

August 26, 2024

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RE: Appendix 8.0 – FHA Defect Taxonomy for Servicing Loan Reviews – 2024 Update

On behalf of our low-income clients, we write to comment on HUD’s proposed defect taxonomy for loan servicing reviews. We believe an effective taxonomy can clarify HUD’s expectations to servicers and thereby improve borrower outcomes. By expanding the discussion of remedies for defects and specifying remedies to address issues with the borrower accounts, HUD’s latest version is a significant improvement from the previous iterations.

We have attached a redline version of the draft defect taxonomy along with a completed worksheet. Our topline recommendations, all of which are highlighted in the redline version, include the following:

1. We strongly support the use of financial remediation to address issues with the borrower accounts caused by servicer defects.

We strongly support HUD’s statement that remedies should “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.” This statement is consistent with HUD’s core obligations of protecting the Mortgage Mutual Insurance Fund (MMIF) and “meet[ing] 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, and HUD’s statement reflects these requirements.

Moreover, by providing a clear remedial standard, HUD’s statement gives servicers guidance on how to address issues that they find prior to any HUD evaluation. When servicers are able to catch problems earlier in the process, less drastic measures are needed to remediate any issues. We suggest that the defect taxonomy specifically incorporate provisions of HUD Handbook 4000.1 that allows servicers to fix problems on their own without having it become a Finding pursuant to HUD’s evaluation policy.

2. FHA should allow for compensation to borrowers as a potential remedy.

HUD should add direct borrower compensation as a potential financial remedy because there are situations where refunds or adjustments to the loan are not available. For example,

borrowers who have faced an improper foreclosure no longer have an account to adjust and no refund is available.

HUD, however, should state that the borrower compensation the servicer pays to address the defect does not have any effect on the contractual or other legal relations between the borrower and the servicer. This will avoid the potential for servicers providing a low amount of money relative to the harm while also receiving a valuable waiver of claims from the borrower. Unrepresented borrowers may be tempted by these offers. The compensation should only count toward the servicer's obligation to address the defect.

3. FHA should clarify when compliance with other applicable law constitutes a Tier 3 defect.

In several Defect Areas, HUD includes a version of the following sentence to describe a Tier 3 defect, which does not require a servicer response or any remedial action: “[d]elinquent and default servicing was not conducted 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.” E.g. pp. 14, 17. We urge HUD to revise this sentence because it is overbroad and imprecise. Under the plain language of this sentence, HUD could ignore delinquent and default servicing defects that clearly violate HUD requirements as long as the servicer complied with other state and federal laws applicable to default servicing. For example, under the draft language a servicer that ignored all HUD loss mitigation and notice requirements while foreclosing on a property in Mississippi would face no consequences as long as it complied with Mississippi foreclosure law and RESPA servicing guidelines. This would be the case even if the servicer could have complied simultaneously with all HUD guidelines and the applicable state and federal servicing laws. This cannot be what HUD intended.

HUD should clarify that particular actions that servicers take may be required by federal or state law, and HUD should delete the broad references to “applicable laws and rules that govern servicing activity generally.” An appropriate alternative text would be: “There are apparent defects with respect to HUD policy, but the actions were required to comply with other federal or state law.”

4. HUD should clarify that not all default notice defects fit within Tier 3.

In Defect Area 4 (Loss Mitigation Processing), HUD's language suggests that loss mitigation notice defects may categorically fit into Tier 3 (no remediation). The draft text describing a Tier 3 defect involving loss mitigation processing includes: “Loss mitigation notifications do not include all required elements and/or required information was not provided to the bankruptcy trustee or Borrower.” p. 17. Loss mitigation notices, however, generally provide extremely important information to the borrower about the options that the servicer considered, the information the servicer used, and the steps borrowers can take to appeal the decision. Certain notice errors can cause concrete harm to borrowers and to HUD. These should rise to the level of a Tier 2 defect that requires remedial steps. We suggest that HUD clarify that notice defects are Tier 3 if

they are inconsequential. The draft should be modified to describe a Tier 3 defect as follows:
“Loss mitigation notifications do not include all required elements and the defects are inconsequential and do not require loan-level corrective action.”

We thank you for engaging with stakeholders 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. If you have any questions about this letter, please contact Steve Sharpe, Senior Attorney, NCLC at [ssharp@nclc.org](mailto:ssharpe@nclc.org).

Sincerely,

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