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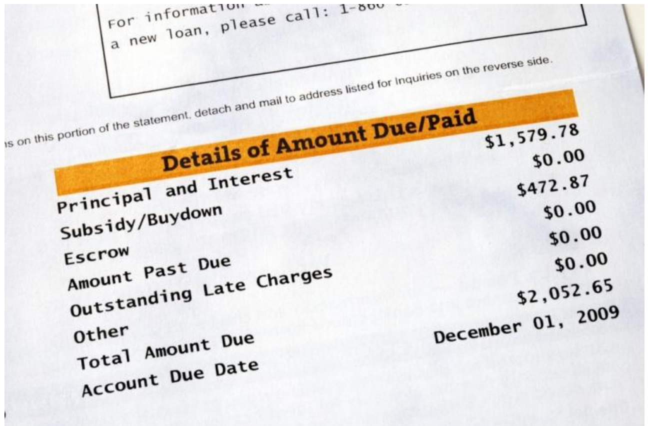
Understanding How An Escrow Account Works



How Most Escrow Accounts Work.

When your mortgage closes, your lender will usually require you to open an escrow account to cover property taxes and homeowner's insurance. You'll make an initial deposit, followed by payments to the account every month. (Usually these are added to your regular mortgage payment.) Usually, your mortgage company collects and directs that a portion of your mortgage payment go into a separate escrow account. The mortgage company makes a payment on your behalf to your insurance company and county or state tax accessor when those bills are due. Funds accumulate in your account every month are used to pay for the property taxes and insurances when they come due.

Do You Really Need Escrow Accounts?

No. Not necessarily. If your mortgage loan to value at the time of refinance or purchase is at or below 80% of the house appraised value, you can waive the escrow to be included in your mortgage payment. You technically could pay your insurance premiums and tax bill yourself if you are responsible and disciplined enough. That's what most people who own their homes outright have to do. But, escrow accounts are great to have. Escrow accounts keep you safe…safe from missing an important payment and safe in case you do not receive the high value things you buy.

How you benefit

Escrow can benefit borrowers by helping them spread insurance and tax expenses evenly over 12 payments. For example, assume your yearly property taxes are two payments of $1,000 each, and your insurance is $400 annually. If you paid these directly, it would mean three large payments a year; your escrow costs, however, would be a manageable $200 a month.

Escrow payments

Your escrow account will have a built-in cushion -- if you miss a payment, the lender must still be able to pay your accounts on time. However, federal law prohibits lenders from requiring more than two months. expenses in escrow. And because your tax and insurance costs will change slightly from year to year, the lender will review and adjust your escrow payments annually.

Most Lenders Require Escrow Accounts Anyway.

Lenders usually require borrowers to include their property taxes and insurance premiums in their monthly mortgage payments and be placed in escrow to ensure the safety of the bank's loan and investment. For example, if the taxes on your home are not paid, your county's tax authority could place a lien on your home which could have a higher priority than the bank's own lien. If you went into foreclosure, that would just be even more money that the bank would lose right off the bat since they would be paid out of the sale proceeds after the county got their tax money. Also, if the house burns down or is flooded, the lender's protection goes with it if the insurance premiums had not been paid. Requiring an escrow account keeps the bank protected.

Good and Bad Points of Escrow.

When the lender takes care of two of your biggest payments, that is taking a huge weight and responsibility off of your shoulders. On the other hand, you provide the bank or escrow company free use of your money for eleven months or so out of the year. It is similar to the interest free loan we give the federal government when we receive a huge income tax refund every year. You will never see a dime of any interest they happen to make off of your money while it is in their possession. Maybe control freaks may still want to try and avoid escrow. There have even been a few cases of mortgage lenders messing up your insurance or tax payments costing more in late fees and penalties.

Escrow Recalculated each year

Most lenders run an analysis program each year to see whether the amount a borrower contributed over the course of the past 12 months was enough to cover all the tax and insurance bills due during that period. Customers receive a transcript of the results showing what was paid out and what was collected.

Lenders typically require that an extra month or two of payments be maintained in the account as a reserve. But because tax assessment or rate changes and premium adjustments can happen any time over the course of 12 months -- and escrow payments remain constant for a year at a time no matter what -- lenders sometimes have to cover shortfalls out of their own pocket. They recoup that money the following year by boosting a person's required monthly deposit.

"After the end of the first year, the regular escrow analysis done by lenders will compare what initially collected from you and what actually paid out. This is what actually came into the account and this is what actually went out.

If there is shortage in escrow account, mortgage company will give you 2 option to pay back in to escrow account. You may pay this in one lump sum so your mortgage payment remains the same or the short can spread over 12 months and added into your mortgage payment so you can pay monthly.

On the other hand, if lender if there is more than enough what is required to be in the escrow account, you will receive a refund for that overage.

Watch closely when loans transfer to another mortgage servicer

Borrowers also should watch their escrow accounts closely when any loan transfer occurs. A transfer can happen in one of two ways: when somebody refinances or when a lender sells its loans to another company.

Legally, the old lender must pay taxes and insurance up until the loan either closes or leaves its possession. But with so much paperwork involved, wires do cross. Sometimes, both companies end up paying the tax bill -- and sometimes neither one does. In either case, a homeowner's bill can be affected the next time escrow is adjusted. As long as the homeowner has made the proper payments, the lender is responsible for any problems created by an unpaid bill, but straightening it out can take time. Lenders say the best way to avoid problems is to communicate and make sure all the parties involved know the game plan. Customers should also keep all records and review them for errors.

In the event of a loan sale, for example, the escrow account typically will transfer to the new lender along with the mortgage. A borrower should receive a statement from the old lender spelling out everything that was collected for and paid out by the escrow account up until the day of transfer. You can compare that with the annual escrow analysis statement sent by the new lender at the end of the year. It should pick up where the old one ended.

With a refinance, the old lender usually shuts the escrow account and either reduces the amount it gets at closing by the balance of the account or refunds the borrower via check. The old mortgage company should provide a short-year analysis of activity in the account up to that point in either case.

A nationwide player, for example, may already have sent an individual's money along to a third-party tax processor or the taxing agency itself ahead of the actual tax due date. If a borrower closes his loan out with the old lender -- and the new lender pays the bill on its actual due date with the new escrow account -- he may end up waiting months to get a refund from the old lender. Some tax authorities may refuse a refund altogether and consider one of those payments a prepayment toward the following period's bill.

People should therefore not count on using an escrow tax rebate to cover the new loan's closing costs.

Why is my Escrow Payment Changing

One of the most complicated things to explain to a person could very well be an escrow (A.K.A. impound) account. I receive call after call asking why the payment is going up on a fixed rate loan, or why the payment is going up so much. Remember the escrow account is what covers your taxes, insurance, possible MIP (Mortgage Insurance Premium) or PMI (Private Mortgage Insurance) and any other Optional Items you may wish to carry on your mortgage account. Allow me to start with a basic example. If a loan has an escrow account covering; Taxes at $1200 per year, and Insurance at $600 per year. The escrow must collect $1800 per year to pay these bills. Your mortgage is paid 12 times per year, therefore 1800 / 12 = a monthly mortgage payment of $150. Here is where it gets tricky, lets say your taxes go up by $400. Your new yearly expense would be $1600 for taxes and $600 for insurance = $2200 per year / 12 = 183.33 as your new payment....right ? Far from it. Allow me to explain why your escrow can change dramatically from the smallest change. Mortgage companies can require an escrow account to hold a min. requirement or cushion. This cushion can be between 0 - 3 months (most companies use a 2 month cushion). When they reanalyze your escrow account, the company is looking at the up coming 12 months...and they are looking for the lowest balance within that 12 months. Using the example on top. If you had a $150.00 escrow payment your required cushion would be $300.00. Lets even make it nicer and say that for the year you ended with that cushion. So starting January your escrow balance is $300.00. For the sake of this example we will say your taxes are due in May and the insurance is due in August. Remember you already have $300, and with the new payment you will pay $183.33 per month to the escrow, BUT the new cushion with a $183.33 monthly escrow payment is $366.66.

Jan payment make the escrow balance $483.33 / Feb $666.66 / March $849.99 / April $1033.32 / May $1216.65 (Time to pay Taxes [-$1600.00]) new May Balance -$383.35 / June -$200.02 / July -$16.69 / Aug $166.64 (Time to pay Insurance [-$600.00]) new Aug Balance -$433.36 / Sept -$250.03 / Oct -$66.70 / Nov $116.63 / Dec $299.96. See it wasn't that bad, and we even ended with a positive balance, good right ? Nope, if you recall we are looking for the lowest point over the 12 months, and your required Cushion or low point is $366.66...so lets compare, you may not fall below $366.66, but in the Month of Aug you ended with -$433.36...that is a difference of $800.02 !!! Here you company may give one of two choices...or both, you can either Pay $800.02 up-front, and you escrow payments will be 183.33...or the #800.02 will be spread over 12 months, adding $66.67 to the 183.33 making the monthly escrow payment $249.99. So because your Taxes went up $400..one way or another, over the next 12 months, you will pay an extra $800.02.

How to get around this...here are a few ideas; 1- Check with your tax assessor for any tax exemption you may qualify for. 2- Shop your insurance company, quotes are free, and it doesn't hurt to find out. 3- If you know your taxes or insurance is going up, start putting a little extra to your escrow on a monthly basis.

On a good note, if your lowest point for the next 12 months is $50.00 above your required Cushion, you should receive a refund for overpayment. I hope this helped, if you have any questions, I will be happy to answer them.

If you have any questions or concerns about mortgage escrow account, email or call me directly.

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