June 28, 2019

U.S. Department of Housing and Urban Development
Federal Housing Administration
451 7th Street, SW
Washington, DC 20410

RE: Proposed FHA Loan-Level Certification Statement and Defect Taxonomy Amendments

To whom it may concern:

The Housing Policy Council, the Mortgage Bankers Association, the American Bankers Association, and the Bank Policy Institute are jointly writing in response to the U.S. Department of Housing and Urban Development's ("HUD" or "Department") request for comments on the proposed amendments to the Federal Housing Administration ("FHA") annual and loan-level certification language, as well as the Defect Taxonomy, that HUD published on May 9, 2019. As you know, these associations provided joint comments regarding the proposed amendments to the annual certifications in a letter dated June 7, 2019. This letter focuses on the proposed loan-level certifications and Defect Taxonomy amendments. We appreciate HUD's extension of the deadline to provide comments on these two additional proposals.

I. INTRODUCTION AND EXECUTIVE SUMMARY

As noted in our June 7th letter, we applaud the Department for restarting the critical policy deliberations regarding the role of the annual and loan-level certifications, as well as the Defect Taxonomy, in FHA's risk management and enforcement regime. We share HUD's view that creating an environment in which lenders can operate within the FHA program with clarity and certainty regarding both FHA's requirements and potential penalties for noncompliance is critical to lenders' active participation in this program that ultimately benefits homeowners. As we discussed in our June 7th letter and address in more detail below, we believe that the certifications (annual and loan-level) and FHA's Defect Taxonomy should complement each other. If they are used, they should foster sound compliance and not create layers of undue risk of liability under the False Claims Act[1] that discourages responsible program participation.

[1] See 12 U.S.C. § 3729.

For the reasons explained below, and as noted in past communications with the Department, we have urged that consideration be given to removing the certification requirements entirely. These requirements are unnecessary considering FHA's ample authority to address deficiencies without certifications. If, however, the Department deems additional statements from mortgagees necessary, we urge the Department to consider using this opportunity to revise its regulations to replace the loan-level certifications with a straightforward, workable lender acknowledgement of key requirements based on loan eligibility and to rely on the existing oversight and enforcement regime.

Given the time necessary to make such regulatory amendments and the importance of limiting the unwarranted risks entailed by the current and proposed certifications, we recommend FHA begin the process by first amending the loan-level certification language to incorporate the following three important concepts that lenders deem essential for active participation in the FHA program: (a) recognition of underwriter judgment; (b) exclusion from the certification of violations that do not make loans ineligible for FHA insurance; and (c) incorporation of the standards for evaluation of defect severity and potential remedies set forth in the Defect Taxonomy.

With regard to FHA's proposals to amend the Defect Taxonomy, we support inclusion of a statement in the Defect Taxonomy and HUD Handbook 4000.1 that the Department will uniformly apply the Defect Taxonomy as a national standard for all loan-level compliance monitoring and enforcement processes. With respect to the origination section, we would propose additional amendments to: (1) account for loan performance for a set length of time following origination as an indication of effective underwriting; (2) further clarify certain remedies; and (3) provide a formal feedback and "cure" mechanism for findings in Tiers 3 and 4, even if only reserved for later use if necessary. With respect to the servicing section, because the proposed provisions are not able to be fully developed at this time due to the existing servicing regulations not reflecting current industry standards or the realities of modern servicing practices, we respectfully suggest that the servicing section of the Defect Taxonomy be removed for now and re-proposed separately and in tandem with amendments to the FHA servicing regulations.

Again, we thank you for the opportunity to comment on these documents, and we look forward to continuing this important process with HUD representatives in furtherance of our shared objectives.

II. LOAN-LEVEL CERTIFICATIONS

A. Background on the Loan-Level Certifications

The risks associated with originating FHA-insured loans have increased significantly over the last several years with the Department of Justice's reliance on loan-level and annual compliance certifications to bring legal actions against lenders for treble damages under the False Claims Act based upon alleged defects in FHA loans. The existing loan-level certifications require underwriters to certify that underwriting decisions comply with all of the discrete FHA requirements that are published in HUD Handbook 4000.1 – an absolute standard without recognition that underwriting entails subjective judgments and that reasonable underwriters could disagree on numerous components of this process in striving to comply with

FHA requirements. It is also nearly impossible for each and every loan that a lender originates, all of which are unique and dependent on a human process, to comport with each FHA standard and be error-free. Technical errors and human errors are inevitable in the manufacturing of mortgage loans, despite best efforts to avoid them. These errors should not form the basis for claims of fraud that result in demands for treble damages on loans for which claims are filed, notwithstanding HUD's existing ability to obtain recovery from lenders. Even when lenders rely on automated underwriting tools, the experienced personnel responsible for processing and underwriting the loan must make subjective data selection and integrity determinations. Unfortunately, an unintentional standard of perfection, which has been misconstrued from the language in the loan-level certification, has become the basis for False Claims Act prosecution by the Department of Justice. The Department of Justice's grafting of an unrealistic standard onto a subjective process has resulted in severe and disproportionate penalties, directly contributing to the retreat of highly competent and responsible lenders from the FHA program.

FHA must take steps to eliminate the causes of unnecessary risk and frivolous litigation to maximize the diversity and breadth of lender participation in the FHA program, thereby expanding access to credit for FHA borrowers. For many lenders to consider increased participation, the loan-level certifications must make clear to lenders that they will be held accountable only for errors that directly impact insurability. Mortgage underwriting standards, including those of FHA, by their very nature, must reflect, enable, and indeed foster subjectivity, providing lenders with both the responsibility and discretion to evaluate each individual borrower's unique circumstances and make reasonable determinations within the bounds of those requirements. FHA sets those standards in a manner that is intended to realize its critical mission of providing homeownership opportunities and access to sustainable mortgage credit to a broader population of borrowers who are underserved by conventional underwriting standards.

We understand that FHA's ultimate underlying purpose for the loan-level certifications is to use the certification as an additional tool to incent mortgagees to comply with FHA's origination and underwriting requirements. We also understand that FHA does not intend to use the certification to subject mortgagees to the risk of liability under the False Claims Act for subsequently-identified inaccuracies that either represent immaterial variances from FHA requirements or are based on facts that the signer of the loan-level certifications could not reasonably have known at the time of signing the certifications. With this in mind, we recommend that the Department revise its proposed approach to the loan-level certifications, giving due consideration to the existing enforcement mechanisms that already exist. This will assist FHA with its goal to optimize the diversity and breadth of lenders participating in the FHA program, which will, in turn, expand access to credit for FHA borrowers.

As we noted in our June 7th letter, mortgagees accept responsibility for conducting their operations in accordance with FHA's origination and underwriting requirements and facing the risk of HUD's administrative enforcement penalties in the event that mortgagees do not meet that responsibility. Mortgagees are reticent and, in some cases, unwilling, however, to face the threat of treble damages under the False Claims Act by attesting to overly broad loan-level certification statements of strict adherence to program requirements. Such potential liability can be grossly disproportionate and excessive and makes participation in the program far too risky for some lenders. The certifications and the penalties for deficiencies must be appropriately established and calibrated to create the fairness, clarity, and certainty that HUD is commendably striving to achieve, and that lenders require to foster more diverse and broad-based program participation.

B. Concerns with the Proposed Loan-Level Certification Statements

As noted in the Department's May 9, 2019 press release announcing the proposed changes to the loan-level certifications, FHA is proposing significant revisions to the Addendum to the Uniform Residential Loan Application, Form 92900-A, that are intended to reorganize the form "in a logical, easy-to-read and understandable format and to eliminate duplicative information collected elsewhere." While we support the Department's efforts to eliminate redundancy and streamline the certification language, the proposed amendments do not ultimately accomplish what we believe should be the primary goal of alleviating unnecessary False Claims Act risk to which lenders are exposed as a result of overly broad certifications.

Unfortunately, the most recent proposed loan-level certification language does not include or even acknowledge the discretion and subjectivity innate in underwriting and permitted by FHA. Importantly, the proposed certifications would delete the current qualification added in 2016 that permits exclusion of any defects that do not cause the loan to be ineligible for FHA insurance. Consequently, the proposed language could, in fact, constitute a step backward toward a "strict liability" standard that is more expansive and more problematic than exists today under the current loan-level certification language. Specifically, the May 2019 proposal would require lenders to certify to strict compliance with every requirement in FHA Handbook 4000.1, without any qualifiers, which prevents the lender from addressing exceptions or variances that would not impair eligibility for FHA insurance.

The proposed certification language also contains overly broad references to the entire HUD Handbook, rather than limiting the statements to the origination/underwriting section. Accordingly, minor and/or technical violations of the full range of discrete requirements could constitute false statements and provide the foundation for a claim for treble damages under the False Claims Act, even though these violations would not render the loan ineligible for FHA insurance.

As a result, the proposed loan-level certification language does not adequately address the mortgage industry's valid concerns regarding the virtually unlimited use of these certification statements as the basis for pursuing significant penalties under the False Claims Act. Nor will it encourage broader participation in the FHA program. The False Claims Act is an important tool for the federal government and *qui tam* relators (private parties who bring actions on the government's behalf) to impose liability on persons or entities who defraud governmental programs, as a fraud prevention statute with significant penalties. Nevertheless, the False Claims Act should be used as was intended – only to combat actual fraud, not minor divergences from agency program rules or reasonable determinations of eligibility made in good faith that do not amount to a fraudulent scheme or otherwise unfairly negatively impact government funds.

As currently drafted, the proposed amendments to the loan-level certifications could permit any variance from the broad Handbook provisions referenced in the certifications as evidence to assert that the loan-level certifications constituted a "false statement" under the False Claims Act, regardless of the impact on the loan's eligibility for FHA insurance. As a result, one-off errors in a loan's origination or underwriting could become the foundation for a False Claims Act allegation. Consequently, to the disappointment of the industry, the proposed amendments will not give lenders the assurance needed to promote broad program participation. Indeed, rather than serve as a fraud prevention tool, an overly broad certification unintentionally becomes an impediment to program participation, thereby unduly constraining

access to affordable, responsible credit for deserving borrowers seeking to fulfill the dream of homeownership. We understand that this outcome does not reflect FHA's intent.

C. Recommendations for the Loan-Level Certification Process and Statements

In light of these concerns, and as noted above, many have urged that consideration be given to removing the certification requirements entirely. The certification requirements are unnecessary in light of FHA's ample authority to address deficiencies without certifications. If, however, the Department deems additional statements from mortgagees necessary, we strongly urge the Department to consider using this opportunity to revise its regulations to replace the loan-level certifications with a simple, workable lender acknowledgement of key requirements based on loan eligibility and to rely on the existing oversight and enforcement regime coupled with a statement that the loan is submitted for insurance based on the judgment of an underwriter making a good-faith determination. Given the time necessary to make such regulatory amendments and the importance of limiting the unwarranted risks entailed by the current and proposed certifications, we recommend that FHA begin the process by first amending the loan-level certification language to incorporate three important concepts, described in detail in Section C.2 below, that lenders deem necessary to increase their participation in the FHA program.

1. Amend the Regulations to Remove the Loan-Level Certification Requirements or Replace with an Acknowledgment

As noted above and in past communications with HUD, the preference of many of our members has been to remove the certification requirements altogether. The HUD regulations regarding insurance of FHA mortgages require that two specific certifications be made upon submission of the loan for FHA insurance endorsement – one by a representative of the lender and one by the underwriter for manually underwritten loans.[2] Nothing in the National Housing Act,[3] however, requires a mortgagee to make any specific certifications to the Department regarding a loan's eligibility for FHA insurance.

Moreover, HUD does not need loan-level certification statements to hold mortgagees accountable for adherence to FHA requirements. HUD already has the requisite authority to

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[2] Notably, Section 203.255(b) states, in applicable part: "[T]he mortgagee shall submit to the Secretary, within 60 days after the date of closing of the loan or such additional time as permitted by the Secretary, properly completed documentation and certifications as listed in this paragraph (b):

> (5) An underwriter certification, on a form prescribed by the Secretary, stating that the underwriter has personally reviewed the appraisal report and credit application (including the analysis performed on the worksheets) and that the proposed mortgage complies with HUD underwriting requirements,....
>
> (11) A mortgage certification on a form prescribed by the Secretary, stating that the authorized representative of the mortgagee who is making the certification has personally reviewed the mortgage documents and the application for insurance endorsement, and certifying that the mortgage complies with the requirements of paragraph (b) of this section. . .

24 C.F.R. § 203.255(b) (emphasis added).

[3] See 12 U.S.C. §§ 1701 et seq.

enforce these requirements. Certifications neither establish nor serve as the primary basis for the obligation of the lender and the underwriter to follow FHA requirements. Approved mortgagees are required to comply with FHA requirements regardless of their provision of certifications, and FHA has the full array of administrative remedies that it may utilize to address alleged violations of such requirements without use of a certification. HUD also has a myriad of other tools that may be used to enhance or bolster the agency's risk controls to ensure compliance with FHA requirements, including pre-and post-closing Quality Control requirements, which set forth internal and third-party compliance audit obligations, the Post-Endorsement Technical Review process, and Quality Assurance Division audits.

Given that HUD has this broad array of administrative enforcement mechanisms to hold FHA-approved mortgagees accountable for violations of FHA requirements, loan-level certifications are not necessary for the Department to take action against an FHA lender that violates those requirements. Moreover, these certifications should not serve as a guaranty or warranty of strict adherence to the full set of broad FHA parameters or as an independent basis for sanctions absent intentional and material fraud. For these reasons, we believe that HUD should simplify the process and achieve greater efficiency and clarity by amending its regulations to remove the requirement that FHA lenders make loan-level certifications to HUD or, alternatively, replace the certifications with a clear and straightforward certification that focuses on the lender's acknowledgement of the applicability of FHA rules to their origination of FHA loans. Such an acknowledgement could be in the form set forth below:

I certify that:

- The mortgage was rated as an "accept" or "approve" by FHA's TOTAL Mortgage Scorecard.

- I have reviewed and am aware of the requirements applicable to the information submitted to TOTAL in accordance with Single Family Housing Policy Handbook 4000.1 (SF Handbook) and the requirements under SF Handbook 4000.1 Section II.A.4.e Final Underwriting Decision (TOTAL) and the FHA administrative remedies and penalties for any failures to comply with these requirements.

- This mortgage is submitted for insurance based on the judgment of an underwriter making a good-faith determination.

OR

I certify that:

- The mortgage was rated as a "refer" by FHA's TOTAL Mortgage Scorecard, or was manually underwritten by a Direct Endorsement underwriter.

- I have reviewed and am aware of the requirements applicable to manual underwriting set forth in Single Family Housing Policy Handbook 4000.1 (SF Handbook) Section II.A.5 and the FHA administrative remedies and penalties for any failures to comply with these requirements.

- This mortgage is submitted for insurance based on the judgment of an underwriter making a good-faith determination.

2. Amend the Language of the Loan-Level Certifications

We appreciate that the above recommendations would require regulatory amendments, which involve a lengthy and deliberative process. In light of the time necessary to implement such regulatory changes, we recommend that FHA begin this necessary process by first amending the loan-level certification language that incorporates the following three concepts that lenders deem necessary to actively increase their participation in the FHA program. The first two concepts reflect the historic practice of the Department in its consideration of potential violations and the imposition of administrative remedies. We merely want the certification language to reflect the way HUD actually conducts business on which lenders have come to rely.

- *Underwriter judgment.* Include an explicit and direct statement recognizing that any certification to the mortgage's compliance is based on the judgment of an underwriter making a reasonable determination in good faith. This will address FHA's objectives and the underwriter's obligation to use sound judgment and discretion to compile accurate information and weigh and balance the risk variables inherent to the underwriting analysis to determine eligibility for FHA financing.

- *Exclusion of violations that do not make loans ineligible for FHA insurance from the certification language.* Exclude from any certification to the mortgage's compliance those defects or errors that would not result in the loan being ineligible for FHA insurance. This will prevent minor and/or technical variances from constituting false statements that may provide the foundation for a claim for treble damages under the False Claims Act, in spite of the loan's unchanged eligibility for FHA insurance. This concept was added to the loan-level certifications in 2016 and, while the language is not as precise as we would recommend, it nevertheless addresses this important point. This eligibility standard is also included in HUD's current self-reporting standard, but not in the proposed loan-level certifications.

- *Affirmation of the Defect Taxonomy.* Confirm, including within the certification and the HUD Handbook, the methodology that HUD will apply to assess the severity of and potential penalties for any violations, to provide assurance that the False Claims Act will only be used to combat actual fraud, not minor divergences from FHA requirements or good faith underwriting determinations that do not amount to a fraudulent arrangement. We recognize the challenge of incorporating the Defect Taxonomy into the certification, but have suggested language regarding how FHA could affirm its use of the Defect Taxonomy.

We have attached a document with suggested edits to the proposed loan-level certifications in Form 92900-A, which incorporate these essential concepts ("Appendix"). To reinforce these concepts, we recommend that, in conjunction with amendments to the loan-level certification, FHA reinsert explicit and direct statements into HUD Handbook 4000.1 affirming the agency's expectation and underwriter's obligation to use sound judgment and discretion to compile accurate information and weigh and balance the risk variables inherent in the underwriting analysis to determine eligibility for FHA insurance. This language was prominent in FHA's previous credit policy Handbook, 4155.2, "Lender's Guide to the Single Family Mortgage Insurance Process." To solidify the application of the Defect Taxonomy to the origination and underwriting process, we recommend adding the following language directly into HUD Handbook 4000.1:

> HUD acknowledges that, with respect to any and all claims that it elects to pursue arising out of a fact or circumstance that would result in the inaccuracy of any certifications set forth in Form 92900-A, or that HUD would use as a basis for misrepresentation, it will (a) pursue such claims in accordance with, and subject to the limitations set forth in, the HUD Defect Taxonomy in effect at the time of the insurance of this mortgage by HUD and (b) interpret the severity of any such inaccuracy consistent with such HUD Defect Taxonomy.

We further recommend that HUD Handbook 4000.1 be augmented to incorporate the Defect Taxonomy within the Handbook itself, which would formalize and give the Defect Taxonomy greater permanence. This step would assist in providing lenders the predictability regarding enforcement of program requirements that they need to consider increasing their participation in FHA lending and expanding the availability of credit through the FHA loan product.

These changes to the proposed loan-level certifications will in no way limit HUD's ability to protect the FHA Mutual Mortgage Insurance Fund or the Department of Justice's ability to pursue fraudulent schemes under the False Claims Act. The recommended edits would merely remedy many of the issues with the current certifications by limiting liability to defects or errors that adversely affect the insurability of the loan. FHA could prevent misinterpretation and misapplication of the certifications by explicitly affirming that immaterial, technical violations of discrete FHA requirements that do not affect the insurability of the loan are not misconstrued to serve as a basis for a false certification.

As noted above, this approach would be consistent with the existing requirement in Section V of HUD Handbook 4000.1 that mortgagees must self-report all "Material Findings" to HUD as part of their internal Quality Control process. The Department defines reportable origination defects as those where "the Finding would have altered the Mortgagee's decision to approve the Mortgage or to endorse or seek endorsement from FHA for insurance of the Mortgage." This self-reporting obligation already requires calibration of material findings by mortgagees and FHA and shows the importance of including a loan eligibility standard in any certification regarding FHA-insured loan origination.

We note that HUD's proposed loan-level certification language continues to require a certification by one individual regarding the review of the appraisal and the underwriting decision. As FHA is aware, the reviewer of these two elements of the origination process is not always the same individual. We recommend that the certifications be amended to reflect this recognized industry practice where distinct underwriters may perform the review of collateral and credit underwriting functions.

Additionally, as previously noted, the proposed certifications make overly broad reference to the entirety of HUD Handbook 4000.1, even though only a few specific sections apply to the automated and manual underwriting requirements. We recommend referencing those specific sections in the certification statements to remedy this issue, as set forth in the Appendix. Moreover, given that the loan-level certifications make several references to HUD Handbook 4000.1, and given the importance of these compliance statements, it is imperative that HUD provide mortgagees with sufficient time to implement changes when it amends the Handbook. Announcing amendments to Handbook 4000.1 that become effective immediately – a practice that FHA has engaged in as recently as this past April – will put mortgagees in the position of being out of compliance with the Handbook provisions until they can amend their

policies and processes to implement the changes, while at the same time being forced to certify to compliance with the Handbook provisions to obtain FHA insurance endorsements.

Finally, we note that the proposed revisions to Form 92900-A would remove language in the existing version of the form that applies to Veterans Administration ("VA") Form 26-1802a, which relates to the origination of VA-guaranteed loans, but do not provide any information about how that information would be collected in the future. While we appreciate the Department's efforts to streamline the FHA requirements contained in Form 92900-A, we note that if it is the Department's intent to create two separate forms for FHA-insured and VA-guaranteed loan origination activities, such a change would constitute a substantial operational change for lenders that would require sufficient time to implement.

III. DEFECT TAXONOMY

As noted in the Department's May 9, 2019 press release, HUD's revisions to the Defect Taxonomy would update severity tier definitions, add potential remedies that would align to the severity tiers, and add new defect areas for servicing loan reviews. In particular, the addition of remedies that explicitly correspond to each severity tier represents a major improvement in terms of the clarity that the Defect Taxonomy can bring to lenders, provided lenders are confident that HUD will consistently apply these remedies, which, as noted above, would be fostered by incorporating the Defect Taxonomy into HUD Handbook 4000.1.

Below, we provide our comments and recommendations regarding the applicability of the Defect Taxonomy to HUD's internal enforcement mechanisms, as well as specific comments related to both the proposed origination and servicing sections. Specifically, we recommend that the Defect Taxonomy be amended to provide the mortgage industry with a clear statement of what it is intended to be: the national standard the Department will uniformly apply for its compliance monitoring and enforcement processes. The existing disclaimers should be replaced with such a statement and pared back, if not removed.

A. Defect Taxonomy Applicability

Our overarching concern with the proposed amendments to the Defect Taxonomy is that the document continues to be limited to loan-level violations of FHA requirements and does not address HUD's potential pursuit of administrative sanctions for patterns of violations, fraud, misrepresentation, or program abuse or referrals by HUD of any violation of any severity to its Mortgagee Review Board, Enforcement Center, other HUD office, or Office of Inspector General. It is also unclear what HUD is referencing with the statement on page 3 that the Defect Taxonomy does not "[l]imit FHA's actions with regard to fraud or misrepresentation," particularly given the multiple references to fraud and misrepresentation throughout the Defect Taxonomy. As such, this statement should be removed, as it will cause confusion regarding the applicability of Tiers 1 and 4 and the associated remedies.

We also believe that the administrative sanctions that HUD imposes on an approved mortgagee for violations of FHA requirements should not depend on the division or group within HUD that brings the enforcement claim. Otherwise, there is the possibility of inconsistent application of these principles and the possibility of the mortgagee being sanctioned twice for the same violation by different divisions within HUD and in different ways.

Importantly, without clarity as to consistently applied measures and remedies, the Defect Taxonomy lacks the ability to provide lenders with the certainty necessary to increase lender

participation in the FHA program and improve access to credit through this important loan product. For this reason, we believe that the Defect Taxonomy should provide the mortgage industry with a statement of the national standard the Department will apply uniformly for compliance monitoring and enforcement processes. In connection with the Defect Taxonomy and separately, HUD should publicly articulate the standards it will follow in pursuing fraud or misrepresentation, as well as a pattern and practice of violations by a mortgagee and other systemic findings. Again, these changes in no way limit HUD's ability to properly enforce and apply discretion in determining remedies within the identified ranges.

Additionally, as noted above, there must be a harmonization of outcomes between and among the annual and loan-level certifications, the Defect Taxonomy, and the full scope of HUD's enforcement authority to ensure that violations that do not impact a loan's eligibility for insurance do not rise to the level of a false certification, a Tier 1 or Tier 2 violation, or a basis for other severe administrative sanctions or referrals by HUD. For example, we recommend that Tier 3 of the Defect Taxonomy expressly state that these violations will not render the loan ineligible for FHA insurance. Moreover, for Tier 4 violations, we recommend that FHA clarify that the "could not have known" standard is based on information a lender could not have known through a reasonable underwriting and quality control process.

B. Origination Section

With regard to the proposed amendments to the origination section of the Defect Taxonomy, we very much appreciate the differentiation among violations based on perceived level of severity, which more clearly delineates those violations that HUD views as rendering the loan ineligible for insurance, *i.e.*, those issues for which HUD will pursue indemnification. We also appreciate that the proposed amendments to the origination section would create greater consistency in the severity tier definitions across the defect areas. We also support the proposition that the imposition of any remedies is at the discretion of HUD and not mandatory, which we believe gives HUD the flexibility to consider individual circumstances, and reiterate the importance of lenders having the opportunity to respond to preliminary findings before FHA imposes any remedies.

In addition to the proposed changes announced by HUD, we would recommend additional amendments to: (1) take into consideration loan performance for a set length of time after origination as an indication of effective underwriting; (2) clarify and expand upon certain potential remedies; and (3) provide a formal feedback and "cure" mechanism for findings in Tiers 3 and 4. We discuss each in more detail below.

1. Loan Payment Performance Standard

Specifically, we would recommend that HUD look to those portions of the Fannie Mae and Freddie Mac ("Government-Sponsored Enterprise" or "GSE") representations and warranties and remedies frameworks issued in 2013, 2014, and 2016 that lessen or eliminate the risks and remedies for loan defects where there is satisfactory loan performance for a specific period of time. Under the GSE framework, loans that perform for the first three years following sale to the GSE are not subject to remedies, such as repurchase, for breaches of selling representations and warranties pertaining to underwriting, with certain exceptions and variations. The Defect Taxonomy also should take into consideration a borrower's timely payment history for a set length of time following origination, as a timely payment history

indicates that the underwriting was effective and accurately determined the borrower's ability to pay. Our proposed framework is as follows:

- FHA will not pursue penalties/indemnification for a "Seasoned Loan"[4] with a Tier 1 or Tier 2 violation of FHA's single-family underwriting and eligibility requirements with respect to:
    - the borrower, which includes the lender's assessment of the borrower's credit history, employment and income, assets, and other financial information used for qualifying the borrower for the loan;
    - the subject property, which includes the lender's analysis of the description of condition, marketability, and valuation of the property to determine its adequacy as collateral for the mortgage transaction; and
    - the project in which the property is located, which includes the lender's analysis of the condo, co-op, or Planned Unit Development project in accordance with FHA's requirements.

This three-year "sunset" provision would reinforce FHA's existing practices for early delinquencies and thereby offer explicit guardrails for lenders that would encourage greater participation and improve responsible access to credit, a benefit seen in other loan portfolios.

2. Further Amendments to Potential Remedies

Regarding the remedies identified in the Defect Taxonomy, we recommend that the Department consider implementing the following recommendations.

First, Tier 2 indemnification should applied as five years from date of endorsement – rather than indemnification for the life of the loan.

Second, with regard to the Borrower Assets section, the relationship among the three bullets in Tiers 2 and 3 is unclear. Additional clarity is needed regarding how FHA determines that "the borrower was not likely to accumulate sufficient funds," and what constitutes "strong indication the funds were from an unacceptable source," as those standards are highly subjective and ill-defined.

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[4] A "Seasoned Loan" would be defined as a loan closed by an approved lender on or after the date of HUD's initial enactment of the Defect Taxonomy on June 18, 2015 and that meets specified performance standards as follows:

- With respect to the first 36 monthly payments due following the loan's closing date, the borrower:
    - other than FHA refinance loans,
        - had no more than two 30-day delinquencies,
        - had no 60-day or greater delinquencies, and
        - is not 30 or more days delinquent with respect to the 36th monthly payment.
    - For FHA refinance loans, the earlier of
        - With respect to the first 12 monthly payments due after the loan's closing date, the borrower had no 30–day or greater delinquencies.
        - With respect to the first 36 monthly payments due after the loan's closing date, the borrower
            - had no more than two 30-day delinquencies,
            - had no 60-day or greater delinquencies, and
            - is not 30 or more days delinquent with respect to the 36th monthly payment.

Finally, we note that the Tier 2 remedy of "documentation of compliance at the time of underwriting" is a difficult standard to meet from an operational perspective. A lender may be able to demonstrate that documentation existed at the time of underwriting, but it will be challenging to show that the lender was "in compliance," at that time. For example, it is not clear how the TOTAL Scorecard can be run after closing when the credit report has expired. We recommend amending this language to "documentation that the mortgagee fulfilled the compliance standard in effect at the time of underwriting."

3. Formal Feedback Mechanism for Tier 3 and 4 Findings

In addition to the above recommendations, we continue to request that FHA update the Defect Taxonomy and implementing Loan Review System to include a mechanism that allows lenders the option of submitting a response to findings in Tiers 3 and 4, even if only for later consideration if necessary, as they currently do for findings in Tiers 1 and 2. While we recognize that in many cases, a lender may not seek to appeal or address the distinction between lower tiers, or the accuracy of a finding in these tiers, the lender should have the option to do so. This would create a feedback loop to calibrate and correct tier-ratings through "adjustments" rather than "mitigation," which is particularly important if FHA will ultimately factor these deficiencies into each lender's scorecard or other measurement of compliance. It is important that this functionality be a part of the Loan Review System to ensure that actions taken to address the deficiency are connected directly to the case at issue, rather than through an opaque and indirect process that calls on an already overtaxed FHA Resource Center.

C. Servicing Section

With regard to the newly-proposed section of the Defect Taxonomy that covers servicing activities, we appreciate HUD's attempt to include servicing in the proposal; however, the proposed provisions on servicing are not yet fully developed and do not provide clarity and certainty with regard to servicing deficiencies. Below, we set forth our specific concerns regarding the proposed servicing defect categories and potential remedies. As a result of these significant concerns, we respectfully request that the servicing portion of the Defect Taxonomy be removed from this issuance and that it evolve separately and in tandem with coming amendments to the FHA servicing regulations that will better reflect well-established servicing standards in the market.

1. Concerns Regarding the Proposed Servicing Defect Categories

The four Servicing Defect Areas identified by HUD in the proposed Defect Taxonomy, including the Sources and Causes, cite the language currently in the Handbook; however, the criteria that define severity tier levels is ambiguous and subjective. For example, FHA uses language in Tier 2 regarding processes that failed to comply with guidelines "by a large degree based on tolerances determined by FHA," but does not define those tolerances or degrees. The proposed Defect Taxonomy does not provide any examples of servicing violations that would fit into each tier. Additionally, the terms "delinquent" and "default" appear to be used interchangeably; however, those terms have different meanings in FHA requirements.[5]

[5] We also note that the HUD Handbook citation on page 28 regarding 203(k) transactions in the General Servicing section should be "4000.1 Section II.A.8.a.xx."

In addition, the servicing defect categories do not reflect any set of Quality Control procedures or Quality Assurance audit practices used by HUD, nor do they address any interplay with the HUD claims process, where some level of additional review of servicing practices is performed by FHA and consequences for noncompliance, such as debenture interest curtailment for missed foreclosure deadlines, are imposed. It is unclear how, under this guidance, determinations of noncompliance will be made consistently across HUD audit teams and Homeownership Centers. Unlike in the origination context, in which HUD has routinely audited and provided feedback to the mortgage industry regarding its standards and potential penalties for noncompliance, FHA's record on penalties for servicing violations is not as fully formed. Without reference to an internal governance process that FHA uses to evaluate and categorize servicing defects, the Defect Taxonomy, as proposed, offers little additional clarity regarding this process. The proposal increases uncertainty regarding how the Department will impose penalties for servicing defects.

The vagueness of the severity tier descriptions in the servicing section adds to the ambiguity regarding how HUD will enforce its servicing requirements. It is also unclear which servicing requirements HUD intended to reflect in each of the defect categories. For example, it is not clear whether property preservation and claims requirements were intentionally excluded from the Defect Taxonomy or were intended to be covered by one of the other proposed categories. Such clarity is necessary to ensure operational aspects of servicing are aligned to the Defect Taxonomy's categories.

2. Concerns Regarding the Proposed Penalties for Servicing Defects

The proposed penalties for servicing violations are misguided for several reasons. First, and most importantly, the penalties suggested for violations of servicing requirements, which include broad references to indemnification for Tier 1 and 2 violations, are not permissible under the National Housing Act's "incontestability clause,"[6] and/or HUD's servicing regulations, which clearly state that failure to comply with the subpart governing servicing responsibilities "shall not be a basis for denial of insurance benefits."[7] Second, the proposed penalties rest on whether a claim has been filed, rather than on a developed FHA Quality Assurance process, as discussed in detail above. We disagree with this approach, as the availability of remedies should not hinge on whether HUD expects to pay a claim, but instead should be tied to the error itself. It is also unclear how HUD would determine consistently whether a claim is likely, given the fluidity of delinquent servicing.

Third, the proposed penalties are not proportionate to the errors identified in the defect tiers. For example, demanding full refunds of partial claims regardless of whether the FHA Mutual Mortgage Insurance Fund experiences a loss could result in significant penalties for servicers where no harm occurs to HUD. Finally, the proposed penalties do not reflect that

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[6] The National Housing Act provides that "[a]ny contract of insurance heretofore or hereafter executed by the Secretary under this subchapter 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 in the hands of an approved financial institution or approved mortgagee from the date of the execution of such contract, except for fraud or misrepresentation on the part of such approved financial institution or approved mortgagee." 12 U.S.C. § 1709(e).

[7] 24 C.F.R. § 203.500. We also note that, unlike the origination section, the proposed servicing section of the Defect Taxonomy does not distinguish between life-of-loan and 5-year indemnification periods.

servicing a loan is fundamentally different than originating a loan. While origination is a finite decision point that occurs after a relatively short underwriting and closing process, a servicer can have an extended relationship with the borrower – a relationship that may be transferred to multiple loan owners and servicers during the loan term. Holding current servicers responsible for the errors of prior servicers is unfair. This will detract from the liquidity of mortgage servicing rights and harm the market value of those assets.

3. Recommendations for the Servicing Defect Taxonomy Proposal

As noted in many communications with FHA, the existing servicing regulations do not reflect current industry standards or the realities of modern servicing practices. Before any Defect Taxonomy can be applied, the existing FHA servicing regulations need to be amended. With amended regulations that reflect current servicing standards, the Department will be better able to design a servicing Defect Taxonomy that provides clear guidance regarding the activities that constitute servicing violations and better define the degrees and tolerances referenced for the various tiers. For these reasons, and because of the significant concerns we have set forth above regarding the proposed servicing section of the Defect Taxonomy, we respectfully request that this section of the Defect Taxonomy be removed and be replaced with a commitment that it evolve separately. HUD should re-propose this section in tandem with coming amendments to the FHA servicing regulations that will reflect current servicing standards. We look forward to continued engagement with FHA as it develops these important servicing standards.

IV. CONCLUSION

We thank the Department for the opportunity to comment on the proposed amendments to the loan-level certifications and Defect Taxonomy announced by HUD on May 9, 2019. We would welcome the opportunity to meet with HUD representatives to discuss the proposed amendments to the loan-level certifications and Defect Taxonomy, as well as the recommendations set forth in this letter, in greater detail. If you have any questions regarding our recommendations, please feel free to contact ABA's Rod Alba, Senior Vice President for Mortgage Markets at (202) 663-5592; HPC's Meg Burns, Senior Vice President for Mortgage Policy at (202) 589-1926MBA's; Fran Mordi, Associate Vice President for Tax, Accounting, and Financial Management at (202) 557-2860; or BPI's Naeha Prakash, Senior Vice President and Associate General Counsel at (202) 589-2429.

Thank you for your consideration.

Sincerely,

Housing Policy Council
Mortgage Bankers Association
American Bankers Association
Bank Policy Institute