The Business of Providing Escrow

The primary mission of an escrow administrator is to ensure that the properties underlying its clients' first-lien mortgages are properly insured and that those properties' insurance premiums and tax liabilities are always paid in full and on time.

Until recently the federal government required escrow accounts only for first mortgages that are Federal Housing Authority-insured. However, the recently amended Regulation Z now requires escrow accounts be established for first liens that originated on or after October 1, 2009 and that meet the new "higher-priced mortgage loans (HPML)" designation.

In broad brush, a first lien is considered an HPML if it is secured by residential property and its APR exceeds the Average Prime Offer Rate by 1.5 percentage points at origination. While it's too soon to know, it appears this requirement will most probably apply to jumbo loans, first-lien home equity loans, small mortgage loans, loans with private mortgage insurance, and first-lien loans with no up-front closing costs.

Regulation Z requires that escrow accounts be set up for first-lien HPML property insurance, property taxes, and, if required by the lender, private mortgage Insurance (PMI).

Assuming a loan neither is FHA-insured nor qualifies as an HPML, lenders and subsequent mortgagees otherwise are not compelled to offer escrow services.

Reasons to Offer Escrow

As noted, the idea behind offering escrow accounts is to ensure a borrower remains current on property insurance premiums and property taxes.

By blending a portion of the insurance and tax payments due with the loan's monthly principal and interest payments due, the mortgagee encourages good payment patterns. Borrowers are able to focus on meeting one, predictable, monthly nut. The stress of having to prepare for large—and likely increasing—payments every three, six or 12 months, is removed.

Of course, that convenience applies only to borrowers who are current on their loans. For borrowers who are delinquent, the addition of a monthly escrow commitment offers no such benefits. But establishing an escrow account for these borrowers does serve the purpose of preserving the mortgagee's right to keep the property in saleable shape and unencumbered by tax liens.

That's why Franklin Credit Management Corporation establishes an escrow account, or, as it may otherwise be known, an "impound account", for most any delinquent first mortgage that does not already have escrow. Whether full borrower monthly payments arrive or not, Franklin Credit disburses tax payments and insurance premiums for these accounts to ensure that tax liens do not compromise lien position and insurance coverage does not lapse.

THE COST OF OFFERING ESCROW

Aside from calculating obligations and reserves and tracking advances on behalf of the borrower, escrow also requires active diligence. Who pays for it all?

Escrow processing fees may be charged in other industries, particularly when the funds must be held by an objective third-party, but when a mortgagee escrows for insurance and property taxes, the only fee imposed likely will be at origination and then, only to contract with a tax service that will monitor tax payment delinquency for the life of the loan.

There are some incidental costs during the life of the mortgage that may be passed along to the borrower (e.g., a fee for providing a duplicate tax bill when the taxing authority requires), but generally, when it comes to mortgages, escrow is provided free of charge.

THE COSTS OF NOT OFFERING ESCROW

The primary reasons for offering escrow may well be the costs of *not* offering escrow.

As noted, for current accounts, escrow encourages the loan repayment process to chug along at a steady pace. Couple the affordability and predictability of monthly billings with an automatic debit program, such as Franklin Credit's automated clearing house (ACH) program, that assures borrowers of a convenient, reliable way of making their regular payments, and the mortgagee's loan portfolio should benefit from lower delinquency risk and a more predictable income yield.

For delinquent accounts, escrow may slightly add to delinquency risk and negatively impact yield. But the escrow account permits the escrow provider to advance funds on behalf of the mortgagee to greatly reduce the chance that insurance coverage will lapse or that taxes will go unpaid. The mortgagee reimburses the escrow provider for the funds advanced—if the borrower fails to make escrow payments thereafter, the amount is added to the borrower's total debt. The mortgagee's advance thus is seen as an investment that pays off should the mortgagee ever need to liquidate the loan's underlying asset.

FUNDAMENTAL CHALLENGES

The fundamental challenges to providing escrow, then, are to accurately gauge the advances a mortgagee must make on behalf of its borrowers and schedule repayments that are feasible for each borrower, while meeting insurers' and tax authorities' deadlines—all to ensure the mortgagee's collateral remains free of encumbrance and eligible for insurance claims.

That there are some several thousand property, hazard, flood and mortgage insurers, as well as 3,413 county and parish tax authorities, nationwide presents some logistic complexity.

Consider also that a single property may be subject to demands from several taxing authorities other than the county—the city, school district and/or regional sewerage commission may be represented as well. Each authority will bill on a quarterly, semi-annual, or annual basis. A borrower may be required to pay taxes to the county in the fall and taxes to the city in the spring. Payment requirements can be more nuanced yet: If the borrower is current on his taxes, he may be required to pay the next installment to the city, but if delinquent, make any payment to the county instead. (Sounds unlikely? It happens in Detroit, MI).

SECONDARY CHALLENGES

Logistic complexity is a challenge that can be greatly reduced by automation, but there are many other aspects to providing escrow that require constant monitoring if a mortgagee is to provide escrow services responsibly.

For instance, tax payments can be jeopardized when there is a miscommunication between the borrower and the escrow servicer. Many taxing authorities will accept a tax payment only when it is accompanied by an official bill. Late payment can result when a borrower forgets to forward their original bill to the escrow servicer on time. Payment may arrive even later should the taxpayer misplace the tax bill—in this instance, the escrow servicer may be required to step in and request a duplicate of the official bill from the tax authority. The escrow servicer needs to actively monitor communications from the borrower.

Private Mortgage Insurance (PMI). PMI can benefit the borrower and the mortgagee, but both parties must observe the conditions set forth in the insurer's policy. Indeed, the insurer is likely to cite work rules by which the mortgagee, and its mortgage servicer, must abide.

The rules can be so demanding as to require manual intervention in what might otherwise be an automatable process. For instance, one PMI insurer requires the mortgagee notify it when a borrower commits "early default", which the insurer defines as missing any one of the first 12 monthly payments following the loan's origination. The insurer may make other stipulations, e.g., "When an early default occurs, a Notice of Default (NOD) must be reported to (the insurer) within 15 days after the second payment is due."

Other insurer requirements may cover the format and submission process for NODs; monthly reporting of loan delinquency; procedures to follow when the property is occupied by a tenant; credit reporting (e.g., "once the loan is 75 days past due, the entire loan history must be reported to the three major credit repositories."); and steps in pursuing foreclosure and bankruptcy accounts.

Insurer requirements for sub-prime loans are more stringent yet, defining when a newly delinquent borrower should be called, how often calls should be placed until a promise to pay is obtained, when property inspections should be ordered, and what loss mitigation options should be made available and when. In fact, many insurers provide an approval matrix outlining the workouts, authority levels, and reporting rules that the mortgagee (and its mortgage servicer) should observe. At least one insurer issues a guide to its required "Foreclosure Bidding Instructions by State".

For these reasons, when it comes to processing PMI escrow it is wise to engage an escrow servicer that actively reviews insurer requirements and communicates those requirements to the mortgage servicer.

There's another aspect to PMI that requires attention: As regulated by the 1998 Homeowner' Protection Act and the 2000 Private Mortgage Insurance Technical Corrections and Clarification Act, PMI must be cancelled when a borrower's equity in the property reaches 22 percent of the original loan balance. Or at the latest cancelled when the loan reaches the midpoint of the amortization period, e.g., after 180 payments on a typical first mortgage. Of course, these rules apply only if the borrower is current.

Hazard Insurance. When it comes to hazard insurance, a significant concern for the mortgagee is whether the borrower will miss payments. Your escrow servicer should be able to promptly determine whether a borrower's insurance policy has lapsed and, if necessary, expedite the imposition of forced-place insurance.

Flood Insurance. The mortgagee will want to be sure that the property's flood zone information is up-to-date and that its flood insurance coverage meets Federal Emergency Management Agency requirements. When escrowed loans are boarded at Franklin Credit, flood zone information is checked against the prior servicer's records, but also against documents in the loan servicing file.

Property Damage Claims. When borrowers make claims for insurance relief after their property is damaged, the mortgagee would do well to keep a tight rein on any resulting insurance company pay-outs. All insurance award checks must be countersigned by the mortgagee or its escrow servicer. Franklin Credit countersigns, but then holds the funds back in a "loss draft" account: The first third of the funds is released to the borrower or their authorized contractor upon receipt of the contractor's repair estimate, the second third is released once our inspector confirms the project is 50 percent completed, and the remaining third is released to the borrower or contractor once our inspector confirms the project has been completed.

Tax Liens. A potential hidden cost of escrow is the cost of administering the function incorrectly. For instance, if a borrower remains current on escrow payments but the escrow administrator somehow fails to make timely tax payments, it is conceivable a tax lien could be imposed and encumber the lien position when the borrower goes to sell the property. The escrow provider might then be liable for damages to the borrower. Similarly, should a borrower miss payments sufficient to trigger foreclosure, the mortgagee's rights would be secondary to any tax lien.

Overfunded Excess Accounts. As noted, RESPA requires that an escrow account analysis be performed once yearly. Once the account's required current balance has been determined, any surplus above $50 must be refunded to the borrower within 30 days of the analysis.

Interest on Escrow. Currently, 14 states require that the mortgagee pay interest to a borrower when the borrower's escrow balance is positive. The states specify the minimum interest rate that should be applied and also the frequency of application—four states require the interest be paid to the borrower quarterly, one requires semiannual payments, and the remaining nine, annual payments. If the amount is greater than $10, the mortgagee (or its escrow servicer) is obliged to issue the borrower a form 1099-INT and report all such forms' issuance to the IRS.

Escrow Laws and Regulations. Escrow requirements vary from state to state and can even vary *within* the state. For instance, in California, depending on their primary real estate business, escrow servicers must answer to one of five different state regulators. While the bulk of escrow servicers answer to the Department of Corporations (DOC), which conducts background and fingerprint checks; professionals who research titles for the issuance of insurance policies are regulated by the Department of Insurance; real estate brokers who provide escrow services are governed by Department of Real Estate (DRE) regulations; banks, trust companies, and building and loan or savings and loan associations report to either the DOC or the DRE; and lawyers representing principals in real estate transactions but not actively engaged in the business of an escrow agent are regulated by the state bar.

DECIDING ON THE ESCROW SOLUTION

It is against this backdrop, then, that a mortgagee or a mortgage servicer must weigh the costs of providing escrow services itself, asking such questions as:

- When it comes to providing escrow, how much risk and responsibility should we shoulder ourselves vs. retaining (a) a tax specialist and an insurance specialist, or (b) an escrow servicing specialist who can navigate both realms?
- When it comes to property taxes, can we accurately determine tax delinquencies and negotiate payment intricacies from taxing authority to taxing authority, county to county, state to state?
- When it comes to homeowner's and forced-place insurance, can we accurately track policy lapses and speedily implement corrective measures?
- What will be required to ensure insurance claims are applied properly to each property's repair?
- Can we effectively analyze the escrow reserves required for the next 12 months, and promptly and accurately credit and report borrower interest earned on escrow?
- If we somehow fail to pay insurance premiums and tax levies for escrowed accounts on time, what legal recourse might our borrowers take?
- What degree of risk are we willing to assume should a tax lien encumber our ability to foreclose?
- Can we stay adequately abreast of changes to RESPA and other federal and state laws and regulations governing escrow services?

The advantages of providing escrow cannot be underestimated, but implementing escrow requires a substantial commitment to managing obligations, advances, and collections. It also presents real fiduciary responsibility. The only escrow servicers on your radar should be those readily prepared to address all of the above issues and similar ones.