

**FHA Single Family Housing Policy Handbook
Quality Control, Oversight and Compliance
August 14, 2014**

Comments of National Consumer Law Center

- **Distinguish servicing and origination standards.** The draft text generally combines mortgage origination and servicing topics without distinguishing between these two very different functions. HUD should revise the text throughout to specify Quality Control and Monitoring guidelines that apply specifically to servicing and to origination.
- **All deficiencies that are material should be reported to HUD.** Permitting discretion invites concealment.
- **Require documentation of compliance with Mortgage Letter 2013-32's revised loss mitigation guidelines.** Avoid overreliance on self-reporting by servicers. Quality Control reviews and Monitoring should explicitly require and prioritize review of how servicers comply with HUD's revised loss mitigation guidelines, contained in Mortgage Letter 2013-32. Servicers should document how they applied these guidelines in each case of a delinquency in order to enhance compliance. Overuse of vague codes should trigger additional scrutiny. Third party reviews should be a top priority.
- **Oversample during reviews to target loans serviced by large servicers, loans in foreclosure, loan transfers, servicers with high levels of complaints filed, and loans sent to DASP.** Quality Control and Monitoring should target review of loans at greater risk for quality control problems.
- **Seek borrower input and notify borrowers of Monitoring review results.** HUD should interview borrowers and seek their input as a routine part of the Monitoring process. Borrowers should receive notice of the results of Monitoring reviews of their loans.
- **Fair lending oversight must be commensurate with the law.** Fair lending compliance reviews should cover the gamut of covered activities in both origination and servicing, and should explicitly include the duty to affirmatively further fair housing where applicable.
- **Enhance oversight in response to consistent non-compliance.** HUD should add a system for ongoing monitoring of all foreclosure referrals by servicers found to have repeatedly violated HUD's servicing guidelines. HUD should assess the costs of this additional monitoring as a penalty against the servicer.

- **Enhance penalties for non-compliance.** HUD should enhance penalties for non-compliance with its loss mitigation rules. These penalties should include reimbursement of costs of higher interest rates improperly charged on unmodified loans that should have been modified in a timely manner with a reduced interest rate.

General Comment – The “Drafting Table” format as a mechanism for stakeholder review and feedback. We support HUD’s decision to prepare comprehensive handbooks covering all aspects of FHA loan origination and servicing. The “Drafting Table” format is helpful as a mechanism to review a late-stage draft. However, as we have noted in comments to earlier drafts in this series, the format minimizes the likelihood that HUD will receive timely and meaningful feedback related to the overall drafting process from all stakeholders.

The Drafting Table model solicits line-by-line comments on a draft that has already reached a late stage in the editing process. It is not clear whether certain stakeholders have had access to earlier drafts or participated in prior phases of the handbook development. Offering a nearly completed version to the public for comments that must fit into a spreadsheet format discourages comments that address any pervasive omissions in the text, misdirected focus, or major structural defects. We hope that HUD will adopt a more flexible process for future Handbook comments, or at least limit use of the spreadsheet format to a later draft released after all stakeholders have had the opportunity to submit more general comments. HUD should solicit stakeholder input at the inception of the drafting process, not at the end.

In the text that follows we will direct our comments to specific passages when appropriate. However, we have also included discussions that go beyond a single passage. We are submitting our comments in a separate Word document, in addition to attempting to fit them into the spreadsheet. We hope that HUD will review the more readable version allowed by the Word format.

Page 2 line 26

Under *Institutional Quality Control Program Requirements* the text states that the mortgagee may use its own employees or its chosen contract employees to perform Quality Control functions.

With respect to loan servicing, the Quality Control Program as outlined in the draft (pages 1-18) is unlikely to have a significant effect on compliance. The systems for both institutional and loan level quality control rely almost entirely on self-reporting by servicers. Over the past five years, all major servicers of FHA-insured loans have been subject to large-scale enforcement actions by federal and state agencies. Investigators have documented persistent failures in the servicers’ overall loss mitigation and foreclosure practices. The servicers’ track record for self-policing has been abysmal. The proposed Quality Control Program will likely have a positive effect only when a servicer’s self-reporting is examined in the context of a monitoring review conducted by an outside party. A form of these monitoring reviews is discussed later in the draft. (pages 18-19). The focus of HUD’s quality control must be on the monitoring reviews by outside entities, not on the self-policing inherent in these proposed Quality Control guidelines.

The draft states that mortgagee/servicers may select employees to implement internal Quality Control programs as long as these employees were not in the direct chain of command for the origination decision. (page 2, line 26). This text does not even address loan servicing, but presumably the same reliance on employees and contractors paid by the mortgagee applies to servicers as well. The draft should explicitly address servicing. Rather than the reliance on servicers' staff to conduct Quality Control reviews, HUD should require that disinterested outside entities perform the reviews and report directly to HUD. HUD should develop a list of entities approved by HUD to perform all Quality Control reviews. The list should include entities with expertise in loan servicing.

Page 4 line 22: add "servicing" after the word "eligibility."

Page 4 lines 28 to page 5 line 20. *Fair Lending Compliance*

The Quality Control provisions related to Fair Lending compliance address only the rejection of applications. The text states that a Mortgagee must ensure that "no civil rights violations were committed in the rejection of the application." (page 5, line 12-13). The narrow scope of this language raises a number of concerns. In recent years, the most problematic fair lending violations associated with mortgage lending did not arise from outright rejections of applications. They involved the discriminatory impact of loan originators' exercise of discretion in setting terms for loans that they approved. The Handbook must include a requirement that originators evaluate the impact of their practices on classes of borrowers protected under the Fair Lending laws. The draft fails to mention any duty to affirmatively further Fair Housing. The text omits any mention of Fair Housing concerns related to loan servicing, loss mitigation, and to the approval of loan modifications. For example, mortgagees and servicers should be required to implement strategies that address needs of borrowers and applicants with limited English proficiency who seek loss mitigation help.

Page 5 line 17-18. *Fair Lending and rejected borrowers*. The draft states, "the mortgagee must document the methodology used to review rejected Borrower applications, the results of each review, and any corrective actions taken as a result of review findings." The text must be amended to describe the same duties with respect to a wider range of origination activities, including pricing for approved loans. The documented methodologies must also include those for loss mitigation evaluations, denial and approval of loan modifications, and setting the terms of modifications.

Page 7, line 14. The draft states that in Quality Control reviews the "mortgagee must review its loan performance data to identify any patterns of non-compliance." The reference to "loan performance data" appears to refer only to data regarding payment compliance as an indicator of the soundness of underwriting. While this is an appropriate standard for review of underwriting practices, the text needs to state expressly that the review must identify patterns of non-compliance in servicing as well as in origination. This review must include data points that can reveal a servicer's systematic failure to apply FHA's loss mitigation guidelines appropriately. Servicers must demonstrate how they applied the loss mitigation waterfall in each case. The reviews must detect any referrals to foreclosure made without documented loss mitigation reviews. We suggest certain mechanisms for this review below, p. 16, line 35.

Page 9, line 5. *External reporting of Quality Control data to FHA.* According to the text, findings of fraud and material misrepresentation made in the context of Quality Control reviews must be reported to FHA even if resolved or mitigated. However, the draft states that not every deficiency that constitutes a “material finding” need be reported. A “material finding” is defined as an erroneous action that has a financial impact on the property, the borrower, or FHA. (page 8, line 8). The Handbook should require reporting to FHA of all material findings involving loss mitigation. A servicer should not have the discretion to decide whether evidence of material non-compliance with loss mitigation guidelines is a “material finding” that it need not report, as opposed to a “material misrepresentation” that it must report. The distinction is too subtle to be of any practical value and invites concealment. It is difficult to conceive of what value there is in allowing a servicer to withhold a material finding of non-compliance with loss mitigation guidelines from HUD.

Page 9, lines 8-22. The descriptions under (C) and (D) on reporting to HUD appear contradictory:

According to (C), “Findings that do not involve fraud or material misrepresentation and were already Mitigated or Resolved by the mortgagee do not have to reported to FHA”

According to (D), The mortgagee must report all other Material Findings [i.e., those not involving fraud or material misrepresentation] to FHA no later than 30 days after the mortgagee has completed its own internal evaluation, or within 60 days of initial discovery, whichever occurs first.”

It is not clear from this text what must be reported to FHA. In any case, a mortgagee or servicer should not have discretion to determine that a material finding regarding a deficiency has been “resolved.” Where the mortgagee or servicer believes the problem has been mitigated or resolved, the problem and its mitigation or resolution should be reported to FHA.

Page 11 line 10 to page 12 line 4. *Standard for determining composition of Quality Review sample.*

The text identifies categories of loans that must be included in samples for Quality Control reviews. One category consists of loans showing early payment defaults. This is certainly an appropriate category for review of a lender’s origination practices. The text does not suggest any similar categories for servicing practices. Foreclosure in which the proceedings lasted longer than established time frames; completed foreclosures; and DASP referrals. While there may already be sampling done from the total population of FHA loans being serviced, there should be a more targeted sampling of loans from the population of all cases referred to foreclosure. Further, there should be oversampling of select strata focused on: foreclosures in which the proceedings lasted longer than established time thresholds; completed foreclosures; and DASP referrals.

Page 12 line 12, *Quality Control loan sample selection – Risk Categories* – The text refers only to origination risks. It should specify loss mitigation risk categories, such as where a loss mitigation option was approved and was later reported as having failed. (SFDMS Code AQ). Frequent use of certain vague codes should constitute a risk category and receive heightened scrutiny for both Quality Control reviews and monitoring. These problematic codes include: Code AO – ineligible for loss mitigation (completed evaluation but found ineligible or declined);

Code AP – mortgagor ineligible because did not respond to loss mitigation solicitation, non-cooperation; and

Code AQ, option failure.

Servicers often record terms such as these when in fact they failed to fulfill obligations for proper administration of the loss mitigation process.

Page 14 line 1-28 *Origination underwriting review: Income, Employment, and Asset Information.* The section requires that a mortgagee re-verify certain data in the cases selected for review. There is little reason to believe that a mortgagee that failed to verify income correctly when it originated the loan will accurately verify income in a later review and report the error in its internal Quality Control review records. This section highlights the need to have an outside party conduct the quality review.

Page 15 line 4 *Review of appraisals as part of Quality Control reviews.* The text should add a requirement that the review of an appraisal must be by an individual with expertise in the field.

Page 16 line 35 *Servicing Loan File Compliance Review, Minimum Requirements.* One of the 28 listed requirements is simply to review “loss mitigation.” The text does not describe what this means or what the minimum requirements are for a review of loss mitigation compliance. This is an extremely important subject for review. The Handbook should add text here listing the specific components of a minimal loss mitigation review to include: (1) the servicer’s waterfall analysis consistent with Mortgagee Letter 2013-32 (Appendix A) along with the dollar calculations used for each step; (2) documentation of the income analysis relied upon; (3) documentation of efforts to contact the borrower and obtain information for the loss mitigation evaluation; (4) documentation of compliance with all RESPA/CFPB loss mitigation duties and written notice requirements; (5) compliance with all other loss mitigation review requirements set forth in HUD Mortgagee Letter Nos. 2013-40, 2013-39, 2013-32, 2012-22, 2009-23, and 2000-05.

Page 18 line 6. *Quality Control review, Data Integrity, Servicing Information.* The text states that the mortgagee/servicer “must validate mortgage information submitted to the SFDMS, . . . as applicable.” The SFDMS categories are often vague and leave out important information. Where a servicer has used codes AQ, AO, and AP, the Quality Control review should require detailed explanations of why the servicer used these codes.

Pages 18-21 *Mortgagee Monitoring*

Page 18 line 27: *Institutional Monitoring*

Neighborhood Watch. The Neighborhood Watch database consists of servicers’ self-reporting of loss mitigation activities. The system allows mortgagees and servicers to use extremely vague terms to report certain actions. These include those described above (listing as examples codes AO, AP, AQ). The Neighborhood Watch system has limited value as a monitoring device without any audit or third party verification system.

Page 19 line 2, distinguishes a “public” Neighborhood Watch database from a Neighborhood Watch database accessible only to FHA-approved mortgagees. According to the text, the public site does not provide access to loan level data and contains a limited amount of information on delinquent loans. The public database must provide enough information to allow for public accountability. To the extent that any additional information in the private database relevant to Quality Control is not available to the public, this aspect of the Handbook review process lacks transparency. Generally a public comment process puts all parties on equal footing in providing feedback. However, members of the public without access to the “private” database are unable to access essential information for evaluating this portion of the draft.

Page 19, line 21. The “Mortgage Performance Reports” described here present the same concerns about reliance on Neighborhood Watch and SFMDS data described in these comments, above at page 12, line 12.

Page 20-21 Title II Mortgagee Monitoring Reviews

These two pages covering the Mortgagee Monitoring reviews address the option for mortgagee/servicer oversight that has the greatest potential, of all those discussed in the draft, to be effective. It is the only review mechanism that does not rely solely on self-reporting by mortgagee/servicers. The monitors are not employees or paid contractors of the mortgagee/servicer. The monitors can review complete file systems and investigate activities that occurred over several months or years. Unlike other forms of oversight described in the draft, these reviews can discover common servicer errors such as offering the wrong loss mitigation option to a borrower. They can detect errors in applying the loss mitigation waterfall priorities defined in Mortgagee Letter 2013-32. If a servicer checked off on a form that it evaluated the borrower for all loss mitigation options, a monitor can look for evidence that this review in fact occurred.

The Handbook text should be revised to direct monitors to review for specific documents and issues. For servicing, these include: (1) documentation of compliance with each step of the FHA loss mitigation process, including those for early contact; (2) evidence of compliance with the loss mitigation waterfall protocol contained in Appendix A to Mortgagee Letter 2013-32, including numerical data used in the servicer’s analysis; (3) compliance with all notice and other obligations set forth in the CFPB RESPA rules, 12 C.F.R. §§ 1024.35-41; (4) documentation of reasonable efforts to contact borrowers and complete a loss mitigation application, including compliance with the face-to-face meeting requirement of 24 C.F.R. § 203.604; (5) periodic reviews of loss mitigation as required by 24 C.F.R. § 203.605; and (6) actions taken to assist borrowers with limited English proficiency.

Page 20 line 31. The text states that the scope of monitoring may consist of “interviews with mortgage participants, including employers, gift donors, Borrowers, and appraisers.” The text clearly applies to monitoring of both origination and servicing activities. Although the text provides for monitors to interview borrowers over servicing issues, it does not appear that HUD’s monitors have interviewed borrowers regarding loss mitigation as a standard practice. We recently reviewed approximately 100 monitor report letters that described HUD monitors’ reviews of loss mitigation activity conducted during 2010 and 2011. The monitors did not communicate with the affected borrowers in any of these reviews. Instead, they focused solely on

documents in the servicer's file. Typically, the monitor's report listed deficiencies found during the file review. This list was provided to the servicer, and the servicer had the opportunity to respond and explain its conduct. Borrowers were consistently excluded from this interaction. Borrowers can provide information that is essential to effective monitoring. For example, the borrower may report that he or she sent documents that did not appear in the file. The borrower may have been told something over the phone that was different from what the servicer's notes said. The information that the servicer conveyed, whether in writing or verbally, may not have been comprehensible to the borrower. Problems of this nature have been widely reported in connection with supervisory and enforcement actions, as well as press coverage of servicing problems. HUD should require that monitors attempt to interview borrowers as part of every case review. Where borrowers have worked with an attorney or housing counselor during the loss mitigation evaluation, these individuals should be included as well. The monitor should include the borrower as a recipient of any report about the borrower's case that the monitor sends to the servicer for a response.

Add section: Targeting Certain Servicers for Monitoring. HUD should direct monitoring toward certain servicers whose practices have the most impact on the FHA program. These include:

1. Large servicers: five servicers are responsible for servicing most FHA loans, and monitoring should ensure scrutiny of their practices;
2. DASP loans: a few servicers provide most of the loans to the DASP program, and it is critical that HUD ensure that these servicers have complied with FHA loss mitigation requirements;
3. Loans in foreclosure: Loans in foreclosure are more likely to need loss mitigation and thus are a fruitful area for further examination to determine compliance with servicing requirements.
4. Transfers of servicing: With the increasing frequency of transfers of servicing of FHA loans, monitoring should focus on ensuring that these transfers do not impact negatively on borrowers being reviewed for loss mitigation;
5. Borrower Complaints: HUD should implement a system of tracking borrower complaints, similar to the one developed by the monitor of the National Mortgage Settlement. Unlike the current practice with HUD's National Servicing Center, the National Mortgage Settlement Monitor solicits written complaints in specified formats. The Monitor releases summary data in regular public reports. HUD should adopt a similar system. The system should record complaints about loss mitigation servicing from individual borrowers, housing counselors, and attorneys. HUD should publicize this complaint process and encourage borrower input. The complaint database can then be a basis for targeting monitoring to the servicers that consistently generate complaints. This online database should be in addition to, and not replace, the existing NSC call-in option.

Page 21 line 14 *Servicer Monitoring/Tier Ranking System II.* (This topic is listed as "Under Construction"). The TRSII system has a number of limitations as a mortgagee/servicer monitoring device. As we noted in prior comments on this subject, the recent changes to the TRS system implemented a broader survey of "delinquent loan servicing." The system now weighs factors such as correct codes along with a measure of the frequency of use of loss mitigation. The frequency data does not measure the propriety of a particular loss mitigation option for the

borrower. Overall, this broader scoring dilutes the focus on loss mitigation. Neither SFDMS nor TRSII would capture an instance of giving a borrower the wrong loss mitigation option. By adopting the Monitoring and Quality Review protocols we have suggested above, HUD can improve on the limitations in the loss mitigation oversight built into the TRSII system.

Pages. 24-31 *Actions and Sanctions Against Mortgagees*. This section defines four types of sanctions: (i) Prohibition of Direct Endorsement Approval; (ii) Withdrawal of Direct Endorsement Approval; (iii) Credit Watch Termination; and (iv) Suspension or Termination of Lender Insurance Authority. Each of these four sanctions involves a bar or limitation on a mortgagee's status as a loan originator. None of them address sanctions against a servicer for misconduct related to loan servicing. The entire sanctions section should be amended to expressly incorporate servicing sanctions as well as those for origination.

Non-compliant loan servicing may be completely unrelated to origination defects. A bad servicer can cause unnecessary foreclosure losses even though the loan originator followed FHA underwriting guidelines to the letter. On the other hand, a good servicer can comply with FHA servicing guidelines and minimize losses even though a different entity committed glaring errors in originating the loan. While the draft suggests a need for heightened scrutiny, such as for monitoring visits, the text focuses on high default rates as a criterion for this heightened scrutiny. A high default rate could be a sign of faulty origination practices, but may have no bearing on the adequacy of servicing that takes place years after origination. The draft should establish distinct standards for monitoring of servicing, not just for origination. In our comments we suggest categories where monitoring of servicers would most appropriate, supra, page 21, after line 14.

Page 21 *Add new section: Paying for Monitoring*. If HUD has limited resources to pay for needed monitoring reviews of servicers, one option would be to require that the servicers pay penalties to HUD in an amount sufficient to compensate HUD for the costs incurred in paying outside entities to conduct the reviews. If HUD has found that a servicer committed material violations of HUD guidelines, it would be appropriate that the servicer cover the cost of monitoring to ensure improvement. The penalty payments could cover the cost of hiring specialized individuals who would review all of the servicer's cases before referral to foreclosure. Certain servicers have chosen not to allocate sufficient resources to loss mitigation compliance. Having those servicers pay for monitoring would be an appropriate correction to their decisions to neglect these functions. There is certainly precedent for servicers paying for costs incurred in association with government oversight.

Pages 31-37 *Loan level actions and sanctions*. None of the provisions for loan level actions described here provide for notice to the borrower when HUD has determined that a mortgagee/servicer's conduct involving the borrower's loan was sanctionable. If HUD monitoring determined that a foreclosure sale was inappropriate because the servicer failed to consider and implement available loss mitigation options, HUD must make all reasonable efforts to notify the borrower of this determination. When loss mitigation is ongoing, informing the borrower of HUD's findings can enlist the borrower in the effort to hold the servicer accountable for following HUD's guidelines. In addition, the borrower may have state and federal law remedies related to an improper foreclosure or collection of improper fees. The servicer may

have violated CFPB rules or state unfair and deceptive practices laws in its review of the borrower for loss mitigation. The borrower's pursuit of these individual remedies will further the goal of compliance with FHA requirements.

Pages 31-32 *Indemnification Agreements*

page 31 lines 25-29 The text should specify that a servicer's certification that it complied with loss mitigation requirements when it did not constitutes fraud and misrepresentation for purposes of the section.

Page 32, lines 5-11. We are aware that HUD has used reimbursement agreements as a sanction for servicing violations. However, the Handbook does not mention this option in connection with servicing. Under "principal reduction," the text should specify that HUD will seek recovery of interest that accrued improperly after a servicer failed to comply with loss mitigation rules. Thus far, HUD's refund requirements for servicing defects tend to have been limited to voiding of foreclosure fees and costs that a servicer incurred after it improperly commenced a foreclosure. This is appropriate. However, if a borrower should have been offered a loan modification as of an application date and this modification would have reduced monthly payments, HUD should not reimburse the servicer for unpaid interest accrued at the higher rate than would have been allowed under the modification.

Page 33 line 8-12. *Mortgagee Review Board* - placement of mortgagee/servicer in probation for violation of FHA requirements. A specific option listed as a probation sanction should be to order the ongoing review of all of a servicer's future foreclosure decisions under a system funded by servicer for a fixed time.

Page 33 line 21 *et seq.* The text must state specifically that suspension is a sanction that applies to servicing and to loss mitigation violations.

Page 36 line 8. *Civil Monetary Penalties* (mitigating and aggravating factors) Add to the list of aggravating factors: "harm to the borrower." Under the Housing Act, the borrower's interest in preserving homeownership ranks with protecting the solvency of the insurance fund as a goal of HUD's administration of the FHA single-family home loan program. A servicer that is found to have commenced foreclosure unnecessarily has committed a significant injury both to the insurance fund and to the borrower. The assessment of penalties should take into account the borrower's individual circumstances. If a borrower was clearly eligible for a loss mitigation option, such as a loan modification under FHA-HAMP, and the servicer foreclosed instead, that borrower may have lost the opportunity for homeownership for a lifetime. Bad servicing caused this unnecessary loss. The penalty assessed against the servicer should acknowledge the severe impact of the violation of HUD rules on the borrower.

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