insurance benefits in contradiction to this provision. Indemnification is only appropriate where a loan is no longer eligible for FHA insurance.<sup>6</sup>

While legally questionable, should HUD preserve loan indemnification as a servicing remedy in the taxonomy, it should as a policy matter limit its use only to the most egregious errors that can't be remedied any other way to prevent agency harm. In fact, FHA utilizes a limited 5-year indemnification routinely for loan origination defects. We would also encourage FHA to explore the types of servicing defects where a 5-year indemnification agreement is appropriate. Borrower performance for a 5-year period of time certainly eliminates any correlation between future loss event and the servicing error in question.

Alternatives to indemnification are shown in each defect area "as a waterfall based on degree of impact." However, there is very little clarity about how a cascading or hierarchical set of remedies will be applied in practice. Additionally, there is insufficient explanation about the mitigating or aggravating circumstances that would determine the appropriate remedy on the waterfall. A better approach would be for the Taxonomy to identify one specific remedy for a particular type of defect that can change based on aggravating or mitigating circumstances.

The Associations' believe that the Servicing Defect Taxonomy could be enhanced by clarifying how the existing suite of current servicing remedies, such as curtailment of interest and/or property expenses, factor into the taxonomy.<sup>7</sup> Similarly, the remedies in the Taxonomy should also consider that a servicer's ability to perform a particular remedy may be limited by Ginnie Mae restrictions – remedies like principal curtailments or account adjustments may not always be possible on securitized loans.

Lastly, the remedies should also be appropriate to the particular servicing activities covered by a defect area versus applying the same/similar remedies for each defect area (e.g., how does remittance to FHA factor into the particular servicing activities covered in defect area 3?).

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<sup>6</sup> 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 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.

<sup>7</sup> This would help alleviate our members' concern about duplicative remedies.

## **6. “Fraud or Misrepresentation” Section of the Defect Taxonomy on Page Three**

Generally, the Associations support the concept that instances of fraud should have serious remedies. Additionally, since the language in this section largely mirrors that found in the Origination Defect Taxonomy, our members are generally familiar with these standards.

However, our members still believe that the Taxonomy would benefit from a clear and conclusive definition for “materially misrepresented information.” Additionally, we recommend that evidence of fraudulent or “materially misrepresented information” for servicing should allow for alternative remedies, other than life of loan indemnification. Since loan servicing is less standardized than origination and subject to external factors affecting a borrower’s performance over time, we believe it is rational that the determination of remedies for fraud or misrepresentation account for this changeability with a more comprehensive set of remedies.

### **Overall Implementation Recommendations**

Although the Associations’ members support deploying a Servicing Defect Taxonomy, due to the importance of the guidance, it’s implementation and development should not be rushed.

We ask that FHA consider an iterative process to develop the necessary additional detail required to clarify expectations for servicers’ performance in the taxonomy. The clarifying additions should be incorporated into the Handbook and FHA’s technology infrastructure well in advance of the final effective date. We also recommend that such advance publication be 120-180 days from publication and technology adoption, based on lessons learned from implementation of other similar types of programmatic changes.

As expressed previously, we share FHA’s objectives for the Servicing Defect Taxonomy, to enhance FHA’s oversight of servicing. With a clear and comprehensive framework, servicers will be in a position to calibrate their quality control practices to align with FHA’s standards to prevent servicing defects and to quickly address any errors identified by FHA.

### **Conclusion**

Thank you for the opportunity to comment on the changes to the Handbook. Should you have questions or wish to discuss this issue further, please contact Sara Singhas at [ssinghas@mba.org](mailto:ssinghas@mba.org) or (202) 557-2826, Sharon Whitaker 202-663-5321 at [swhitaker@aba.com](mailto:swhitaker@aba.com) or Matt Douglas 202-589-1924 at [matt.douglas@housingpolicycouncil.org](mailto:matt.douglas@housingpolicycouncil.org).

Sincerely,

American Bankers Association  
Housing Policy Council  
Mortgage Bankers Association