Escrow Scam?

Peter F. Colwell

Anyone who obtains the use of money in an arm's length transaction must pay for the money used. We refer to payment for the use of money as *interest*. There can be no "free lunch;" interest is paid even if there is not an explicit interest rate. "Non-interest bearing" accounts do bear interest.

It would seem that this issue was settled a decade ago when the IRS ruled that borrowers issuing "zero interest," five-year notes were nonetheless entitled to treat some portion of their payments as interest. Deposit accounts are no different; every deposit bears interest, regardless of whether the depositor receives interest directly.

Mortgage lenders that require escrow, or impound, deposits (for payment of borrowers' homeowner insurance premiums and property taxes) must compete with lenders that do not. Escrow accounts typically pay no stated interest. Explicit interest rates charged on loans, therefore, should reflect differences in costs faced by borrowers who must make escrow deposits and those who need not; lenders requiring escrow should charge lower explicit rates. Even mortgage bankers should be able to offer lower rates if they can extract concessions from the institutions in which the escrow accounts are placed.

It is unfortunate that, in investigating financing packages, buyers of real estate (and those who advise them) too often seek information only on interest rates and "points." They should also consider costs of the escrow arrangements to which they would become subject under the terms of various packages. If they ignore escrow costs, borrower/depositors cannot make informed choices regarding tradeoffs. The borrower who does not consider these costs does not see the impact of placing money in an escrow account. As a result, lenders and loan servicers can take advantage of borrowers.

For example, some servicers require the escrow account or accounts to contain an amount sufficient to cover disbursement for tax or insurance a full month or more prior to the date when the payment must actually be made. Recent *Wall Street Journal* and *Consumer Reports* articles tell of borrowers required by servicers to hold cushions of more than $1,000. It should be obvious that requiring such cushions increases imputed interest cost.

Consider in addition combined versus separate tax and insurance escrow accounts. In some states, the accounts are treated jointly; there must merely be sufficient funds between the two accounts to cover payment needs. In many states, however, the accounts may be treated separately. Separate treatment places a floor on each account, thereby raising the imputed interest cost to the borrower, and, in turn, the imputed interest return to the lender or outside servicer.

The amount that a borrower is required to hold in escrow accounts, and therefore the interest rate differential, obviously depends on numerous factors. Among these are the property value, the property tax rate, the insurance rate, the loan to value ratio, the building to value ratio, and the imputed interest rate. Regardless, the differential is not trivial; it might easily reach seven to ten basis points, and peculiar situations could generate even greater differences.

It would seem that "truth in lending" provisions should require lenders to disclose the costs that escrow arrangements impose on borrowers. But apparently such disclosure is not required. (Disclosure clearly is not made to borrowers, but the escrow account area is one is which the laws seem routinely to be ignored.)

An alternative protection for consumers would be to require that interest be explicitly paid on escrow accounts. If this action were undertaken, borrowers would more clearly see the cost of escrow accounts, and their rejection of mispriced loans would narrow the interest rate differential between loans with and without escrow accounts. Borrowers would select financing packages that were truly best for them with regard to cost and risk. ■

Office of Real Estate Research
University of Illinois at Urbana-Champaign
304-D David Kinley Hall
1407 W. Gregory Drive
Urbana, Illinois 61801

Non-profit Org.
U.S. Postage
PAID
Permit No. 75
Champaign, IL 61820