New Federal Lending Rules Require Lenders to Increase Use of Escrow Accounts

January 21, 2013 - If you have ever purchased a home and put less than 20% down, then you know what a mortgage escrow account is. Lenders used these accounts to collect monthly payments for property insurance and taxes. And when those bills come due, the lender makes those payments on behalf of the borrower. In the past, borrowers that were subject to escrow account requirements could get the lender to waive the requirement in is little as one year if they met certain conditions. But a new lending rule that will take effect in June will mean that some loans will require the use of escrow account for a minimum of five years. But there are exceptions.

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The new escrow account requirements were published in this morning's Federal Register. They are being implemented by the CFPB with the goal of reducing the risk of foreclosure when consumers can't pay their taxes or insurance.

This particular rule affects loans that the CFPB calls "higher priced loans". That's code-speak for loans that are not considered "prime". The rule defines these as first mortgages that are priced at least 1.5% above the prime interest rate or subordinate mortgages (meaning a 2nd or a 3rd mortgage) that are priced at least 3.5% points above the prime rate.

Loans that fall into this category currently have an escrow account requirement for the first year of the mortgage. Under the new rules, that requirement will be for a minimum of five years. But there are some exceptions.

Small lenders who agree to keep the loan in their own portfolio can waive the requirement. Additionally, rural areas with very few lenders are exempt. And finally, areas considered "underserved" the Department of Housing and Urban Development may also be exempt. In both the "rural" and "underserved" areas, for the lender to be exempt, the lender must be one of no more than two active lenders within the area being served.

Borrowers using these "higher priced" loan products typically have lower credit scores but they could also include those who are self-employed and who may have trouble producing the documentation required for prime loans. The effect of the new rule on borrowers is that their monthly loan payment will be higher but that should be offset by them not having to make their own payments for property taxes or insurance.

It is important to note that while borrowers may be required to pay their property insurance bills through an escrow account, they still have the right to shop for the best insurance rates and are well advised to do so.

Borrowers also need to know that the monthly amount collected by lenders for their escrow account can be changed; either up or down. Changes in property tax rates or insurance payments can cause these changes. As a borrower, if you think that your lender is collecting too little money to cover these expenses, you should have a conversation with the lender. Not doing so could lead to a significant upward adjustment in your bill later on. You may be able to avoid this by being proactive.

The same is true if you think that your lender is charging you too much. For instance, if you are able to get a significant reduction in your insurance costs by switching providers, then you should notify your lender right away. You may be able to arrange a reduction in your monthly payments as a result.

While borrowers may be required to use an escrow account for a longer period of time under the new rules, they may actually be able to get away from the requirement by refinancing. Any borrower using a higher priced loan product would be wise to do everything possible to improve their overall credit and then refinance into a lower priced loan. Not only could this release you from your overall obligation to use an escrow account, but it could also save you tens of thousands of dollars in interest payments over the life of the loan.

byJim Malmberg
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