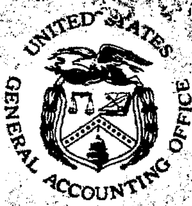

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Study Of The Feasibility Of Escrow Accounts On Residential Mortgages Becoming Interest Bearing

B-114860

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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JUNE 21, 1973

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114860

The Honorable Leonor K. Sullivan
House of Representatives

Dear Mrs. Sullivan:

This is our report on the feasibility and validity of having escrow accounts connected with federally related residential mortgages interest bearing to mortgagors. We made our review pursuant to your request of September 29, 1972. As subsequently agreed, we did not attempt to relate the use of escrow accounts to the requirements of the Truth in Lending Act.

As requested, we have not obtained comments on this report from Federal agencies involved in the residential housing market, lending institution associations, or others concerned.

As previously authorized, we plan to distribute this report to Members of Congress and others who have specifically requested copies. However, we shall not distribute the report further until you release or publicly announce its contents.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

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ABBREVIATIONS

FHA	Federal Housing Administration
GAO	General Accounting Office
VA	Veterans Administration

COMPTROLLER GENERAL'S REPORT TO THE HONORABLE LEONOR K. SULLIVAN HOUSE OF REPRESENTATIVES

STUDY OF THE FEASIBILITY OF ESCROW ACCOUNTS ON RESIDENTIAL MORTGAGES BECOMING INTEREST BEARING B-114860

D I G E S T

WHY THE STUDY WAS MADE

Congresswoman Leonor K. Sullivan asked the General Accounting Office to study whether it was feasible for escrow accounts connected with residential mortgages to be made interest bearing to homeowners.

As agreed with Congresswoman Sullivan's office, GAO did not obtain comments on this report from Federal agencies involved in the residential housing market, the lending institution associations, or others concerned.

Background

Many lending institutions require escrow accounts before granting a residential mortgage loan and use them to pay the homeowners' real estate taxes, fire and hazard insurance premiums, and other assessments when they become due.

GAO, as requested, attempted to determine the costs and the profits made, or the losses sustained, by lending institutions in maintaining escrow accounts.

The Federal Reserve Board reported that residential mortgage debt outstanding as of September 30, 1972, was estimated at $335.1 billion, of which approximately one-third represented Federal Housing Authority (FHA) insured or Veterans Administration (VA) guaranteed mortgages.

Escrow accounts are required for FHA-insured mortgages, are encouraged for VA-guaranteed mortgages, and are commonly used for conventionally financed mortgages.

Over 19,000 lending institutions and mortgage bankers are involved in the residential mortgage market. To determine profitability of the escrow operation and other pertinent information for these institutions, GAO sent questionnaires to a randomly selected sample of 971 commercial banks, mutual savings banks, savings and loan associations, and mortgage bankers.

GAO received responses from 684, or 70.4 percent, of the sampled institutions who owned or serviced about $80.2 billion in residential mortgages.

Several States have studied whether escrow accounts could be made interest bearing to homeowners. GAO asked about the status and the results of a number of class-action suits introduced in various States that would require lending institutions to pay interest to homeowners on escrow funds.

FINDINGS AND CONCLUSIONS

Gross income reported by lending institutions

Mortgage bankers reported they did not earn income from escrow funds but deposited them in non-interest-bearing custodial accounts. Morgage bankers do, however, use escrow collections to establish lines of

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capital credit with banking institutions.

A number of mortgage bankers are subsidiaries of banking institutions and use their parent organization as the depository for escrow collections. (See p. 8.)

Of 505 other lending institutions, exclusive of mortgage bankers, only 220 reported the gross income realized from escrow operations; 29 percent reported an annual gross income under $10,000, 51 percent reported an annual gross income under $25,000, and 83 percent reported an annual gross income under $100,000. Only three institutions--1.4 percent of those providing data--reported an annual gross income in excess of $500,000. (See p. 9.)

Numerous factors which influence the gross income that lending institutions realized from escrow funds include:

--The use made of the escrow funds collected. (See p. 12.)

--The significance of escrow collections: a product of institution size and institution policy regarding escrow account maintenance requirements. (See p. 10.)

--The period of time that escrow collections are available for investment. (See p. 11.)

Cost and profitability data reported by lending institutions

Most lending institutions in GAO's sample did not provide data on the profitability of their escrow operations. An analysis of the 505 responses received from lending institutions, exclusive of mortgage bankers who reported that they did not earn income, showed that

--96 did not require or maintain escrow accounts;

--246 maintained escrow accounts but did not report income, costs, or both; and

--163 furnished data related to the profitability of their escrow operations.

Of the 163 institutions that provided data, 52 reported losses from escrow operations, 17 reported that costs of maintaining escrow accounts and income were approximately equal, and 94 reported that escrow operations resulted in a net profit. (See p. 14.) Reported unit costs of maintaining escrow accounts ranged considerably from under $3 to over $12 an account. (See p. 16.)

Further examination at 18 sample institutions showed that costs of providing the escrow function, even when cost data had been reported, were not supported by accounting records or specific cost studies. (See p. 16.)

At four institutions where GAO made cost analyses, results showed that annual profitability or loss realized on the maintenance of escrow accounts varied substantially, depending on the method used to determine costs. (See p. 17.)

Benefits of escrow accounts to taxing authorities

All 22 governmental taxing authorities we visited said that they had accrued significant savings by collecting property taxes through lending institutions. (See p. 19.)

Other studies made on escrow accounts

Studies made by California, Connecticut, and Massachusetts showed that the escrow operation had been only marginally profitable for lending institutions. (See pp. 21 to 23.)

Lender reaction to interest-bearing escrow accounts

According to the lending institutions, requiring interest to be paid on escrow accounts will adversely affect homeowners, the mortgage industry, taxing authorities, and achievement of the Nation's housing goals.

The lending institutions feel such action would result in abandonment of the escrow method or recouping costs of maintaining escrow accounts through increased mortgage rates, service fees, or other methods. (See p. 25.)

Other matters of possible interest in considering legislation on escrow accounts

GAO directed its study of escrow accounts primarily to gathering data on lending institutions' gross income, costs, and net profits applicable to the maintenance of escrow accounts.

GAO became aware of other considerations during its study which, although not studied in detail, may be of interest in developing and evaluating legislative proposals. These include

--the question of whether homeowners should receive interest on escrow funds as a matter of equity,

--the practice of some lending institutions' providing homeowners with alternatives to using escrow accounts, and

--the question of whether escrow accounts should be established only when required by Federal or State law or regulation. (See pp. 27 and 28.)

CHAPTER 1

INTRODUCTION

At the request of Congresswoman Leonor K. Sullivan (see app. I), GAO conducted a study of the feasibility of homeowners' receiving interest on the funds they deposit with lending institutions in escrow accounts for paying taxes, insurance, and other assessments.

Many lending institutions, as a condition to granting a mortgage, require that homeowners' monthly mortgage payments include an amount for real estate taxes, fire and hazard insurance premiums, and other assessments. Generally, the lending institution estimates the probable annual tax, insurance premiums, and other charges and allocates monthly payment for the homeowner. Consequently, when a homeowner makes a monthly mortgage payment, part of the payment goes into an escrow account which the lending institution uses to pay the homeowner's real estate taxes, fire and hazard insurance premiums, and other assessments when they become due.

The escrow arrangement benefits both lending institutions and homeowners. Lending institutions are concerned with protecting their mortgage loans. A borrower's failure to keep tax payments current could result in a tax lien on the property which would take precedence over the lending institution's lien. If insurance premiums are not paid, the insurance coverage could lapse and the lending institution's investment would be impaired if the property were destroyed or damaged. The escrow arrangement insures lending institutions that tax, insurance, and other obligations are met and thus enables them to protect their investments.

Many homeowners find the use of escrow accounts helpful in insuring that they meet their property tax and insurance obligations, particularly homeowners with limited financial resources for whom a single large tax payment or insurance premium could be financially difficult. The escrow arrangement enables these homeowners to budget monthly for such expenditures. They also find it convenient to have the lending institution pay their tax and insurance obligations.

ORIGIN OF THE ESCROW CONCEPT AND CURRENT FEDERAL INFLUENCE

Escrow accounts began during the economic depression of the 1930s when many homeowners, because of their inability to pay property taxes, lost their homes through foreclosure. The Home Owners Loan Corporation, created by the Congress to take over the loans of delinquent borrowers, was the first institution to require that part of the annual tax bill be collected monthly for the mortgage loans held. The Federal Housing Administration (FHA), also created during the 1930s, required that lending institutions collect a monthly pro rata portion of property taxes on FHA-insured loans.

Some States followed these Federal agencies' procedures and passed legislation requiring escrow accounts to be established for high-risk mortgage loans--when the homeowner's equity is a comparatively small portion of the total value of the property. Massachusetts, for example, requires an escrow account for all loans in excess of 70 percent of the estimated property value, while New Hampshire has set its requirements at 75 percent.

The positions of the three principal Federal agencies involved in the residential housing market--FHA, Veterans Administration (VA), and the Farmers Home Administration--on the use of escrow accounts are summarized briefly below. Collectively, these three Federal agencies insured, guaranteed, or had direct mortgage loans outstanding in excess of $110 billion at June 30, 1972.

Federal Housing Administration--FHA requires that all loans it insures include in the monthly mortgage payment a pro rata portion for property taxes, special assessments, hazard insurance premiums, and FHA's mortgage insurance premium. In fiscal year 1972 lending institutions collected over $317 million in mortgage insurance premiums alone under the escrow arrangement.

Veterans Administration--Escrow accounts are mandatory for mortgages under VA's direct loan program. At the end of September 1972, VA had $53.5 million of escrow funds on deposit in the general fund of the U.S. Treasury as a result of their direct loan

activities. Under its guaranteed home loan program, VA does not require, but strongly encourages, lending institutions to establish escrow accounts for collecting ground rents, taxes, assessments, and hazard insurance premiums. Many lending institutions are unaware that collections are not mandatory under the VA-guaranteed loan program.

Farmers Home Administration--The Farmers Home Administration, which has a total of $5.1 billion in direct and insured loans in rural areas, does not currently require escrow accounts to be established. Because of serious problems in delinquencies in paying taxes, the Farmers Home Administration is considering adopting a policy requiring escrow accounts on their direct and insured mortgage loans.

The Federal Reserve Board reported that residential mortgage debt outstanding at the end of September 1972 was estimated at $335.1 billion, of which approximately one-third represented FHA-insured or VA-guaranteed mortgages. Escrow accounts are required for FHA-insured mortgages, are encouraged for VA-guaranteed mortgages, and are commonly used for conventionally financed mortgages.

To obtain information pertinent to the study, we distributed a questionnaire to a statistical sample of 971 lending institutions. On the basis of the escrow collection data reported, we estimate, statistically, that escrow collections, nationwide, amount to about $9.4 billion annually.

CHAPTER 2

GROSS INCOME EARNED ON ESCROW FUNDS BY LENDING INSTITUTIONS

Escrow accounts related to residential mortagages are held largely by four types of lending institutions: commercial banks, mutual savings banks, savings and loan associations, and mortgage bankers. The first three originate mortgage loans essentially for their own portfolios and usually perform all the functions of mortgage loan administration.

MORTGAGE BANKERS

Mortgage bankers originate mortgage loans for the purpose of reselling them to other institutional investors--insurance companies; real estate trusts; and institutions active in the secondary mortgage market, such as the Federal National Mortgage Association--rather than retaining them in their own portfolios. Generally, a mortgage banking company services the loans that it sells, including the collection of escrow funds, for a servicing fee.

Mortgage bankers do not generally invest escrow funds. Under existing FHA regulations, mortgage bankers are required to keep escrow funds in custodial accounts in institutions whose deposits are insured by a Federal agency and to pass on to the homeowner any interest that is earned. Officials of the Mortgage Bankers Association of America informed us, and the responses to our questionnaire confirmed, that most mortgage bankers deposit escrow funds in non-interest-bearing accounts. These accounts enable mortgage bankers to avoid costs that would be incurred if interest income were distributed to individual mortgagor accounts. Consequently, there are no directly measurable earnings to mortgage bankers from their escrow operations. Mortgage bankers, however, generally require escrow accounts reflecting, in part, their

--heavy involvement in FHA, VA, and high-risk-insured conventional loans and

--need for the escrow feature to improve the marketability of mortgages.

Therefore mortgage bankers are major holders of escrow funds. The 166 institutions that responded to our questionnaire and that used escrow accounts reported total annual collections in excess of $1.5 billion.

Although mortgage bankers earn no direct income from escrow collections, they benefit in other ways. They use escrow deposits to establish lines of credit with other lending institutions. This, in turn, enables bankers to borrow capital to provide mortgages--their principal activity from which they derive their loan origination and servicing income.

Some mortgage banking companies are subsidiaries of banking institutions and use their parent company as depositories for escrow collections. These escrow funds are then available for investment by the parent company. Since these benefits are not measurable, we were unable to obtain gross income data and therefore could not determine the net profitability of escrow operations to mortgage bankers.

GROSS INCOME EARNED BY COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS

Of the total of 505 commercial banks, mutual savings banks, and savings and loan associations responding to our questionnaire, 409 reported that they used escrow accounts. Only 220 of these institutions, however, furnished data on the gross income that they realized from their escrow operations.

An analysis of the data reported showed that, for most of the institutions, annual gross income tended to be low or moderate. Specifically,

--183 institutions, or 83 percent, had gross incomes under $100,000;

--112 institutions, or 51 percent, had gross incomes under $25,000; and

--64 institutions, or 29 percent, had gross incomes under $10,000.

only three institutions, or 1.4 percent of the total, reported gross incomes in excess of $500,000.

The factors that determine the gross income that lending institutions realize from their escrow operations are primarily the amount of escrow funds collected and available for investment, the period of time the funds are available for investment, and the nature and yield rate of the available investment opportunities. These factors tend to vary considerably among lending institutions.

Magnitude of escrow collections

Most lending institutions are small firms with limited financial resources and, consequently, limited mortgage portfolios and for whom escrow collections tend to involve modest amounts. Commercial banks and savings and loan associations, in particular, are characterized by numerous institutions with deposit holdings under $25 million. (See app. III.) Of the 75 institutions of this size that responded to our questionnaire and that had escrow accounts, 56, or 75 percent, collected less than $250,000 annually. In many cases, the reported escrow collections were substantially less.

The institution's policy regarding escrow account maintenance requirements also affected the volume of escrow collections. Many institutions do not require escrow accounts for large segments of their mortgage portfolio. For example, 60 percent of the commercial banks that provided data reported that they required escrow accounts for less than 25 percent of all their outstanding mortgages. A number of mutual savings banks and savings and loan associations--12 and 19 percent, respectively--also reported that they required escrow accounts for less than 25 percent of all their outstanding mortgages.

Analysis of the Percentage
of Lending Institutions
Using Escrow Accounts for Mortgage Loans

Percent of mortgages having escrow accounts	Percent of lending institutions		
	Commercial banks	Mutual savings banks	Savings and loan associations
zero to 25	60	12	18
26 to 50	8	16	16
51 to 75	11	22	15
76 to 100	21	50	51
Total	100	100	100

Our study showed that, of the $954.3 million of annual escrow collections reported, over $901 million belonged to larger institutions with deposit holdings of more than $50 million.

Period of time that escrow collections are available for investment

The period of time that escrow funds are available for investment influences the gross income. Most of the escrow collections made represent local property taxes that lending institutions will pay on behalf of the homeowners. Before such disbursements are made, the escrow funds collected are available to mutual savings banks, commercial banks, and savings and loan associations for investment. The gross income realizable by lending institutions, even with identical escrow collections, will vary depending on the frequency that property taxes are required to be remitted to taxing authorities.

For example, a lending institution with annual escrow collections of $1 million that remits property taxes annually has an average of $500,000 available for investment. Assuming a 5-percent yield from investments, this institution would realize income of $25,000 from the escrow operation. If this institution remitted property taxes semiannually, it would have an average of only $250,000 available for investment, and realized income would amount to $12,500 from its

escrow operations. More frequent remittances would reduce the income potential even further.

Of the 159 commercial banks, mutual savings banks, and savings and loan associations with collections of $1 million or more, most reported that tax funds collected were being remitted to taxing authorities semiannually or more frequently. Over two-thirds of all collections were being remitted at least semiannually, as shown below.

Analysis of Frequency of Property Tax Remittances Made by Institutions with Escrow Collections over $1,000,000

	Number of institutions	Total escrow funds remitted	Percent of total remittances
		(millions)	
Annual remittances	71	$291.7	32.5
Semiannual remittances	46	173.7	19.3
Quarterly or more frequent remittances	42	433.1	48.2
Total	159	$898.5	100.0

Our study showed that governmental tax agencies in the areas of major population density generally collect real property taxes semiannually or quarterly. New York City, for example, collects taxes quarterly, while Cook County, Illinois--which includes the city of Chicago--and Los Angeles County, California, collect taxes semiannually. The trend appears to be toward more frequent collections at the State, county, and municipal levels. For example, Massachusetts recently passed legislation that will require governmental taxing authorities to collect real property taxes semiannually starting in 1974.

Investment of escrow funds by lending institutions

Escrow collections must be available to pay homeowners' tax and insurance obligations as they become due. Consequently, commercial banks, mutual savings banks, and savings and loan associations invest such funds in short-term

securities, Federal funds,[1] or certificates of deposit. Some commingle escrow collections with other receipts of the institutions and use them for investment.

The gross income from investment of escrow funds varies significantly from period to period. Our study showed that, over the 12-month period ended September 30, 1972, interest rates on Federal funds, for example, ranged from 3.10 to 5.25 percent while the interest rate on certificates of deposit fluctuated between 3.75 to 5.20 percent. Many institutions expressed the view that the instability of the short-term investment market would preclude paying any fixed rate of interest on escrow accounts. All other factors being equal, it appeared that income from escrow operations would vary substantially with the fluctuations in the short-term investment market.

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In summary, the gross income lending institutions earned from escrow funds varies significantly from institution to institution. We believe that such factors as the significance of escrow collections, the period of time that funds are available for investment, and the variable nature of the short-term investment market should be considered in the formulation of any legislation that would require escrow accounts to be interest bearing to mortgagors.

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[1]Loans made between banking institutions to meet Federal reserve requirements.

CHAPTER 3

COST AND PROFITABILITY

Most lending institutions reported that maintaining escrow accounts was costly and that it was not feasible to pay interest on them. Many of these same lending institutions, however, could not, or did not, provide data on their gross income from investment of escrow funds or costs of maintaining escrow accounts or both. There were wide variances among those that did report.

ANALYSIS OF DATA ON GROSS INCOME AND COSTS RELATED TO ESCROW ACCOUNTS

To determine whether escrow operations were profitable to lending institutions, each institution in our sample was asked to report

--the income realized from its investment of escrow funds for the year ended September 30, 1972;

--the costs incurred over the same period to maintain the accounts;

--the average unit cost incurred to maintain an escrow account; and

--the basis it used to determine costs; i.e., accounting systems, cost studies or cost analyses, estimates, or other means.

Of 179 mortgage bankers responding to our questionnaire, 166 reported that, although they maintained escrow accounts, they did not invest these funds and therefore derived no income. Thirteen other mortgage bankers and 96 other institutions reported that escrow accounts were not required or maintained. The remaining 409 lending institutions stated they maintained escrow accounts and used escrow funds for investment. Of these 409 lending institutions, 246, or about 60 percent, could not, or did not, provide data on their gross income, maintenance costs, or both.

Only 163 institutions furnished data related to the profitability of their escrow operations. This data showed

a wide range of profitability: 52 reported that escrow operations resulted in a net loss, 17 reported that the cost to maintain escrow accounts and gross income earned were approximately equal, and 94 reported that their escrow operations resulted in a net profit.

The number of institutions that furnished data on gross income and cost of maintaining escrow accounts was too small to enable us to express an opinion, on the basis of a statistical analysis, on the profitability of escrow operations to lending institutions as a whole. The following schedule summarizes the data received from the 409 lending institutions maintaining escrow accounts.

Profitability of Escrow Operations Reported by Lending Institutions

	Mutual savings banks	Commercial banks	Savings and loan associations	Total
Institutions reporting gross income and costs:				
Escrow operations resulted in a net loss	13	6	33	52
Costs and income from escrow operations were approximately equal	3	6	8	17
Escrow operations resulted in a net profit	37	7	50	94
	53	19	91	163
Institutions not reporting gross income, costs, or both	57	65	124	246
Total	110	84	215	409

The reported unit costs of maintaining escrow accounts also varied greatly among lending institutions, as shown in the following schedule.

Annual Unit Costs to Maintain Escrow Accounts

Type of institution	Under $3.00	$3.00 to 5.99	$6.00 to 8.99	$ 9.00 to 11.99	$12.00 and over	Total
Commercial banks, mutual savings banks, and savings and loan associations	13	33	28	25	28	127
Mortgage bankers	9	19	20	28	30	106
Total	22	52	48	53	58	233

EXAMINING COST DATA AT SELECTED INSTITUTIONS

To determine the reasons for the wide variance in the cost of maintaining escrow accounts, we selected 18 lending institutions for a detailed examination. Eleven were institutions who were not paying interest on escrow accounts, and the remaining institutions, all savings and loan associations, used the capitalization method to credit mortgagors for the use of tax and insurance escrow collections.[1] In the capitalization method, mortgagors are, in effect, receiving interest on their tax and insurance payments at their existing mortgage rates. The monthly payments reduce the principal balance of their loans until the funds collected are required for disbursement.

Of the 18 selected institutions, 15 were unable and 2 declined to provide specific cost information on their escrow operations. Officials of these institutions stated that the cost data reported had been largely estimates, not supported

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[1]A total of 43 savings and loan associations reported that they followed the capitalization method.

by cost studies or derived from their accounting systems. The remaining institution had made a cost study for determining the cost of maintaining its escrow accounts. This study showed that the escrow operation was not profitable.

The method used to determine costs is a major factor in analyzing the profitability of the escrow operation. At three of the institutions, we calculated the costs of the escrow operation using three different cost determination methods: incremental cost, fully allocated cost, and a modified fully allocated cost. At another institution, we limited our calculations to the incremental and the modified fully allocated cost methods.

In the incremental cost method, overhead and general and administrative costs are limited to those that would be avoided if a given function--in this case, the escrow function--was eliminated. In the fully allocated cost method, overhead and administrative costs are computed on a straight allocation basis in proportion to the direct costs of a function, such as direct salary and direct computer costs. In the modified fully allocated cost method, certain costs--such as advertising, contributions, and organizational fees--are excluded from the overhead and general and administrative cost pools. The results of our computations are shown below.

Comparison of the Net Profitability of Maintaining Escrow Accounts Under Selected Cost Determination Methods

	Annual income and expense for escrow operations					
	Total costs			Unit cost per escrow account		
Cost method	Income	Cost	Net income or loss (-)	Income	Cost	Net income or loss (-)
Incremental cost:						
Institution A	$ 11,870	$ 5,122	$ 6,748	$14.91	$ 6.43	$ 8.48
Institution B	33,883	6,190	27,693	22.96	4.19	18.77
Institution C	133,828	18,476	114,852	20.23	2.80	17.43
Institution D	112,946	31,869	81,077	16.89	4.77	12.12
Modified fully allocated cost:						
Institution A	11,870	21,617	-9,747	14.91	27.15	-12.24
Institution B	33,883	25,816	8,067	22.96	17.50	5.46
Institution C	133,828	94,525	38,803	20.23	14.35	5.88
Institution D	112,946	105,714	7,232	16.89	15.81	1.08
Fully allocated cost:						
Institution A	11,870	26,192	-14,322	14.91	32.90	-17.99
Institution B	33,883	35,717	-1,834	22.96	24.20	-1.24
Institution C	133,828	126,301	7,027	20.23	19.16	1.07

 BEST DOCUMENT AVAILABLE

As the table shows, the profitability reported would vary substantially depending on the method used to determine the cost to maintain escrow accounts. If the escrow service was provided by a Federal activity, the fully allocated cost method of determining costs would be required to establish necessary charges. In this regard, the Office of Management and Budget policy--as expressed in its Circular No. A-25--provides that, where a service provides special benefits to an identifiable recipient above and beyond those which accrue to the public at large, a charge should be imposed to recover the full cost to the Federal Government of rendering that service.

COMPARABILITY OF THE COST OF MAINTAINING ESCROW ACCOUNTS WITH THE COST OF PROVIDING OTHER ACCOUNT SERVICES

In our questionnaire, we asked each mutual savings bank, commercial bank, and savings and loan association, to identify the average unit cost of providing other account services, such as savings accounts and Christmas club accounts. This information was intended to determine whether there was any comparability between the cost of maintaining escrow accounts with the cost of providing other account services.

Although responses were received from 505 such lending institutions, only 172, about 34 percent, provided us with the unit costs of providing other account services. The reported costs of providing these other account services varied significantly among the institutions and, in this respect, were similar to the diverse unit cost data reported for escrow accounts. Therefore we were unable to compare the cost of maintaining escrow accounts with the costs of providing other account services.

CHAPTER 4

ADVANTAGES OF ESCROW ACCOUNTS TO TAXING AGENCIES

To determine the value of escrow accounts to governmental tax collection agencies, we visited 22 agencies in 7 States and the District of Columbia. These agencies (see app. IV) ranged in size from Los Angeles County (property tax collections of $2.2 billion) to the Village of Mineola, New York (property tax collections $1.0 million), and expressed a strong preference for collecting property taxes through lending institutions. It appears, therefore, these agencies are major beneficiaries of the escrow practice.

ADVANTAGES OF COLLECTING TAXES FROM LENDING INSTITUTIONS

Officials at each of the agencies we visited were asked to cite the advantages or disadvantages of collecting real property taxes through lending institutions. All 22 cited specific advantages in collecting taxes through the lending institutions. The major advantages follow.

1. It enabled taxing authorities to bill and collect property taxes quicker and more economically.

2. It greatly reduced the number of tax delinquencies and the need for more extensive collection action.

3. It eliminated the problem of bad checks when dealing with individual homeowners.

None of the agencies we visited could provide us with the cost savings realized by dealing with lending institutions.

The 22 taxing authorities reported that there were no significant disadvantages; in fact, 13 stated specifically that there were no disadvantages.

FORECLOSURES ON MORTGAGES WITH ESCROW ACCOUNTS VS. FORECLOSURES ON MORTGAGES WITHOUT ESCROW ACCOUNTS

Officials of the 22 taxing agencies said that several thousand tax foreclosures had been made in the last year. None of the officials, however, could tell us the number of tax foreclosures on properties with escrow accounts or without escrow accounts. Most of the officials stated that almost all foreclosures made for nonpayment of taxes applied to properties without escrow accounts (and usually without a mortgage), because lending institutions would not allow a mortgaged property in its portfolio to be foreclosed because of a tax lien. Officials of the Cook County Treasurer's Office (Chicago) stated that it was inconceivable how the use of escrow accounts could have any other effect but to decrease the tax foreclosure rate.

Of the lending institutions responding to our questionnaire, 74 percent reported that they had made tax searches to insure that local taxes were paid and credited to the appropriate homeowner account. Most of the lending institutions (84 percent) that made tax searches also stated that homeowners were not charged a fee for the searches. (See app. II.)

Lending institutions and mortgage bankers can also foreclose on mortgaged property. In our questionnaire we asked the lending institutions to provide us with data on their foreclosure experiences as they related to the use or nonuse of escrow accounts. The data provided indicated that most lending institutions usually grant mortgages without escrow accounts only when there is limited risk involved and the mortgagor's equity is substantial.

Data provided by the mortgage bankers in our sample indicated that most of their foreclosures occurred on property with escrow accounts. Mortgage bankers, however, deal heavily in high-risk loans where there is little homeowner equity involved. We believe, therefore, that the information obtained could be extremely misleading.

CHAPTER 5

ACTIONS OF STATE LEGISLATURES

AND CLASS-ACTION SUITS

In recent years considerable efforts have been directed to requiring lending institutions to pay interest to mortgagors on their escrow account balances. Legislation has been introduced in several States, a large number of class-action suits have been filed in the courts, and several studies have been made and several articles have been published on this issue.

LEGISLATION INTRODUCED AT THE STATE LEVEL TO MAKE ESCROW ACCOUNTS INTEREST BEARING TO HOMEOWNERS

During our study we found that legislation had been introduced in at least four States--California, Connecticut, Massachusetts, and New York--requiring escrow accounts to be interest bearing to homeowners. The status of this legislation follows:

State of California--Legislation has been introduced several times requiring the payment of interest on escrow accounts. None has been enacted. In 1971 the State Senate requested various State regulatory agencies to study the amount of money held by lending institutions for the payment of taxes, the amount of interest paid on such funds, and the cost of administering such funds.

The reports prepared by the various regulatory agencies did not comment specifically on the profitability of the escrow function to lenders. The cost of maintaining escrow accounts follows.

Lender category	Escrow cost as a percentage of average escrow balance
Banks	2.37
Savings and loan associations	4.06
Life insurance companies	5.80
Mortgage loan brokers	7.50

Assuming a 5-percent yield rate on earnings from escrow funds, it appears that banks--as a category--would be making the most money from their escrow operations, a marginal percentage of profit would be realized by savings and loan associations, and the escrow operation would be nonprofitable for the other institutions.

State of Connecticut--In 1968 legislation was introduced in the Connecticut General Assembly requiring interest to be paid on escrow accounts. The legislative council, at the request of the general assembly, studied the feasibility of the proposed legislation and recommended that no legislative action be taken.

The council concluded that maintaining escrow accounts is beneficial to most mortgagors; interest on escrow funds would be minimal; taxing authorities benefit from the practice; lending institutions would probably raise mortgage interest rates if required to pay interest on escrow accounts; and there would be no true benefits to borrowers. The general assembly accepted the council's recommendation.

State of New York--The attorney general introduced a bill in the State legislature that would require lending institutions to pay interest on escrow accounts. We contacted the attorney general's office to determine the status of the bill and were informed that no action had been taken on the bill in 1972. The attorney general had reintroduced it in 1973, and no action had been taken at the time of our study. The attorney general's office informed us that no studies had

been made on the economic aspects of lending institutions' paying interest on escrow accounts.

State of Massachusetts--Early in 1972 the Commissioner of Banks for the State of Massachusetts made a study on the profitability of the tax escrow operations to lending institutions. As part of this study, the Massachusetts banking department mailed a questionnaire to all financial institutions under its jurisdiction--commercial banks, mutual savings banks, cooperative banks, and credit unions--and compiled information on the amount of tax escrow funds collected, the institutions' investment policies, the earnings realized on investments, and the average monthly processing and administrative costs.

The Massachusetts study showed that, for the taxable year 1971, escrow collections totaled $386.7 million and that the average net profit realized was 1.26 percent. The banking department noted that this net profit was made during a period in which Federal funds, Government bills, and certificates of deposit were at a high level. The banking department further commented that at the time their report was issued, in April 1972, interest rates on short-term investments were substantially lower than they had been in 1971.

The Massachusetts study was made in connection with a petition that legislation require banks to pay interest on real estate tax deposit accounts. The Massachusetts Supreme Court has recently decided to hear arguments on this matter.

One of the respondents to our questionnaire reported that Minnesota had also studied the feasibility of requiring interest to be paid on escrow accounts and had drawn conclusions similar to those of the Legislative Council of Connecticut.

CLASS-ACTION SUITS ON
INTEREST-BEARING ESCROW ACCOUNTS

A large number of class-action suits have been introduced in the courts for requiring specific lending institutions to pay homeowners interest on their escrow funds. Legal actions have been introduced in at least 11 States--including New York, California, Pennsylvania, and Florida--and the District of Columbia. Several lending institutions in our sample advised us that they were defendants in such litigation and felt it would be inappropriate, under the circumstances, to respond to our questionnaire.

To determine the status of these legal actions, we contacted the attorneys who were representing the plaintiff homeowners in two such class-action suits. One suit had been introduced in California and the other involved a class-action suit brought at the District Court of the United States for the District of Columbia. Both attorneys informed us that, to date, they knew of no class-action suit that had been finally concluded. The class-action suits of the attorneys contacted were based on legal premises, such as unjust enrichment, violation of the truth in lending law, usury, breach of contract, fraud, and breach of trust.

CHAPTER 6

LENDING INSTITUTION POSITION ON PAYING

INTEREST ON ESCROW ACCOUNTS

Lending institutions expressed almost unanimous opposition to paying interest on escrow accounts. All the mortgage bankers that provided us with data and 94 percent of the other respondents indicated that such a policy was not feasible for their institutions. Many respondents indicated that imposing such a requirement would not, in their opinion, serve the best interest of homeowners, governmental taxing authorities, or the Nation's housing goals.

According to lending institutions, an interest-bearing policy would ultimately result in many institutions either (1) abandoning the escrow practice or (2) recouping costs of maintaining escrow accounts through increased mortgage rates, service fees, or other methods.

ABANDONING THE ESCROW PRACTICE

Many institutions stated that, should the escrow requirement be abandoned, those most adversely affected would be governmental taxing authorities and that segment of the home-buying public that normally would acquire their homes with minimum downpayments.

Many institutions view governmental taxing authorities as being major beneficiaries of the existing escrow arrangement. The institutions believe that abandoning escrow accounts would result in governmental taxing authorities' experiencing increased administrative costs since they would be required to collect local property taxes directly from homeowners. These institutions also stated that the increased cost of governmental authorities' collection activities would probably be passed on to the taxpayers through higher tax rates.

The lending institutions also believe that abandoning the escrow practice would require them to be more discriminate in the type of mortgage loan they approve. Many of the institutions stated that, in the absence of escrow accounts, they would make fewer high-ratio-type

loans--including those normally associated with the FHA-insured and VA-guaranteed home loan programs--when a homeowner's equity in the mortgaged property is minimal. These institutions questioned whether, when viewed in this context, an interest-bearing escrow policy was in the best interest of the home-buying public or the Nation's overall housing goals.

INCREASE IN MORTGAGE RATES

Other lending institutions stated that, although they would not eliminate escrow accounts, they could not afford to pay interest on them. Essentially, these institutions indicated that the cost of paying interest on escrow funds would be recovered from the homeowners generally through an increase in mortgage interest rates. Others indicated, however, that costs would be recovered by charging for the escrow service or for tax searches.

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We did not examine the validity of these responses. They are included in the report to show lender institution reaction and to set out possible impacts that legislation would have requiring lending institutions to pay interest on escrow accounts.

CHAPTER 7

OTHER FACTORS FOR CONSIDERATION IN

DEVELOPING LEGISLATIVE PROPOSALS

GAO's study of escrow accounts attempted, as requested, to examine lending institutions' escrow operations in economic terms: that is, in terms of the cost to maintain such accounts and the net profitability of the escrow operation to lending institutions. During the study, however, a number of other issues relating to escrow account activity emerged which involved other than economic considerations.

Although we did not evaluate these other issues, they may be of general interest in developing and considering legislative proposals dealing with escrow accounts.

INTEREST ON ESCROW ACCOUNTS: A QUESTION OF EQUITY RATHER THAN COST

Class-action suits have been introduced largely on the basis of equity rather than cost considerations, and there appears to be some argument as to whether the cost of maintaining escrow accounts by lending institutions should be the primary factor in deciding whether escrow accounts should be interest bearing.

From an equity consideration, the monetary benefits that currently exist in the escrow arrangement accrue exclusively to lending institutions. By maintaining escrow accounts, lending institutions are able to protect the soundness of their mortgage investment against both uninsured losses and tax liens that could be levied for nonpayment of taxes. Lending institutions invest escrow funds or use their escrow collections to establish lines of capital credit. The question then becomes whether the benefits realized by lending institutions from escrow accounts should be shared with the owners of such funds.

ALTERNATIVES TO THE ESCROW REQUIREMENT

Consumer-oriented articles have criticized lending institutions for not providing alternatives to the traditional escrow arrangement for homeowners. The available alternatives used by specific lending institutions include:

Capitalization method--Lending institutions using the capitalization method (see p. 16) are in effect paying interest to homeowners on their escrow accounts. About 23 percent of the savings and loan associations that furnished data, generally the smaller institutions, were using this method of handling escrow payments.

Pledged savings accounts in lieu of escrow accounts--A number of lending institutions informed us that they offer mortgage loan applicants the choice of an escrow account or an interest-bearing pledged-savings account. When the use of a pledged-savings account is elected, the homeowner is required to make a lump-sum deposit in the amount of the tax bill which is nonwithdrawable during the life of the mortgage loan. Under this method, the homeowner receives interest on his savings account if the institution is assured that sufficient funds will be available to meet unpaid tax bills.

Limited-term escrow accounts--Generally, the contractual establishment of an escrow account will continue for the life of the mortgage loan. One lending institution advised us, however, that it was the institution's policy to provide a mortgagor with the option of paying his own taxes or retaining the escrow account when the borrower's equity in the property reaches 40 percent of the property's appraised value. This policy recognizes the changes that do occur in a homeowner's equity in the property and the diminishing risk to the lending institution through the homeowner's increased equity or the appreciation in property values.

According to one lending institution, much of the criticism raised on escrow accounts has been caused by certain institutions' requiring such accounts unnecessarily. This respondent stated, generally, that escrow accounts should be used only when required by Federal or State laws and regulations and should not be imposed upon a homeowner whose interest in the mortgaged property is sufficient to meet property-related obligations.

CHAPTER 8

SCOPE OF REVIEW

As requested by Congresswoman Sullivan, we directed our review toward determining

- --the costs that lending institutions experience in maintaining escrow accounts,

- --the net profit earned or loss sustained by lending institutions from their escrow operations,

- --the comparability of costs incurred to maintain escrow accounts for mortgages with the costs applicable to similar account services provided by lending institutions,

- --the total amount of money involved in escrow accounts,

- --the effect of the failure to establish escrow accounts on foreclosure rates,

- --the extent to which borrowers are charged with searches for tax records, and

- --the value of the escrow practice to governmental tax collection agencies.

Over 19,000 lending institutions and mortgage bankers are involved in the residential mortgage market. To obtain information on lending institutions' gross income, costs to maintain escrow accounts, net profits, foreclosure experience, and related matters, we distributed a questionnaire to a statistical sample of 971 commercial banks, mutual savings banks, savings and loan associations, and mortgage bankers. We received responses from 684, or 70.4 percent, of the sampled institutions. These respondents owned or serviced about $80.2 billion in residential mortgage loans and had escrow collections in excess of $2.5 billion. (See app. II.)

On the basis of the escrow collection data reported, we estimate, statistically, that escrow collections, nationwide, amount to about $9.4 billion annually. The response rate to other data requested was too inadequate to make statistically reliable projections.

As part of our study, we also

--discussed the issues, etc., involved in the study with officials of Federal agencies involved in the residential mortgage market, including FHA, VA, the Farmers Home Administration, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation;

--obtained the views of 22 governmental taxing authorities on the advantages and disadvantages of collecting local property taxes through lending institutions;

--inquired into the studies made by California and Massachusetts on the feasibility of making escrow accounts interest bearing to homeowners;

--obtained information from attorneys, representing plaintiffs, on the status of class-action suits to require lenders to pay interest on escrow accounts; and

--examined data furnished by 18 selected lending institutions, about half of which were paying interest on escrow accounts, to determine the accuracy of the gross income and costs of maintaining escrow accounts.

LEONOR K. (MRS. JOHN B.) SULLIVAN
3D DISTRICT, MISSOURI

COMMITTEES:
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COAST GUARD, COAST AND GEODETIC SURVEY, AND NAVIGATION

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September 29, 1972

Honorable Elmer B. Staats
Comptroller General of the U.S.
441 G Street, NW
Washington, D.C. 20548

Dear Mr. Staats:

As ranking Member of the Subcommittee on Housing of the House Committee on Banking and Currency and chairman of the Subcommittee on Consumer Affairs, I have been working for some time on legislation to try to assure greater justice to home buyers in the treatment of the funds they are required to deposit with mortgagees each month in escrow accounts for the payment of taxes and insurance. FHA and VA require that such escrow accounts be established for all insured or guaranteed mortgages; the Federal Home Loan Bank Board does not require such accounts on conventional mortgages but encourages insured savings and loans to establish and maintain them. In most instances, the mortgagor receives no interest on these deposits, although the mortgagee usually derives interest or other important economic benefits from the use of these funds prior to paying them out for their intended purpose.

This letter is to request that the General Accounting Office conduct a study to determine the feasibility and validity of having Federally-related residential mortgage escrow accounts be made interest bearing to the mortgagor, or--and this would be of particular interest to my Subcommittee on Consumer Affairs--be figured into the annual percentage rate of the finance charge under the Truth in Lending Act to the extent that these required deposits constitute additional income to the mortgagee.

Section 914 of H.R. 16740, the proposed Housing and Urban Development Act of 1972, directs the Board of Governors of the Federal Reserve System to conduct a study of escrow accounts. As you may know, the Committee on Rules has declined to clear H.R. 16740 for floor action, and consequently it is now unlikely that this will be considered by the House during the remainder of this Congress. I intend to introduce legislation early in the next Congress to provide mortgagors on Federally-related mortgages with a fair share of the interest or other benefits derived by mortgagees or their agents in the handling of these funds. It will be extremely helpful to me and other Members of the Committee on Banking and Currency and the

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Congress as a whole if the escrow study the Committee had proposed in H.R. 16740 could be conducted by the General Accounting Office during the remaining months of this year so that the results are available when either the Housing Subcommittee or the Consumer Affairs Subcommittee would be able to look into legislation on the treatment of escrow accounts in the new Congress.

The question of whether or not GAO has the authority to conduct a study to determine the feasibility of making escrow accounts interest bearing is answered by the fact that the project would have a direct bearing on Federally insured and guaranteed mortgage programs. Interest bearing escrow accounts would provide increased income for mortgagors and thus improve their ability to obtain FHA and VA insured and guaranteed mortgages and to meet mortgage payments. By the same token, the risk of foreclosure and the consequent cost to the FHA insurance fund in particular and to the taxpayers of the nation in general would be significantly reduced. The scope of the issue is indicated by the fact that FHA and VA housing programs constitute one-third of the nation's entire housing market. Moreover, FHA and VA mortgage programs for the most part depend on Federally regulated and insured lending institutions or secondary mortgage markets in which the Federal Government participates. Finally, adoption of legislation requiring that escrow accounts be interest bearing would have a beneficial impact on all of the nation's homebuyers and home owners and thus strengthen the effort to achieve the national housing goals established by Congress in the 1968 Housing Act.

A number of mortgage lending institutions and groups of individuals connected with residential real estate loans and real estate management are now paying interest on escrow accounts or accounts which are similar to escrow accounts. Details are contained in the Congressional Record insert enclosed with this letter.

I also call your attention to the question of the effective interest rate paid by local governmental bodies that borrow on a short-term basis to fill temporary revenue gaps that exist prior to the semi-annual or annual payment of property taxes which are collected and held by mortgage lending institutions. Details on this issue are also contained in the enclosed Congressional Record insert. An analysis of this type of situation would also prove very useful to Members of the Committee.

Section 914 requires that the study of escrow accounts include information on:

1. The cost to lenders of maintaining such accounts;

2. The profit or loss they sustain;

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Honorable Elmer B. Staats September 29, 1972

3. A comparison of this cost with costs of similar accounts services;

4. An estimate of the amount of money involved in escrow accounts;

5. An estimate of the effect of failure to establish escrow accounts on foreclosure rates;

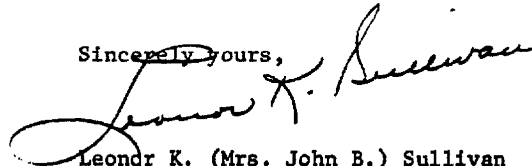
6. The value of this practice to tax collection agencies;

7. The extent to which borrowers are charged with searches for tax records.

The various items that make up this broad study of escrow accounts were suggested by various members at the time the Banking and Currency Committee adopted Section 914. They comprise a series of legitimate questions which should be answered in the study.

I am looking forward to discussing the project further with members of your staff as soon as possible.

Sincerely yours,



Leonor K. (Mrs. John B.) Sullivan
Member of Congress
3rd District, Missouri

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SELECTED STATISTICS ON LENDING INSTITUTIONS

RESPONDING TO THE GAO QUESTIONNAIRE ON ESCROW ACCOUNTS

Data on sample	Commercial banks	Mutual savings banks	Savings and loan associations	Mortgage bankers	Total
Number in universe	13,744	489	4,402	758	19,393
Number in sample	190	158	402	221	971
Number responding	132	115	258	179	684
Percentage of response	69.5	72.8	64.2	81.0	70.4
Number of mortgages:					
Owned	175,533	1,058,114	1,020,058	131,974	2,385,679
Serviced	35,148	10,005	30,359	3,041,039	3,116,551
Total	210,681	1,068,119	1,050,417	3,173,013	5,502,230
Value of mortgages (in millions):					
Owned	$ 3,176.3	$ 14,433.4	$ 16,788.8	$ 2,546.2	$ 36,944.7
Serviced	621.0	97.5	429.2	42,107.9	43,255.6
Total	$ 3,797.3	$ 14,530.9	$ 17,218.0	$44,654.1	$ 80,200.3
Annual escrow collections reported (in millions)	$ 65.2	$ 532.2	$ 357.0	$ 1,583.6	$ 2,538.0
Policy on homeowners' escrow account deficits:					
Advances made	29	95	180	137	441
Advances not made	55	15	31	29	130
Number charging a fee for advances made	3	6	71	1	87
Tax searches made	71	93	172	115	451
Tax searches not made	36	21	53	49	159
Number charging a fee for tax searches	6	3	27	34	70

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DISTRIBUTION OF LENDING INSTITUTIONS

BY SIZE OF DEPOSITS

Size of deposits	Commercial banks		Savings and loan associations		Mutual savings banks		Total	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
(millions)								
Less than $5	3,767	27.5	542	12.3	5	1.0	4,314	23.2
$5 to $9.9	3,292	24.0	670	15.3	20	4.1	3,982	21.5
$10 to $24.9	3,852	28.1	1,341	30.5	76	15.6	5,269	28.3
$25 to $49.9	1,461	10.7	849	19.2	118	24.1	2,428	13.1
$50 to $99.9	684	5.0	529	12.0	109	22.3	1,322	7.1
$100 and over	638	4.7	471	10.7	161	32.9	1,270	6.8
Total	13,694	100.0	4,402	100.0	489	100.0	18,585	100.0

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APPENDIX IV

SCHEDULE OF GOVERNMENTAL TAX AGENCIES VISITED

	Amount of annual property tax collections (000,000 omitted)
TAX AGENCIES COLLECTING PROPERTY TAXES SEMIANNUALLY:	
California:	
Los Angeles County	$2,152
Santa Clara County	346
San Francisco City and County	259
San Mateo County	179
Stanislaus County	48
Washington, District of Columbia	45
Illinois:	
Cook County	1,400
New York:	
Village of Garden City	4
Village of Mineola	1
Town of Hempstead	253
Virginia:	
City of Alexandria	21
Arlington County	31
Fairfax County	100
Total	4,839
TAX AGENCIES COLLECTING PROPERTY TAXES ANNUALLY:	
Colorado:	
Denver County	47
Jefferson County	36
Arapahoe County	36
Adams County	16
Georgia:	
DeKalb County	53
City of Decatur	1
City of Atlanta	80
Maryland:	
Prince Georges County	119
Montgomery County	130
Total	518
TOTAL COLLECTIONS	$5,357