CONSUMER INFORMATION
4-20-00

Mortgage escrow accounts

1. What is a mortgage escrow account?

This is an amount of money maintained at a lending institution in order to pay the annual taxes and insurance on mortgaged property. Approximately one-twelfth of the estimated annual cost of taxes and insurance is paid into the account each month from the borrower's monthly mortgage payment. Then the lending institution pays the taxes and insurance from this account when they are due. An escrow account is required by many lending institutions in order to insure that the taxes and insurance premiums are paid on time.

It is, in a sense, a budgeting device which requires borrowers to set aside enough money to pay their taxes when due. If there is not enough money in the customer's escrow account at the time of tax payment, sometimes lenders will advance the funds at no charge, and allow the customer to pay back the advance through higher escrow payments.

Escrow accounts also reduce tax collection costs for local governments. The lending institution usually makes one large tax payment to each tax collector, which saves the government the cost of collecting many small checks from individual borrowers over a period of time.

2. Do I have a choice about whether to maintain an escrow account?

The lender usually decides whether you must maintain an escrow account, but sometimes government regulations leave the lender no choice. The Federal Housing Administration (FHA), for example, requires that lenders making FHA insured loans establish escrow accounts on those loans. The Veterans Administration (VA) does not require that escrow accounts be maintained on all VA-guaranteed home mortgages, but most lenders do.

Mortgage loans other than FHA and VA-loans are generally known as conventional mortgages. Conventional mortgage loans are made by mortgage companies, banks, savings banks, and some credit unions and are of two types – prime and sub-prime mortgages. For each type of conventional mortgage loan, the lender decides whether to require an escrow account. Most conventional loan contracts contain escrow clauses, especially those with very low down payments. The lender may also take into consideration the customer's previous payment record. And even if a lender does not require it, some borrowers may prefer to maintain escrow accounts because they view escrows as convenient budgeting devices.

3. Do lenders pay interest on escrow accounts?

Few, if any lending institutions in Michigan pay interest on the money in an escrow account. Many borrowers feel that they are entitled to share the interest that the lender earns by investing these tax and insurance funds. If an escrow account were not required, a borrower could deposit tax and insurance money in an interest-bearing account until a payment was due.

There is one method of escrow collection in which the portion of the borrower's monthly payment required to pay taxes and insurance is deducted each month from the balance owed on the mortgage. Then, when the institution makes a tax or insurance payment for the customer, the amount of the payment is added back to the principal balance. Since this reduces the amount of loan interest that a customer pays, it amounts to earning interest on escrow balances at the same rate of interest as on the mortgage loan. This method is sometimes called escrow capitalization and, although beneficial to consumers, it is seldom used by lending institutions today because of its high cost.

4. What happens when the lender doesn't pay taxes on time?

A lending institution must pay the taxes in full if the escrow account balance is enough to cover the payment due. If there is enough money in the account and the lender fails to pay the taxes when due, it is liable to the customer for all penalties or fees incurred because of the failure to pay. Borrowers generally can tell whether taxes have been paid on time because lenders are required to send escrow account statements listing deposits and disbursements. An institution must send these statements at least once a year, but may instead choose to include information about the escrow account balance in the monthly billing statement.

5. What happens as taxes increase or new taxes are assessed?

When taxes increase, an escrow account may run short unless the money payment is adjusted. When the tax increase is large, which might occur with a millage increase, a special assessment for street improvements, or a new home assessment, a borrower may not be able to meet the added expense right away. Lending institutions generally recognize this and usually notify the borrower of the date and the amount of the increase. The borrower then has the option of paying the increase all at once or paying it in installments after the next payment adjustment date.

6. Are there limits on how lenders handle escrow accounts?

Federal law allows institutions which include escrow provisions in their mortgage contracts to collect the amount needed to pay for taxes and insurance plus one-sixth over that amount. This is important because many lending institutions do not require the excess deposits, while others require varying amounts up to the limit. The main purpose for this practice is to prevent a deficiency from occurring in an escrow account as taxes and insurance rise from year to year. The larger collection also helps to insure that the institution will be able to make each tax payment when it is due in the event that a borrower is unable to make a monthly payment on time.

Escrow payments are accounted for using a process called the "zero balance" method – so called because at some point during the year, the balance in the escrow should approach zero. In the following example, the monthly escrow payment of $66.67 is calculated by adding all the tax and insurance payments for the year together to total $800, and dividing by twelve.

ZERO BALANCE METHOD

Date	Description	Borrower's Monthly Escrow Payments	Lender's Disbursements	Total Escrow Balance
12-31-99	Year-End Balance			$33.35
1-1-00	Escrow Payment	$66.67		100.02
2-1-00		66.67		166.69
3-1-00		66.67		233.36
3-1-00	Insurance Premium		$200.00	33.36
4-1-00		66.67		100.03
5-1-00		66.67		166.70
6-1-00		66.67		233.37
7-1-00		66.67		300.04
7-1-00	School Tax		$300.00	.04
8-1-00		66.67		66.71
9-1-00		66.67		133.38
10-1-00		66.67		200.05
11-1-00		66.67		266.72
12-1-00		66.67		333.39
12-1-00	Winter Tax		$300.00	33.39

Average Monthly Escrow Balance = $125.04
Total of Monthly Payments = $800.04
Total Taxes and Insurance Paid = $800.00