

Comments to

**U.S. Department of Housing and Urban Development,
Federal Housing Administration's (FHA) Office of Single Family Housing**

Regarding

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

Submitted By

**National Consumer Law Center
(on behalf of its low-income clients)**

January 28, 2022

On behalf of the low-income clients we represent, we write to comment on HUD's proposed defect taxonomy for loan servicing reviews announced on October 28, 2021. We appreciate HUD's work on developing a defect taxonomy for mortgage servicing because we think an effective one can be a critical tool in clarifying HUD's expectations to servicers and thereby improving borrower outcomes as well as industry participation. As described below and in our separately submitted comment joined by other consumer and mortgage industry organizations, we believe that HUD's proposed taxonomy lacks sufficient detail needed to be effective. We would greatly appreciate the opportunity to meet with HUD to discuss the proposal before any further action is taken.

In these comments, we provide detail on the defects that HUD should consider a high priority and should look for in every loan-level servicing review that uses the final defect taxonomy. The highest priority defects, as listed below, are those that 1) increase the risk of unnecessary foreclosures or 2) impose unwarranted costs and fees on borrowers. We propose that HUD create a general standard for determining appropriate remedies for all defects, and its standard should be to put borrowers in the position they would have been if the servicers had complied with the relevant HUD guidance and no defects had occurred. This standard provides the correct outcome for borrowers and minimizes risk to the Mutual Mortgage Insurance Fund ("MMIF"). Finally, when HUD identifies a defect that is likely to harm multiple borrowers, the taxonomy should rank the defect at the highest level of severity. For these systemic defects the examiner needs to identify the causes, and, when warranted, forward the cases for further enforcement.

1. HUD should revise its proposed Defect Taxonomy to include fundamental components of a successful taxonomy.

HUD's defect taxonomy for use in assessing loan-level servicer performance should provide detail to stakeholders about HUD's priorities and its expectations. Specifically, a successful taxonomy should:

- Classify which violations of HUD policies are most severe and which are not;
- Assess severity based on the level of concrete harm the conduct poses to borrowers and FHA;
- Assign a range of appropriate remedies for each specific violation;
- State the aggravating and mitigating factors that HUD will consider in determining the particular remedy and the process for how HUD will consider these factors; and
- Describe how HUD will address systemic issues identified in the evaluation process.

A defect taxonomy satisfying these criteria will promote HUD's program and policy goals. It will facilitate compliance because servicers will use it to enhance their own quality control process. By promoting fairness and predictability, it will reduce FHA servicing costs and will help retain existing lenders and encourage new lenders to participate in the FHA program. It will ensure for all stakeholders that HUD's review process is focused on significant issues that support sustainable homeownership and the health of the MMIF and not more minor violations.

The creation of a defect taxonomy provides HUD an opportunity to invite a discussion of policy goals and to set priorities for loan servicing. A defect taxonomy that simply summarizes published guidance without providing any detail on examination priorities or range of penalties is counterproductive, as it gives the impression that any given violation could be met with no penalty or the harshest penalty. A summary of HUD's rules and handbooks gives no additional concrete guidance about what HUD seeks to achieve through this taxonomy.

The version of the taxonomy that FHA published on October 28th does not meet the basic criteria for a successful taxonomy. Outside of fraud or misrepresentation, which are specifically addressed, the taxonomy does not provide insight into HUD's servicing policy priorities through the categorization of particular violations by severity. It instead provides broad statements of what conduct is unacceptable without detailing how the agency weighs a defect. In addition, in those broad statements, as described below, HUD specifically fails to mention borrower harm and refers only to harm to a property or to FHA.

The proposed taxonomy also does not state the range of remedies available for a particular violation. Instead, HUD indicates that all remedies are available for any violation without giving any guidance on how the agency will employ particular remedies. By failing to specify the range of remedies, the proposed taxonomy conveys the impression that all defects are subject to a maximum penalty. The taxonomy states that a servicer may mitigate a defect finding through documentation; however, because the taxonomy lacks detail on the connection between violations and remedies, the role of mitigating and aggravating factors is unclear.

HUD's taxonomy proposal is further flawed because it fails to incorporate an assessment of patterns of defects into its criteria of severity. The correction of patterns of servicer non-compliance should be at the core of HUD's severity analysis. Instead, HUD opens its description of this taxonomy proposal by stating that it "does not [a]ddress FHA's response to patterns of loan-level defects."¹ Ignoring patterns of servicer misconduct cannot be a sound basis for a defect taxonomy. This deliberate omission deprives borrowers of the most effective remedies that can promote compliance with the servicing goals of the FHA program.

The lack of effective focus of this taxonomy proposal appears to be rooted in a failure to take account of the differences between loan origination and servicing. A defect taxonomy for loan servicing must work with functions that are very different from those that operate in loan origination. In contrast to loan originators, servicers are involved in ongoing relationships with thousands of borrowers. They simultaneously apply common practices to thousands of accounts, carrying forward transactions that build one upon another over time. With common software and standardized communications with borrowers, there is a great potential for servicing errors to multiply among borrowers and spread out over time. A defect taxonomy must be vigilant in detecting these systemic problems and ensuring that they are corrected before more borrowers are harmed. HUD can do much better in addressing these concerns.

¹ HUD, Draft Update of the FHA Defect Taxonomy for Servicing Loan Reviews to the Single Family Housing Policy Handbook 4000.1 at 1 (Oct. 28, 2021).

The taxonomy we propose below seeks to provide more clarity and certainty for all stakeholders. It states a general standard for imposing remedies that allows for mitigated penalties when the servicer can show the defect has been remedied and enhanced enforcement when systemic problems need to be addressed. We recognize that our proposal would benefit from consideration by other stakeholders with different perspectives on which defects lead to harm to the MMIF and to borrowers. This is fundamentally why we believe HUD should pause the current version and revise its proposal; time is needed for all stakeholders to discuss how defects should be defined and prioritized.

2. In assessing severity of a defect in connection with any taxonomy, HUD must account for the harm caused to borrowers.

Any finalized defect taxonomy must cure HUD's omission of borrower harm as a factor to consider in determining the severity of a defect. Protecting FHA-insured borrowers through examination of servicer performance is one of HUD's core functions. The statute outlining HUD's operational goals in running the MMIF lists two core obligations: HUD must protect the MMIF and HUD must "meet the housing needs of the borrowers that the single family mortgage insurance program under this subchapter is designed to serve."² These fundamental goals must be at the center of all of HUD's work with the FHA-insured mortgage program, including HUD's examination of FHA-insured servicer performance.

Despite these two goals, HUD's draft defect taxonomy omits consideration of borrower harm in assessing defects and instead focuses solely on protecting the MMIF. In each defect area, HUD defines as unacceptable a defect that "results in adverse impacts on the property or FHA."³ The scope of the relevant harm never includes harm to the borrower. In fact, HUD fails to mention borrower harm during any discussion of relevant defects despite the agency's statutory obligation to meet the housing needs of low- to moderate-income borrowers.

HUD cannot limit its examination to how defects impact the insurance fund. HUD has to meet both of its statutory goals, and as a result, its defect taxonomy must assess harm to the borrower as central to its examination work. In our proposal below, we put the focus of the assessment both on the harm to the borrower and to the MMIF. HUD should ensure that these considerations are included in any final taxonomy.

3. HUD should classify defects by severity and focus on the most severe defects.

As stated above, HUD's defect taxonomy should reflect the agency's priorities by stating which violations are most severe and which are not. We have provided below a proposed list of the highest priority defects that examiners should look for in reviewing a loan file. Providing a specific list in the defect taxonomy should ensure that compliance with these critical issues is considered in every examination.

² 12 U.S.C. § 1708(a)(7)(B).

³ HUD, Draft Update of the FHA Defect Taxonomy for Servicing Loan Reviews to the Single Family Housing Policy Handbook 4000.1 at 6, 8, 10, 12, 14, & 16 (Oct. 28, 2021).

We created our list of high priority defects in order to achieve fundamental policies. Examinations should give the greatest attention to defects that 1) increase the risk of unnecessary foreclosures or 2) impose unwarranted costs and fees. These policies promote HUD's statutory goals of protecting the MMIF and promoting homeownership for FHA-insured loans. Foreclosures destabilize the borrower and the borrower's neighborhood, and they impose a significant cost on the MMIF. Unwarranted costs and fees drain the fund and financially harm the borrower.

Many of the high priority defects listed below implicate both fundamental policies. For example, servicers who improperly deny borrowers for loan modifications deprive borrowers of their primary path out of foreclosure and impose significant costs on the MMIF and the borrower (by diminishing home equity). Servicers who incorrectly provide a loan modification with a higher monthly payment impose an unwarranted cost on the borrower and increase the likelihood of redefault. Servicers who fail to respond to borrower inquiries and fail to process borrower appeals impose roadblocks to cost-saving foreclosure alternatives.

The **high priority defects** should be ones that demonstrate:

- a. A failure to properly apply FHA's standard, disaster, or COVID-19 loss mitigation waterfalls;
- b. An incorrect denial of a loss mitigation option;
- c. A failure to fully respond to borrower inquiries or appeals;
- d. A failure to timely respond to a borrower's request for loss mitigation;
- e. The communication of inaccurate account or loss mitigation information to borrowers;
- f. Improper fees and charges to the borrower;
 - i. With higher severity where the assessment of the fee or cost indicates lack of staff training (on part of servicer or vendor) in FHA guidelines, or software programming that embeds the defect and allows similar improper assessments against other borrowers;
- g. Lack of diligence in maintaining contact with borrowers in default to complete loss mitigation reviews, with aggravating factors to include:
 - i. Evidence of a borrower's written or verbal communications of interest in pursuing loss mitigation, without appropriate servicer follow-up;
 - ii. Failure to conduct ongoing loss mitigation reviews for borrowers in default;
 - iii. Evidence of changed circumstances for borrowers in default without appropriate servicer response;
- h. Delays in completing loss mitigation applications and reviews;
 - i. Incremental severity based on length of delay: e.g. 15, 30, 60 days, etc.;
- i. Requests for unnecessary or duplicative documentation from borrowers in connection with loss mitigation;

- i. High severity where request indicates lack of staff training (on part of servicer or vendor) in FHA guidelines, software programming that imbeds the defect, or other organizational issue;
- j. Defects that misrepresent borrower eligibility for an FHA loss mitigation option
 - i. High severity where misrepresentation indicates lack of staff training (on part of servicer or vendor) in FHA guidelines, or software programming that imbeds the defect;
- k. Defects in response to borrower inquiry, including:
 - i. Response not timely (severity scaled to length of delay);
 - ii. No response;
 - iii. Response does not address issue raised;
 - iv. Lack of diligence in investigation;
 - v. Documents not provided when appropriate to request;
 - vi. Heightened severity when defect indicates lack of staff training in FHA guidelines;
- l. Any other defect that increases the risk of unnecessary foreclosures or imposes unwarranted costs and fees.

We recognize that high priority defects do not encompass all of the requirements HUD imposes on servicers, and, therefore, we believe HUD should also provide standards for medium and lower priority defects. The high priority defects should be listed in detail because they are the ones the examiner should consider in any exam. We have chosen to propose general standards for medium and low priority defects rather than list defects with specificity.

Medium priority defects are violations of HUD rules that the servicer has not remedied and that indicate a threat of concrete harm to the fund or borrowers. These could be defects that show a lack of care, poor staff training, the failure to integrate vendor services, or the inadequate allocation of resources to a particular servicer function. These are conditions that, if left uncorrected, are likely to harm one or more borrowers and the fund in concrete ways.

Low priority defects are ones that represent a failure to meet a HUD requirement that caused no harm to the borrower or the fund, that the servicer remedied in full prior to HUD's assessment, and that the servicer has demonstrated is highly unlikely to occur again. These defects do not indicate a threat of future concrete harm to the fund or borrowers.

The agency should assess whether enumerating specific medium and low priority defects would fit the needs of the defect taxonomy and HUD's priorities in administering the program. In order to best protect borrowers, we strongly believe, however, that the agency should specifically enumerate high priority defects so that they are assessed in every loan-level evaluation.

4. In response to any defect, HUD should have a general standard of putting both the borrower and the agency in the position they would be in if the servicer had not failed to comply with the HUD rule.

Instead of simply listing all the possible remedies HUD could seek, the defect taxonomy should provide a general standard for addressing defects. **It is our position that the remedies HUD imposes should seek to put borrowers in the position they would have been in if the servicer had complied with the relevant HUD guidance and no defect had occurred.** This standard provides the correct outcome for borrowers and minimizes risk to the fund. Such a standard requires an individual analysis of each defect and how to remedy it. In some cases, it will simply require the servicer to remove a charge from the borrower's account. In cases where loss mitigation was incorrectly determined, HUD should direct the servicer to re-analyze the account and provide the proper loss mitigation options.

To this end, for active loans, HUD's defect taxonomy should further state that the primary tools HUD will use to achieve the remedial goal are account corrections such as principal reduction, interest curtailment (both for the borrower's account and to HUD), interest rate corrections, and borrower refunds. By focusing on these tools, HUD can rectify the borrower's account and minimize risk to the MMIF while not subjecting the servicer to the total loss of its ability to make an insurance claim or some similarly steep penalty.

For loans that were foreclosed or paid off, the remedial standard will be more difficult to achieve since the borrower is no longer in the home. Nonetheless, HUD should consider requiring the servicer to compensate borrowers who were improperly foreclosed. Moreover, defects that have led to unnecessary foreclosure will likely be good candidates for referral for systemic enforcement as discussed more below. The difficulty in rectifying an improper foreclosure is a reason why HUD should focus on examinations of active loans. This will allow HUD to discover and address defects in time to actually help homeowners.

In order to better illustrate how our proposed remedies would work in a particular case, we provide the following example.

Assume that Servicer X failed to calculate the proper market interest rate on a loan modification pursuant to Handbook 4000.1 and thus imposed a 4.5% annual interest rate on the borrower instead of a 4.25% annual interest rate.

The impact of this seemingly small difference in interest rate could be quite severe. On a \$200,000 loan, the borrower with a 4.5% interest rate pays more than \$10,000 over thirty years than the borrower who has a 4.25% rate (\$164,813.20 vs. \$154,196.80 in interest). However, HUD can use account correction tools to fix the account by requiring Servicer X to reduce the rate going forward and adjust the account so that the 4.25% interest rate applied from the beginning of the modification. This would require the servicer to reapply the payments, possibly refund money to the borrower or reduce the principal balance, and absorb any interest payment differences that the servicer sent out

to investors. However, especially if caught soon enough, Servicer X's penalty exposure is reasonable, and the penalty will provide the borrower with the proper outcome.

It will not always be possible to create a remedy that precisely puts borrowers in the position they would be in had no defect occurred. For example, defects related to the timing of HUD's outreach efforts may not be subject to remediation through an available loss mitigation option. In cases such as a failure to satisfy a deadline for outreach, HUD should consider requiring non-compliant servicers to forgive a specified number of installment payments in order to bring the loan back within the deadline. This type of penalty could give the servicer the opportunity to make the proper outreach while not causing the servicer to lose its right to an otherwise valid insurance claim or face a stiffer penalty.

Our proposed standard for remedies allows for consideration of mitigating and aggravating circumstances. When a clear remedial path is available, as in our example above, HUD should require it; however, there will be other circumstances where the remedial path to make the borrower whole is not clear. In those cases, HUD can decide whether to mitigate based on circumstances in which the servicer has demonstrated that the defect has been addressed in a manner that makes it is unlikely to occur again. With respect to enhancing penalties, HUD should consider enhancing penalties for more extreme defects and for defects that reveal a systematic practice. Those cases should especially be referred for further enforcement. However, in all cases, HUD should act to put borrowers in the position they would be had the defect not occurred.

5. The defect taxonomy should require further inquiry into high priority defects in order to catch systemic errors.

We recognize that defect taxonomy is only used for loan-level defects and is not a substitute for HUD's systemic review. However, examiners using the defect taxonomy should have an eye toward identifying issues that may have a systemic impact even if the defect taxonomy is not the means of addressing them.

When HUD identifies a high priority defect that is likely to impact other loans, the defect taxonomy should direct the examiner to consider the cause of the defect. The defect taxonomy should require examiners to assess whether the high priority defect occurred beyond the individual case. The examiner should assess whether the higher priority defect implicates a pattern, practice, or structural problem with the servicer. In making this determination, HUD should provide the servicer with an opportunity to show that defect does not implicate a pattern, practice, or structural problem. The burden should be on the servicer to show that a defect was in fact an isolated error and not a systematic error.

The defect taxonomy should also direct the servicer to forward cases that reflect systemic issues to HUD's Mortgagee Review Board (MRB) for further consideration or penalty. Of course, if the servicer agrees to correct accounts and can demonstrate that the cause of the error has

been addressed, there may not be more for the MRB to do; however, the defect taxonomy should make it clear when referral is proper.

HUD can see a compelling description of the degree to which systemic errors can pervade a mortgage servicer's operations by perusing the complaint that the CFPB filed against Ocwen loan servicing in 2017.⁴ The complaint summarized findings from the CFPB's 2014-2016 investigation into Ocwen's practices. Many of the defects that the CFPB discovered were caused by the servicer's decision to use a faulty software program that multiplied errors over the 2.8 million accounts it serviced. Similarly, poor staff training and ineffective oversight of staff spawned defects that affected tens of thousands of borrowers. During the period from 2014 through 2016 the software systematically produced more than 870,000 errors that the CFPB had to direct Ocwen to correct.⁵ Eighty percent of the servicer's loan modification analyses showed errors in eligibility and payment schedules.⁶ In over 60% of instances borrowers who contacted the servicer to correct errors had to make repeated efforts to obtain replies, up to five or more times in many cases.⁷ The defective software led to inadequate and delayed responses to consumer disputes, often not even addressing the subject of the complaint.⁸ In 98% of cases the servicer failed to adequately document corporate advances assessed to borrowers' accounts.⁹ In other areas, Ocwen systematically mishandled borrower escrow accounts and engaged in the practice of foreclosing while loss mitigation reviews were underway.¹⁰ Ocwen was a particularly large servicer, but the CFPB's examination shows clearly that a servicing defect seldom arises out of the blue as a one-time rarity. By focusing examinations on these types of errors, and instructing examiners to identify their causes, HUD will be able to prevent these errors from affecting so many borrowers and reduce the disruption to the fund

As an integral part of the severity assessment the taxonomy must consider the cause of the defect. Remedies must ensure that the servicer corrects the cause of a problem rather than just adjusting an individual borrower account. The defect taxonomy should provide guidance on how to proceed with systematic review.

6. Conclusion

We appreciate the opportunity to comment on HUD's proposed defect taxonomy. Because HUD's draft defect taxonomy does not satisfy basic criteria for it to be successful, HUD should not finalize it and should instead further engage with stakeholders in connection with developing a more detailed draft. We have provided detail on how the taxonomy can better avoid unnecessary foreclosures and improper costs to the fund and to borrowers; however, a further dialogue is needed to work toward a more detailed draft.

⁴ CFPB v. Ocwen, No. 17cv80495 (S.D. Fla. April 20, 2017) available at https://files.consumerfinance.gov/f/documents/20170420_cfpb_Ocwen-Complaint.pdf

⁵ *Id.* ¶ 46-47.

⁶ *Id.* ¶ 70.

⁷ *Id.* ¶ 170.

⁸ *Id.* ¶ 170-173.

⁹ *Id.* ¶ 43.

¹⁰ *Id.* ¶ 121-129; 191.