

July 5, 2022

Julia Gordon
Assistant Secretary for Housing, Federal Housing Commissioner
Department of Housing and Urban Development
451 7th St S.W.
Washington, D.C. 20410

RE: Defect Taxonomy

Dear Commissioner Gordon:

We are writing to share our reactions to the Defect Taxonomy straw proposal that the Housing Policy Council (HPC) sent to HUD on May 12, 2022. We appreciate HPC's work on this proposal and willingness to share it with us, and we will continue our conversations with HPC and its members on this important topic. As we stated in our January 28 joint letter, we think an effective defect taxonomy can be a critical tool in clarifying HUD's expectations to servicers and thereby improving borrower outcomes. We urge HUD to convene further conversations on the taxonomy.

Below we provide our topline reactions to HPC's proposal. In addition, we have attached a redline version of its proposal with our suggested edits.

1. **Borrower harm:** Like HUD's original defect taxonomy draft, the industry's proposal does not explicitly address or seek to remedy harm to borrowers due to defects. It instead only mentions harm to the property and/or FHA. Protecting FHA-insured borrowers through examination of servicer performance is one of HUD's core functions, and it should be explicitly addressed in the taxonomy. Indeed, the statute outlining HUD's operational goals in running the Mutual Mortgage Insurance Fund (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." 12 U.S.C. § 1708(a)(7)(B). Both of 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. As a result, we have added references to borrower harm to the defect taxonomy proposal.

2. **Addressing systemic issues and definition of cause:** HPC's document briefly discusses when cases should be referred to the Mortgagee Review Board, but does not discuss how to deal with systemic servicing defects and how to address their causes. The remedies section, however, could and should consider the cause of a defect and address what happens when an examiner uncovers a defect that may be systemic (for example, a \$25 unauthorized fee that a software program or form letter simultaneously imposes on thousands of borrowers). To fully remedy these situations, the servicer should be required to show that the problem has been

resolved for the current borrower and to provide evidence that the cause of the defect has been fixed. If the cause hasn't been fixed, the case should then be sent for further review. While the remedy for the individual loan at issue will not change, the remedy for a given defect must take into account the risk of further harm to other borrowers from the same defect. To address this, we have added language in the Remedies section of the defect taxonomy to address the steps HUD should take when a potentially systemic defect is identified.

3. Materiality definition: We recognize the need to distinguish between material defects and those that are not material. However, in addition to defects that cause concrete harm, HUD should classify defects as material if they significantly increase the risk of foreclosure and other concrete harm to borrowers.

4. Material misrepresentation: Unlike HUD's original draft taxonomy, the HPC version does not mention the term "material misrepresentation" at all. The defect taxonomy should clearly address material misrepresentations, and HUD has included them in Tier 1 in its draft. In our proposal, we placed material misrepresentations in Tier 2 because, while material misrepresentations are important to address, it is better to do so by correcting their financial consequences rather than by using a life-of-loan indemnification.

The definition of material misrepresentation should address the content of the servicer's communications to the borrower. This should cover a servicer's or mortgagee's misrepresentation or omission of information required to be provided to borrowers by FHA guidelines. The misrepresentation/omission is material if it impairs the borrower's ability to make informed decisions about the borrower's rights and obligations under the loan agreement or presents a risk of systemic harm. Misrepresentations that cause harm or threaten to cause further harm should be remediable.

5. Borrower outreach and communication examples: With respect to Defect Areas 3 and 4 (Delinquent/Default Servicing and Loss Mitigation), HPC proposes that defects arising from servicers' communications, outreach, and collection efforts should be classified categorically as non-remediable and non-material. Defects related to borrower outreach should not be automatically classified as Tier 3 defects and non-remediable by definition. Instead, HUD should consider whether a particular defect is material or non-material in a particular case and whether it's remediable. There are clearly cases where a failure to follow FHA's outreach and communication rules harms the borrower and is remediable. For example, it is critical for servicers to accurately and fully respond to borrower escalations and inquiries about their loans. The defect taxonomy should include an assessment of how servicers respond, and we have included this as an example defect.

We thank you for engaging with consumers and industry on the Defect Taxonomy, and we look forward to continuing our work with the agency and with stakeholders on how to create a system that works well for borrowers, servicers, and the MMIF.

Sincerely,

Center for Responsible Lending
National Consumer Law Center (on behalf of its low-income clients)
National Fair Housing Alliance
National Housing Conference