

The Functioning and Regulation of Escrow Accounts

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Abstract

About 40 million Americans have mortgages serviced by escrow accounts. Yet escrow accounts are rarely covered by an explicit agreement between borrower and lender and are often poorly understood. As a result, escrow accounts have become the subject of growing controversy. Federal regulation of escrow accounts has become increasingly detailed and intrusive during the past two decades, and the subject is under almost continuous regulatory review. In the 1990s, the attorneys general of at least 10 states have sued large escrow account servicers over administration of accounts.

The purposes of this article are to explain briefly how escrow accounts work, benefit relevant parties, and are regulated by federal agencies, and to evaluate alternative regulatory programs. Most of the legitimate social goals of federal regulation could be achieved by requiring an explicit escrow agreement at the time of closing on a mortgage. A second-best requirement would be that interest be paid on escrow balances.

Introduction

Escrow accounts are the stepchildren of the mortgage business. Although most newly originated mortgages include requirements for escrow accounts and billions of dollars are invested in escrow balances, mortgage borrowers do not understand how escrow accounts work and why escrow payments increase so rapidly. Escrow accounts are rarely covered by an explicit agreement between borrower and lender. Instead of requiring an explicit agreement, as has been done for mortgage loans in general, Congress has increasingly regulated the details of escrow accounts. States have also become increasingly involved in regulation of and litigation over escrow accounts.

This article first explains how escrow accounts work and why they work as they do. It then explains the competitive nature of mortgage servicing and how servicers earn profit on their activities and discusses the benefits that escrow accounts provide to the relevant parties in the mortgage lending process. Finally, and most important, it traces and evaluates the increasingly

detailed pattern of escrow account regulation by the federal government.

What is an escrow account?

An escrow account consists of funds held by a third party, who collects, holds, and disburses the funds pursuant to a contract or an obligation between two parties. An escrow account for a home mortgage is held by the organization that services the mortgage.¹ The funds are paid into the escrow account by the borrower and are disbursed by the servicer to pay local real estate taxes, hazard insurance premiums, and mortgage insurance. Payments to the escrow account are made by the borrower to the servicer along with the monthly debt service payments, and the servicer makes timely disbursements of the funds to tax collection agencies and hazard and mortgage insurance companies.

An escrow account is a voluntary agreement between mortgage borrower and lender. Most borrowers who can qualify for a mortgage with an escrow account can also qualify for a mortgage without one. However, escrow accounts provide important protection for investors in mortgages in the secondary market. For most borrowers, a mortgage that does not require an escrow account carries a substantially higher interest rate than one with an escrow account. Basic economic principles suggest that these accounts exist in the competitive mortgage servicing market because the parties to the agreements receive benefits that exceed the costs of the resources devoted to administering the accounts. Yet the conflict and litigation over escrow accounts, and the congressional concern with them, indicate deficiencies in the status quo. It is important to evaluate the issues, since inappropriately designed legislation could do more harm than good.

How escrow accounts work

Escrow accounts are more complex than most people outside the mortgage servicing business realize. This section briefly explains the functioning of escrow accounts.

The first kind of escrow payment is the *periodic payment*. Periodic payments are almost always made monthly. The monthly

¹ Three functions are performed in connection with a home mortgage: origination, servicing, and investing in the mortgage. All three functions may be performed by one organization, but nowadays they are frequently performed by different organizations.

check written by the borrower includes both the mortgage debt service and the periodic escrow payment. For virtually all escrow accounts, the periodic escrow payment equals one-twelfth of the tax and insurance disbursements that the servicer estimates will have to be made during the coming 12 months, plus or minus a prorated amount for remedying any shortage or overage in the account.

The second kind of escrow payment is a one-time payment made at closing, when the borrower purchases the home. The *closing escrow payment* consists of two parts. First is a *reserve*, equal to one or two months' periodic payments, to provide a balance that the servicer can use to pay the tax and insurance bills when they are due even if the borrower is delinquent in making periodic escrow payments. The second part of the closing escrow payment is an amount that, when added to the periodic payments, will be enough to pay tax and insurance bills when they are due.

To illustrate, suppose the annual tax and insurance bills will be due just one month after closing—that is, just after the borrower has made the first periodic payment (one-twelfth of the annual tax and insurance bills). In that case, the closing escrow payment should include the other eleven-twelfths. At the other extreme, however, suppose the annual tax and insurance bills will not be due until after the 12th periodic payment. In that case, the borrower will have paid the full amount of annual tax and insurance, and the second part of the closing escrow payment is unnecessary.

Much of the controversy regarding escrow accounts relates to the second part of the closing escrow payment. Disbursements that must be made from escrow accounts are due at different times and intervals. Tax bills may be due quarterly, triannually, or semiannually. Insurance premiums are normally due annually. There are two methods of setting the amount of the second part of the closing escrow payment.

Under the first method, the *single-item accrual* method, the second part of the closing escrow payment equals the portion of the tax and insurance obligation that has accrued as of the closing date. For example, if the semiannual tax bill will be due two months after closing, then four-twelfths of the annual tax bill is payable at closing. Likewise, if an annual insurance premium is due four months after closing, then eight-twelfths of the annual premium is due at closing. "Single-item" refers to the fact that the accrual is calculated separately for tax and insurance and the sum of the two is due upon closing. The single-item

accrual method is the method most commonly used by mortgage escrow servicing organizations and by mortgage loan originators.

Under the second method, the *composite* method, the second part of the closing escrow payment is an amount that, at some time during the ensuing 12 months, will cause the escrow account balance to equal the reserve.

Under the composite method, the escrow balance falls to an amount equal to the reserve once each 12 months. Under the single-item accrual method, the part of the escrow account that represents each item (taxes and insurance) falls to an amount equal to the reserve once each 12 months. Thus, if disbursements for taxes and insurance are due at the same time (regardless of how many payments must be made per year), the single-item and composite methods require the same closing escrow payment. If disbursements are due at different times, the single-item method requires a larger closing escrow payment (regardless of how many payments must be made each year).

A simple example will make clear the difference between the single-item accrual and the composite methods:

The closing date is June 30. The annual insurance premium is \$1,200, and the entire amount is due on January 15. Taxes are \$2,400 per year—\$1,200 due on April 15 and \$1,200 on October 15. The reserve due at closing is $2(\$300) = \600 , whichever method is used. The periodic payment is $(\$1,200 + \$2,400)/12 = \$300$, whichever method is used. The closing escrow payment consists of the reserve plus the amount needed so that, with periodic payments, the account balance is adequate to make disbursements when they are due.

The second part of the closing escrow payment depends on which method is used.

Under the single-item accrual method, a \$1,200 insurance premium will be due after six monthly payments of \$100 each have been made for the insurance account. Thus half the premium, or \$600, must be paid at closing. In addition, a \$1,200 tax disbursement will be due after three monthly payments of \$200 each have been made for taxes. Thus half the required disbursement, or \$600, must be paid at closing. The total closing escrow payment is the reserve plus the amounts needed at closing for the next tax and insurance disbursements:
 $\$600 + \$600 + \$600 = \$1,800$.

Under the composite method, the biggest drain on the escrow account will occur on April 15, when the second semiannual tax payment will be due just three months after the annual insurance premium has been paid. By April 15, nine periodic payments will have been made to the escrow account and disbursements of \$1,200 for tax and \$1,200 for insurance will have been made. To meet the April 15 tax bill, a deposit of $\$1,200 + \$1,200 + \$1,200 - [9(\$300)] = \$900$ is required. Including the reserve of \$600, the total closing escrow payment will be \$1,500. With this payment, enough funds will be in the escrow account to meet the October 15 and April 15 tax bills and the January 15 insurance premium, and the escrow balance will just equal the reserve after the April 15 tax bill has been paid.

Thus, in this example, the escrow payment required at closing is \$1,800 under the single-item accrual method and \$1,500 under the composite method. Although the numbers in the example have been chosen partly for ease of calculation, the magnitudes are typical of those for a modest home.

If the borrower had not had to pay into an escrow account, he or she could have invested the amounts of the closing and periodic escrow payments. The cost of the escrow account to the borrower is the forgone interest on such an investment. In 1994 the forgone after-tax interest rate might be 3 percent, assuming the funds would have been invested in a passbook savings account or a money market account. (Such an investment must be extremely liquid, since most deposits will be needed for disbursements within one to six months.) With a 3 percent interest rate, the annual cost of the escrow account to the borrower in the example above is \$67.50 if the single-item method is used and \$58.50 if the composite method is used.² The escrow account is worthwhile to the borrower if the services it provides are worth more than the forgone interest. The difference in forgone interest between the two methods is \$9 per year.

Actual escrow payments differ from those in the example because of eccentricities in real estate tax collection procedures and because disbursements must be forecasted in advance. Inflation implies that disbursements increase almost every year,

² Whichever payment method is used, the borrower has a maximum of \$900 and an average of \$450 of periodic payments in the escrow account. The forgone interest on this amount is \$13.50 per year. Forgone interest on the closing escrow payment is $.03(\$1,500) = \45 if the composite method is used and $.03(\$1,800) = \54 if the single-item method is used. Thus, total forgone interest is $\$45 + \$13.50 = \$58.50$ if the composite method is used and $\$54 + \$13.50 = \$67.50$ if the single-item method is used.

so both reserves and periodic payments must be increased. The result is some conflict between borrowers and servicers.

Basic economics of mortgage servicing

The separation of mortgage-related activities during the past 20 years so that separate institutions originate, service, and invest in mortgages has resulted from government deregulation of financial markets and the availability of powerful and inexpensive computers. The result is that business entry is relatively free in all three mortgage-related activities. Although there are economies of scale and very large firms in all three activities, all three activities are highly competitive. The largest servicing firm services only about 2 percent of outstanding home mortgages.

In addition to managing escrow accounts, mortgage servicers receive debt service payments, disburse funds, keep records, foreclose mortgages, provide oversight for hazard repairs, issue statements, and answer borrowers' inquiries. Servicers find that clear monthly statements and annual analyses help minimize costly inquiries by borrowers.

Sophisticated modern computers and software enable a single organization with a modest number of employees to service thousands of mortgages. Likewise, organizations that service large numbers of mortgages can purchase sophisticated software and employ professionally trained people to explain escrow transactions to borrowers, answer questions, and deal with complaints while the borrower is on the phone. The increased economies of scale resulting from computerization have motivated originators to negotiate contracts with large organizations that specialize in servicing mortgages.

Mortgage servicing requires valuable resources and therefore costs money. Servicing costs are paid partly by fees from originators, partly by the difference between the mortgage's interest rate and the servicer's borrowing rate during the short period for which the servicer may "warehouse" the mortgage prior to its sale to an investor, partly by a fee collected from the buyer of the mortgage, and partly by late charges and other fees occasionally collected from borrowers. Escrow account balances are not profitably invested, but they are used to reduce the funds that servicers need to have forwarded from banks or other sources.

Advantages of escrow accounts

Basic economic principles suggest that for escrow accounts to survive in competitive mortgage markets, all parties to the agreements must benefit. The relevant parties regarding escrow accounts are the borrower, tax collection agencies, hazard and mortgage insurance companies, investors, and servicers who administer escrow accounts pursuant to agreements made by originators.

Borrowers

There have been no quantitative studies of the benefits of escrow accounts to homeowners. It is tempting for an economist to conclude that if the market is competitive and survives for long periods, the consumer benefits must exceed the \$55 to \$70 annual cost of forgone interest for typical escrow accounts.

Evidence that there are unmeasured disadvantages to escrow accounts consists of occasional unfavorable accounts in the press, persistent litigation, and national and state interest in legislation that would impose additional regulations on escrow account administration. However, statements filed in litigation and conversations with government officials indicate that many people concerned with escrow account controversies do not understand the benefits escrow accounts provide to borrowers. Undoubtedly, the largest benefit to borrowers is that escrow accounts provide security to investors in mortgages in the secondary mortgage market, thus permitting mortgages to trade in that market at lower interest rates than investors would otherwise require. In addition, servicers of escrow accounts provide four specific benefits to borrowers.

First is assistance in budgeting. Each month, the borrower makes one payment, which covers not only mortgage debt service but also prorated real estate tax bills and insurance premiums on the dwelling and mortgage. An escrow account not only permits the homeowner to write only one check per month but also ensures that amounts in the account will be adequate to cover insurance premiums and property tax bills when they are due and that the disbursements will be made in timely fashion. Thus homeowners' payments do not vary frequently, and there is no need to put aside extra money in months when bills and premiums are not due so that enough money will be available when they are due. Escrow accounts also simplify borrower budgeting by providing a buffer against changes in tax liability and

insurance premiums. If taxes increase, for example, the homeowner can spread the higher payments to the escrow account over as many as 12 months, avoiding the need to accumulate additional funds in anticipation of the larger tax bill. Servicers systematically estimate tax and insurance premium increases on the basis of past trends.

The second service provided to borrowers is record-keeping and the rendering of statements. Servicers who administer escrow accounts typically send borrowers periodic statements of payments to and disbursements from the escrow account. Thus the homeowner knows just how much has been paid for taxes and home insurance and can use the statements for tax purposes and for general financial planning and analysis.

The third service provided by organizations that service escrow accounts is information. Borrowers can turn to professionals for explanations and answers to questions.

The fourth service is protection during financial stress. Even though a borrower is late in making a periodic payment or a check is lost or delayed, the servicer pays tax bills and insurance premiums on time. This fiduciary responsibility of servicers sometimes prevents disastrous situations.

Property tax collection agencies and insurance companies

Local property tax collection agencies and hazard insurance companies are also beneficiaries of the services provided by escrow accounts. First, they typically receive a small number of relatively large checks from escrow account servicers, sometimes by tape-to-tape transfer, instead of a large number of small checks from individual homeowners. The result is lower processing costs. Payments are accompanied by statements that facilitate accurate crediting of accounts. Second, escrow account servicers often pay tax and insurance obligations even if the escrow account contains inadequate funds. Thus they enable homeowners to avoid penalties and property tax collectors and insurance companies to avoid expensive payment delays and collection procedures.

Investors in mortgages and mortgage-backed securities

The investor's asset is the mortgage that the escrow account services. Investors buy mortgage-related securities at low

interest rates only if the mortgage is protected. Only then can they invest in such securities without independent evaluation of the quality of the mortgage. Investors must be certain that the dwelling is protected from hazards and from liens by tax collection authorities. Escrow accounts and the fiduciary responsibility of servicers to pay tax and insurance bills on time assist in the smooth and low-cost functioning of markets for mortgage-related securities. Although studies have estimated that the secondary mortgage market has resulted in lower mortgage interest rates to borrowers, there has been no estimate of how much of the interest rate savings is the result of escrow accounts.

Mortgage servicers

Mortgage servicers receive a large part of their revenues from the fees and interest savings permitted by escrow accounts. In an accounting sense, mortgage origination loses money, and servicers make their competitive returns from their servicing activities. The implication is that additional regulatory requirements on servicers, such as further limitations on escrow balances or a requirement that interest be paid on escrow balances, would impose costs on servicers that would have to be recovered via higher interest rates and other charges on borrowers.

The following sections briefly describe existing and proposed federal escrow account regulations. The article concludes with my evaluation of the need for additional regulation.

Federal regulation of escrow accounts

The basic federal government legislation that regulates escrow accounts is the Real Estate Settlement Procedures Act of 1974 (RESPA), as amended. It applies to mortgages bought by Fannie Mae and Freddie Mac and to mortgages insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA).³ It is safe to suggest that nearly all mortgages are originated consistent with RESPA's terms and with mortgage documents issued by federal agencies. Rules issued pursuant to RESPA and mortgage documents are complex and detailed; this section is intended only to provide their general outlines. (For a more detailed statement, see U.S. Department of Housing and Urban Development [HUD] 1991 and 1992.)

³ The Government National Mortgage Association buys only FHA and VA mortgages, so no separate rules apply to mortgages it purchases.

Here, the term *rules* will be used regardless of their precise source.

Rules permit the originator to set monthly payments to escrow accounts equal to one-twelfth of annual tax and insurance obligations, as reasonably forecasted by the servicing organization. HUD (1991, 1992) reports that some servicers set payments so that amounts to be disbursed accrue one month before the disbursement date, and some set payments so that amounts to be disbursed accrue only by the month in which the disbursement is due. The language in the rules, as well as analysis by HUD and court findings, indicates that both the single-item and composite methods discussed above are consistent with all rules. The issue is nevertheless still being litigated (Attorneys General 1990; *Sanders v. Lincoln Service Corporation* 1991).

Rules require that disbursements be made by due dates or before penalties are incurred. All rules permit or do not prohibit the accumulation of reserves up to no more than one-sixth of the annual forecasted disbursement amounts. Reserves can be increased proportionately as forecasted disbursements increase.

Rules also cover excesses and deficiencies in escrow payments. If current payments will generate escrow balances in excess of forecasted required disbursements (plus reserves), the servicer must credit the excess to subsequent payments by the borrower or refund the excess to the borrower, at the borrower's option. The servicer can require that deficiencies be made up before disbursements must be made.

The implication of the above rules is that escrow payments at closing can be required as was discussed previously; that is, escrow payments at closing must include the required reserve plus an amount that, when added to periodic payments due before disbursements must be made, will result in a balance adequate to make disbursements.

By and large, the existing rules appear reasonable. Rules differ in substantive ways among agencies, and a uniform and simple set of rules would make it easier for borrowers and servicers to understand and comply with them. Whether all the rules are necessary is less certain. Mortgage origination has become much more competitive than it was when RESPA was passed, and competition should serve as the best regulator to protect consumers' interest.

Before going on to discuss reform proposals, I will examine more critically the assumption that, because of competition in the mortgage markets, escrow accounts provide benefits for all involved parties.

Mortgage market competition and escrow accounts

The important underlying premise of the preceding sections is that federal government reforms during the past two decades have enabled every aspect of mortgage markets—origination, servicing, and investing—to be highly competitive. Many kinds of organizations can and do enter and compete in all three businesses. The implication is that any changes in regulations that impose additional costs on organizations that provide any of these services may result in less favorable mortgage terms to borrowers. In addition, any changes that made escrow accounts more expensive to administer would have another effect—mortgages without escrow accounts and securities backed by such mortgages would be acceptable to investors only at higher interest rates, a cost that would ultimately be passed along to the borrower.

Researchers have not separated benefits attributable to escrow accounts from benefits attributable to other servicing activities. It would be logically possible to unbundle escrow account administration from other servicing functions. However, it seems patent that doing so would be economically inefficient. Not only do the accounts have to be the same so that all servicing functions can be performed on them, but the market has shown a strong tendency to retain the bundled activities.

I will argue below that most of the discontent about escrow accounts and most of the pressure for additional regulation result from the fact that escrow accounts are not covered by a clear agreement between borrower and lender at the time of origination.

Possible changes in escrow account regulations

In the past several years, Congress has considered several bills that would change federal regulation of escrow accounts (see, for example, the proposed Escrow Account Reform Act of 1991). A variety of changes have been or might be proposed.

Papers filed by plaintiffs in litigation over escrow accounts claim that account balances required by servicers are excessive, although no plaintiff has yet demonstrated in court that account balances are excessive relative to the federal rules discussed above. Many advocates of reform believe that interest payments should be required on escrow balances, and about a dozen states now require some kind of interest payment. Advocates of interest payment requirements do not seem to be aware that such requirements might result in higher mortgage interest rates being charged to borrowers. It seems clear that a uniform national interest payment requirement would be preferable to the various state requirements that are emerging. Finally, some advocates urge that borrowers be permitted to terminate escrow accounts at some specified time, for example, when a certain percent of the mortgage principal has been paid.

Interest payments to borrowers on escrow accounts

It has been pointed out that only part of the cost of servicing escrow accounts is paid by mortgage buyers and other non-borrower sources. The remaining costs are paid by borrowers in the form of points or interest payments or both on mortgages. If federal rules were to require that servicers pay borrowers interest on escrow balances, servicers would have to recover the revenue through servicing contracts with originators, who would pass the additional costs on to borrowers through higher points or interest charges or both.

If escrow account servicers were required to pay borrowers interest on escrow accounts for mortgages originated after federal law had been changed, they could cope with the situation fairly easily. They would have to adjust the ways they contracted for servicing accounts with originators so that they would not be placed in a financially untenable position. Again, the result would be correspondingly higher costs to borrowers. In addition, the complex computer software that servicers use would have to be redone, adding to servicers' costs and therefore to borrowers' costs as well. Perhaps more important, servicers incur heavy costs in answering borrowers' inquiries. That fact has led servicers to keep escrow account terms as simple as possible. For example, they endeavor to make changes in borrower payments as infrequently as possible. To the extent that interest payments increased borrower inquiries, the additional costs of responding to such inquiries would be passed on to borrowers.

It should be noted that most borrowers' tax status would not be changed if interest were paid to borrowers on escrow balances and points or interest charges for mortgages were raised correspondingly. Mortgage points and interest payments are deductible from federal income tax, and interest payments on escrow accounts would be taxed, so a corresponding increase in a deductible payment and a taxable receipt would leave taxpayers in the same tax status. Since interest income is taxable for all taxpayers but mortgage interest is deductible only for taxpayers who itemize, a few taxpayers would be worse off if interest payments were required on escrow accounts. However, itemization is beneficial to most homeowners with substantial mortgages.

It should also be mentioned that a requirement to pay interest on new escrow accounts would yield some benefits to mortgage servicers. Once all relevant parties understood the new situation, controversy, litigation, other regulations on escrow accounts, and borrower inquiries and complaints might be reduced. For example, if the interest borrowers received on escrow accounts were similar to the interest they could obtain on passbook savings if they managed the funds themselves, they would have less cause for concern about the amounts of reserves or the methods of estimating future disbursements from escrow accounts.

Likewise, payment of interest on escrow accounts should logically persuade the federal government to abolish other rules regarding amounts kept in escrow accounts. In particular, the requirement that interest be paid on escrow accounts should terminate controversy and litigation about the distinction between the single-item and composite methods of determining closing escrow payments. If the borrower received interest on escrow accounts, it would make little difference which accrual method was used, and the federal government should not specify a method. It may be that some borrowers are sufficiently illiquid that the consumption value of the escrow balances might exceed the interest on the account; however, any such benefit would be ephemeral and would dissipate within a few months.

Finally, if a federal requirement for interest payments on escrow accounts were imposed, similar state requirements should be abolished. It would be confusing and redundant to have both federal and state requirements.

All of the above analysis applies to proposed federal legislation to require interest payments on *new* escrow accounts. There can be no doubt that it would be bad government policy to require interest payments on preexisting escrow accounts. Such a

requirement would arbitrarily abrogate existing contracts and impose financial distress on mortgage servicing organizations.

Amount of interest to be paid

If the federal government requires the payment of interest to borrowers on escrow account balances, the rules for interest rate levels and methods of calculation will be important. Market interest rates fluctuate widely, as has been seen in recent years. It follows that no specific interest rate should be included in federal law; a fixed rate would be too high at some times and too low at others. The best option would be to require that the interest rate, or the method of calculating the interest rate, be specified in the agreement signed at origination. Presumably, most originators would choose a formula similar to those that set periodic interest rates on adjustable-rate mortgages. For example, the agreement might state that the interest rate would equal that paid by the originator on passbook savings accounts or that paid on 30- or 60-day certificates of deposit. The second-best option would be for federal law or rules to specify the formula by which escrow account interest rates must relate to market interest rates.

Single-item versus composite method

There must be few examples of so much ink, litigation, and legislative and regulatory concern having been devoted to such a minor social issue. As has been shown, the forgone interest to the borrower differs only trivially between the two methods. Illiquidity might be an issue for some borrowers; however, the extra liquidity entailed by the difference between the two methods is slight. The social returns on terminating this controversy would be enormous. It is difficult to imagine that federal regulation of this matter is justified; however, it would be in the interests of all parties that the issue be covered by an agreement signed at closing.

Other regulatory issues

If the federal government required that interest be paid to borrowers on escrow account balances, most other federal rules regarding escrow accounts would be unnecessary. Most such rules are motivated by the fact that the unnecessarily large escrow account balances required by originators penalize

borrowers if interest is not paid on balances. If interest is paid, the penalty to borrowers disappears. Federal limitations on the number of months of required reserves, for example, should be abolished. Similarly, the issue of when escrow balances can be accumulated (a month before disbursements must be made or only *by* the month in which disbursements must be made) should not be regulated. It has been suggested that the federal government should impose specific formulas by which servicers could set inflation factors, the amount by which servicers estimate disbursements will increase during the next 12 months. At present, the rules mostly specify that inflation factor estimates must be reasonable. If interest is paid on escrow balances, the motivation for more specific controls on estimated inflation factors disappears.

It has been proposed that federal law require that borrowers be allowed, without penalty, to terminate escrow accounts at any time after the mortgage balance falls below a stipulated percentage of the original amount of the loan. Once again, a requirement that interest be paid on escrow account balances would remove the motivation for this proposal. It is unnecessary in any case. Borrowers can and do prepay mortgages, mostly without penalty. In addition, there is no legal prohibition on a contract that gives the borrower the right to terminate the escrow account in stipulated circumstances. Whether borrowers are allowed to terminate escrow accounts—and if so, in what circumstances—should be left to the market.

Uniform rules for federally related mortgages

Rules regarding escrow accounts differ in important details among various federally related mortgages. If the federal government legislated a requirement that interest be paid on escrow balances, then most such rules would be unnecessary. My recommendation is that whatever rules the federal government decides to retain regarding escrow accounts should be made uniform among the various categories of federally related mortgages. Differences in requirements among mortgage categories appear to serve no public purpose and make escrow account servicing confusing and complex.

Conclusion

The premise of this article is that mortgage servicing is an important, competitive, and efficient sector of the economy. A

federal requirement that interest be paid on escrow account balances of newly originated mortgages would do little harm. The cost would be passed on to borrowers, but considerable friction surrounding escrow account administration might be dissipated.

Most of the friction arises because there is typically no detailed agreement about escrow accounts between originator and borrower at closing. Such an agreement would stipulate the details discussed in this article, including whether interest was to be paid on escrow balances and, if so, how the rate would be calculated. Federal rules already specify in detail what information must be provided to the borrower at closing. One more rule, requiring that the borrower be informed if an escrow account is required and how it would be administered, would be desirable. It would make almost all other actual and proposed rules about escrow accounts unnecessary.

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