HB
115

HB 115

Tape #	Date
5	2/20
5	2/24
6	2/24
25	4/8

ALASKA PUBLIC INTEREST RESEARCH GROUP

P. O. BOX 1093
ANCHORAGE, ALASKA 99510

PHONE 274-6765

File with HB 115

April 22, 1975

Representative Bob Bradley
Chairman
House Commerce Committee
Pouch V
Juneau, Alaska 99801

Dear Representative Bradley:

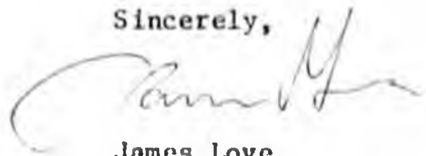
Enclosed is a copy of a proposed amendment to HB 115, an act which would compel mortgage lending institutions to pay interest on mortgage reserve account funds.

The proposed amendment should remove most of the difficulties inherent in tying the interest rate to the passbook savings rate, an objection often raised by the banking industry. With modern computerized accounts, the one-half percent margin for lending institutions provides ample income to cover the cost incurred in administering the accounts.

If this bill is passed as amended, each home owner with a mortgage will receive between $25 and $50 dollars each year in interest earned on their money being held in escrow.

Please advise me if this information is sufficient.

Sincerely,



James Love
Director

File under
HB 115

Alaska Public Interest Research Group

Mortgage Escrow Accounts

or

GIVING INTEREST WHERE INTEREST IS DUE

April 29, 1975

Remember the old-fashioned Christmas Clubs? Periodically, a small amount would be deposited into this account and at the end of the year the depositor would get back exactly the amount he had put into it. This scheme prevailed under the guise of another "free of charge" service from your friendly bank.

The depositors were overwhelmed by such service. Likewise the banks were overjoyed to have these interest free deposits! It took a while, but it finally dawned on people that they were simply contributing to the wealth of the banking industry. What had started as an added service, "free of charge" ultimately turned out to be just another form of swindle upon the slow-witted trusting consumer. Fortunately, people finally caught on, resulting in a marked decline of members in such "Clubs".

However, yet another form of "no interest" operation still goes on, accumulating several billion dollars a year on which savers do not earn a cent. And again, consumers are beginning to show a lot of interest in this "no interest" scheme.

It exists under several names-escrow, impounded funds, and T&I Accounts (Tax and Insurance). Every homeowner who makes monthly payments to a savings and loan association, mortgage company or local bank is donating hundreds of dollars to the multi-million dollar wealth of these lending institutions.

Unlike the Christmas Clubs though, the escrow account concept was a response to a critical problem. The depression of the thirties found Americans literally unable to buy homes. Few banks had sound liquid cash positions and lending for property and homes was considered very risky. Extremely high down payments were demanded, along with very high interest rates and very short periods were allowed for re-payment(thirty year mortgages were unheard of). The average American, even the employed ones, found such demands impossible to meet.

At this point the Federal government decided to intervene. In 1934 the Federal Housing Administration was created by the National Housing Act. It provided for low down payment loans with the FHA insuring the repayment of principle and interest. The FHA went to the lending institutions and argued for a situation where housing would be more in the reach of middle class Americans with the monthly loan payments closer to an average rental payment. The banks, shaky and fearful, claimed home loans were too big a risk, so the FHA said the government would insure them against loss. Not dollar for dollar, but enough to encourage a change in lending practices. Additionally, the FHA formulated regulations by which all insured loans would have to be governed. One of these regulations was the establishment of "escrow" accounts.

Prior to escrow, an owner of a mortgaged property was responsible for paying taxes and insurance as they fell due. As money became scarce, many owners could not meet insurance payments or simply did not buy any. Tax payments were often not met. Unnumbered citizens lost their property to foreclosure by the local taxing bodies or through uninsured damage. In the cases where the equity was low (little of the loan paid off), the banks suffered severe and heavy losses. Escrow accounts, where each monthly loan payment included payment toward future tax assesments and insurance payments, and those monies were set aside in special accounts, were the solution for both the person paying off their mortgage and the lender. It meant that when taxes or insurance fell due the money existed in the escrow account. The mortgagor did not have to scramble for the "extra" cash and the banks did not have to fear that the money they had loaned would be lost to foreclosure or uninsured damage.

The benefits of the establishment of escrow accounts cannot be underestimated. It played a large part in making home ownership possible for literally millions of Americans. And it has through the years supplied millions upon millions of dollars profit to lending institutions.

Now that we have given credit where credit is due, it is time to move on to discussing giving interest where interest is due.

While escrow accounts, as we have pointed out, arose from a genuine need and remain a real service to mortgage customers, it is a service you pay exorbitantly for.

For instance, the cost nation wide in monies lost to the home buying consumer, borrowing from just savings and loan associations alone, is in excess of $75.6 million annually! And, based on the GAO (General Accounting Office) estimate of the aggregate of escrow deposits in all lending institutions, this service costs in total are $470 million a year.

This rip-off works in a very simple manner. Each month, when you make your mortgage payment, you also pay 1/12th of your estimated tax and hazard insurance bill. This money is set aside in an escrow account. As far as the homeowner is concerned, it is sitting idle, growing payment by payment, until the bank receives the bills and pays them. (Taxes in Anchorage are paid twice yearly, insurance once.) However, it takes very little reflection on anyone's part to realize that "idle" money is an absolute anathema to a banker. In fact, it would be senseless to expect a business whose profits come from "using" money-buying, selling, investing-to allow perfectly good money to languish unused. Nor does it.

Your money is used. Lenders invest these funds in short term securities for financial gain. Such use of consumers money that is on deposit with a financial institution is a matter of course, an accepted and approved practice.

And in a straightforward transaction the depositor receives some of the profits his money makes. When the bank uses your money, it pays you interest-just as you pay interest to the lending institutions when you borrow and use their money. With one glaring exception. The overwhelming majority of lenders will pay you no interest on your escrow monies on deposit with them. No matter how much proft they make from its use.

The figure mentioned earlier of $470 million---four hundred-seventy million dollars---is the amount American homeowners who are paying off mortgages would have received in one year if they got even 5% interest on their impounded monies. (And lest you think impounded is a harsh term, try buying a home through a financial Institution without agreeing to deposit your tax and insurance money with them!)

The arguments of lenders on this subject are curiously contradictory. Lenders repeatedly emphasize the benefits which the Escrow System provides them protection against unnecessary foreclosure. They also question the necessity of requiring payment of interest since the amounts involved would be so small as to not make it worthwhile. Yet at the same time they threaten to raise interest rates or cancel escrow services if payment of interest is required. If the interest on escrow would be so small, why should its payment affect an institution to the point that it would be forced to re-coup by raising the interest on money lent? If the escrow system is so beneficial to lenders, why would they abandon it simply because of the forced payment of a "paltry" sum?

Additionally, local lenders like to talk about the unique money problems of Alaska. They claim that the majority of the escrow money deposited with them is actually not theirs to use. Your mortgage is in fact usually sold to

bigger outside investors and the local institution is paid by them to service the account-bill you, collect payments, make payments etc. The claim is that escrow monies go, along with the principle payment, to the invester currently holding your mortgage. The example most often used is FNMA, the Federal National Mortgage Association (Fannie-Mae). They are the nations' single largest investor in residential mortgages, holding a net portfolio of 23.6 billion in mortgages and loans. Some local lenders claim that FNMA requires the original lender and servicing institution to pass along their escrow accounts. That if institutions do not, that FNMA will not buy the mortgages and Alaska will loose one of its major sources of capital, and therefore consumers will not be able to buy homes!

It is true that there is not enough money in Alaska to serve the needs of all those people qualified to borrow. If groups like FNMA refused to give our local lenders money for mortgage paper there would be a drastic reduction in available home loans.

It is not true that FNMA demands the use of the escrow money and is therefore the one using it, not our local institutions. It is not true that they will not invest in the mortgage market of Alaska without it. Not according to the public and printed statements by FNMA.

One page 41 of Background and History by FNMA, under "Treatment of Tax and Insurance Escrow Funds by Servicers" it is stated:

> "Prior to July 1949, servicers were required to remit all collections, including those for the payment of taxes, charges, assessments, and hazard insurance to the Association and such items were paid direct. Beginning in July 1949, such funds then held by the Association were transferred to the appropriate servicers and were deposited in a custodial account maintained by each such servicer in a depository institution approved by it, and the servicers thereafter paid taxes, hazard insurance, etc., as they became payable. In January 1953, the dollar amount of the funds that could be held on deposit by a

servicer in an approved custodial account was limited to $250,000, and in January 1954 these deposits were further limited to (a) a sum not exceeding $10,000 for any one mortgagor account, or (b) in any event not in excess of $250,000. Effective at the end of, and subsequent to, February 1955, the total amount of the deposits that could be held by a servicer in an approved custodial account or accounts could not exceed the greater of (a) $2,500 or (b) the sum equal to two times the average monthly collection of the deposits for taxes, hazard insurance, etc., but in no event in excess of $250,000.

With respect to home mortgages purchased after August 1970, all escrow funds are held by the servicers."

In a January, 1975 interview with Mr. Dickson of FNMA's Mortgaging Programing in Washington D.C., our researcher was assured that the above statement is FNMA's current policy. He also stated that as of August 1970, FNMA actually pays a servicing fee to the institutions which sold the mortgages.

Which brings us to another favorite arguement offered by lenders. That the sum in individual accounts are so small, and the servicing process so costly that virtually any money made from investing said deposits is eaten up. That in fact, if lenders are required to pay any meaningful interest it will cost them more than they make from the account and therefore they will have to cease offering escrow services.

As far as we can ascertain, this arguement has never been substantiated with facts and figures. Nor do we believe it can be. Figures given at national hearings in 1972 showed that for a median size savings and loan association (assets of 15 million) investing their escrow monies at 4% the yield would be 7 times greater than their labor costs involved in administering the accounts. (Presentation by Home Federal Savings and Loan Association made to the Senate Committee on Banking, Housing and Urban Affairs at a public meeting held in Souix Falls, Idaho on conventional mortgage forms.)

One need only take a look at the usual kind of investment made with escrow monies-short term Federal Securities-to see the kinds of profits that are available.

The U.S. Treasury Department issues securities whose interest rate is determined by bids from prospective investors prior to each issue. There are three types; the one most useful to investors of escrow monies are called Treasury Bills, or T-Bills. These Bills have a term of one year and usually come in $10,000 denominations, although twice in 1974 issues were made of $1,000 T-Bills.

These Bills are suited to escrow investors because they mature in time for the escrow funds to be available for payment of taxes and insurance. The last issue of T-Bills is returning on your money an interest yield of 5.04%, and the next issue will yield 6.31%.

With this kind of interest available the lending institutions could readily pay the costs of administering the escrow accounts and still give a 5% return to their depositors.

Of course, now the question arises, "What would this mean to me, individually?"

Perhaps the best way to answer that question is to take a look at the institutions in Alaska that give some kind of interest on escrow account. There are two.

Home Federal Savings and Loan Association of Anchorage pays passbook savings rate on ALL escrow account, from single family residences through commercial mortgages. The present rate of interest is 5 1/4%, compounded daily. Statements are issued quarterly showing how much is in the reserve account and how much interest has been earned. Home Federal has only been open a little over a year but they estimate the average gain to the home buyer is about $30 a year.

Alaska Mutual Savings bank also pays interest on escrow accounts, but only to owners who occupy a single family residence. The interest rate is much lower, 3 1/2% on balances up to $700, going to 5 1/4% on any monies accumulated over $700. An owner of a $60,000 home, paying $160 in taxes would receive $23.

This coupled with the fact that even without a mill rate increase for 30 years, as the value of your property goes up so will the amount of taxes and insurance you must pay into escrow. Over the life of a 30 year mortgage a homeowner could expect to receive over $1000 from the interest on his escrow.

The following box from CHANGING TIMES illustrates further.

Suppose you did it yourself

Ronald and Ruth Martin are fairly typical homeowners. In May 1963 they purchased a four-bedroom house for $20,500 with $3,500 down. Improvements and general appreciation have since increased its value to approximately $35,000. Their lender insisted on escrowed insurance and tax payments.

To see how they might have fared as do-it-yourselfers, *Changing Times* asked the Martins to go back and restructure the payments they have made over the past nine years, crediting each required deposit to a hypothetical savings plan at 4½% interest compounded quarterly and using this account to simulate payment of each tax and insurance bill as it had come due.

The Martins made a substantial lump-sum payment into the account at the time of settlement. Their monthly escrow payments, and hypothetical deposits, were just under $37 at the start and have gradually increased to about $57 as both taxes and insurance premiums have gone up.

After searching their files and doing all the arithmetic, the Martins found that as of May 1972 they would have been almost $300 ahead under the savings-account method.

Of course, they would have spent a small percentage of the difference on stamps and envelopes for bill payments and an occasional letter. As it turned out, they got involved in correspondence anyway. Twice during the nine-year period—in 1964 and again in 1968—their insurance was canceled because the lender didn't pay the premiums on time. This despite the fact that one of the justifications for mandatory escrow accounts is that they prevent such problems.

July 1972 CHANGING TIMES *The Kiplinger Magazine* 7

It becomes clear that not only can one argue persuasively for the payment of interest from a moral standpoint, but that there are compelling financial reasons. Plainly, the income loss to consumers is substantial. In a year of Federal tax rebates, the economic value of getting fair interest on any money one is required to deposit cannot be ignored.

It is important to note that the movement to resolve the present economic inequities inherent in no interest escrow account is nation wide. Solutions are being proposed and discussed in the U.S. Congress as well as in many state legislatures. Litigation in behalf of the consumer has been filed in states across the country. Despite the fact that for the last three months AkPIRG has been gathering information on what is happening in other areas, it is probable that we have just scratched the surface of available information. What we have found follows.

LEGISLATION

National

1.) Senator Wright Patman of Texas, Chairman of the House Committee on Banking and Currency, in 1972 introduced a bill, H.R. 13337, Real Estate Settlement Cost Reform Act, that would have required lenders to pay interest on money in escrow accounts at the rate of more than one percentage point below the lowest rate currently paid by the institutuion.

2.) Represenative Leonore Sullivan of Missouri introduced H.R. 12066 in December, 1973, the "Proposed Federal Real Estate Settlement and Escrow Account Act."" This bill was one of ten introduced in 1973 relating to escrow accounts. It provided that, among other things, on federally related mortgage loans the borrower may elect to pay his own taxes and insurance premiums when due, but if he elect to have the lender set up an escrow account for this purpose, the borrower and lender may mutally agree between them as to whether interest shall be paid and at what rate of interest.

3.) Representative George E. Brown, Jr. introduced two bill in 1973. H.R. 11460 (also known as H.R. 9315), "The Escrow Account System Improvement Act" which deals with reform within the present system of escrow accounts Under section 6, a ceiling interest rate of 6 3/4% would be required on all

escrow deposits. This figure is 3.4% less than the prevailing rate on loans by the Federal Reserve banks to member banks, that difference going for escrow account service costs. The 6 3/4% interest would not be paid directly to homeowners but would be credited toward reducing the balance. The rate could be revised downward but not below 4%

The second bill, H.R. 12275, "Escrow System Improvement Act" would replace escrow accounts with an "Escrow Service Plan" where monthly deposits would be "capitalized", payments not segregated into special accounts with interest calculated, but credited directly toward reducing the balance due on the loan.

States

1.) Connecticut - As of September, 1974, escrow accounts must pay 2% interest.

2.) Indiana - would require insurance companies and other companies engaged in the business of lending money secured by residential or commercial mortgages on real estate to pay interest at the annual rate of 4% to mortgagors on escrow monies.

3.) Minnesota - would require banks, savings and loans and other financial institutions engaged in home financing receiving monies for insurance coverage or real estate taxes to pay interest on such monies at not less than the same rate and on the same basis applicable to its "regular savings account".

4.) Utah - would provide that persons having monies deposited with an escrow agent for payment of taxes and/or insurance in connection with real property transactions shall be entitled to receive interest payments on such monies at least annually and at least equal to interest payable by banks on regular savings accounts.

5.) New York-recently-enacted-must pay 2% a year on home mortgage escrow accounts.

6.) Maryland-enacted 1974-must pay interest on new mortgages where the loan interest in 10% or greater.

7.) Massachusettes - beginning on July, 1975, banks will credit interest to escrow but exact rate not yet set (as of 7/8/74).

8.) Oregon - Gerald Ansell, engineer, has been attempting since 1969 to win legislative acceptance of a plan that would either make interest mandatory on escrow accounts or have each payment capitalized to the credit of the borrower.

LITIGATION

Five Theories

There are in general, five theories for recovery that have been and are presently being pursued in litigation on behalf of the mortgage consumer.

Breach of Contract

This particular theory is the one presently being used in the case in Houston against 43 institutions. In a nut shell; when lending institutions arbitrarily and unilaterally change from a system like capitalization, a system from which the mortgage customer receives monetary benefit, to escrow, under the original contract and without notice, to the detriment of the customers and to the benefit of the lending institution, enriching them unjustly, it is argued that the lending institutions have breached the contract.

Express Constructive Trust

It is argued that since funds in an escrow account are deposited for a particular purpose and the mortgagee has notice of the expenses that the funds are to pay, a trust relationship is created. An express trust arises as a result of a manifestation of the intentions of the parties, that is, from contract

provisions; while a constructive trust is imposed by the court as an equitable doctrine to prevent unjust enrichment. Therefore, under the trust theory through conveants in the mortgage, lending institutions agree to act as agents of the mortgagors and discharge tax and insurance premium obligations giving rise to a fiduciary relationship of trustee and beneficiary. The payments for taxes and insurance premiums are a pre-deposit for a specific purpose, namely to pay property taxes and insurance premiums - obligations belonging to the mortgagor. Since such pre-deposit payments are deposited in an escrow account for a specific purpose, legal and equitable title does not pass to the mortgagee; instead mortgagee holds this money as a fiduciary for a specific purpose.

Under this interpretation, the earnings derived from escrow funds might be considered an unjust enrichment upon which the court could impose a constructive trust, requiring the payment of interest to all required to maintain mortgage escrows.

Truth-In-Lending

Quite simply, this arguement rests upon the premise that if a bank states it is charging the homeowners 8% but then collects from him an additional interest free loan every month, the effective rate of interest is higher than 8%. Since the substance of Truth-in-Lending is to deliver to the borrower "the truth", the lending institutions in failing to state the full annual percentage rate of the loan, are violating the Truth-in-Lending requirement, and unjustly enriching themselves at the expense of the taxpayer/homeowner.

Anti-Trust

The contention is that the lenders through conspiracies, tying arrangements, and conscious parallelism, are monopolizing the market which results in the borrowers having no alternative but to deal with the lender. Tying seems

the most widely applicable. An argument can be made that the non-payment of interest by lending institutions on escrow account is a tying agreement. In other words, the lending institution will loan money to the mortgagor only if the mortgagor agrees to put funds into the monthly escrow account held without interest by the lending institution. Hence, when a borrower is not allowed interest on the monthly escrow payments, he is in essence, giving up a certain amount of earnings (that he might receive elsewhere) which is analogous to the purchase of a tied product.

Usury and "Unconscionable" Theories

Usury laws basically provide one potential cause of action in which a mortgagor may seek cancellation of the mortgage debt. Such was the allegation in Graybeal v American Savings and Loan Association. As a rule usury is governed by state statue which limits the rate of return that a lender may exact from the borrower. The borrower is giving the lender additional funds when he makes monthly payments into the escrow account, and the lender's refusal to pay interest on the funds in effect increases the interest rate the borrower is paying on the principal debt. Since many home loans are usually made at the statutary maximum rate of interest, the additional of the "negative' charge will increase that rate in excess of the legal limit.

Cases

1.) In Sears v First Federal Savings and Loan Assn., 275 NE 2nd 300 (1971) the first appellate consideration of interest-free escrow accounts problem, the plaintiff brought a class action suit on behalf of all mortgage borrowers of the defendant alleging that the $19 million held by the defendant in escrow constitutes funds held in trust by the lender. The plaintiff argued that by commingling escrow and general deposit funds, the defendant violated its fiduciary duty and thus plantiff was entitled to an accounting of all profits earned on the

trust according to the theory of unjust enrichment. A strict construction of the contract clauses by the court resulted in a judgement in favor of the lending institution but did not resolve the question of whether lending institutions should pay interest on escrow funds.

2.) In Washington D.C., 1972, attorney William Dobrovir filed a class action suit against 16 of the city's lenders with usury and violation of both the Truth-in-Lending Act and the Sherman Anti-Trust Laws alleged. Dobrovir demanded an injunction against the continuence of the escrow practice as well as the restoration to the plaintiff of money lost through non-payment of interest. The case was settled in May, 1974 resulting in two leading S&Ls agreeing to give most mortgage customers the option of making their own insurance and tax payments in the future.

3.) As of July, 1973 a similar case was pending in Houston, Texas, which made the same allegations based on constructive and/or Express Trust.

4.) Another class action suit was brought in 1973 in Houston. It went before the Federal District Court in Houston, against 43 banks, savings and loan associations and mortgage companies authorized to do business in Texas and having a principle place of business in Houston. Briefly, the institutions are being sued for breach of contract for abandoning unilaterally the capitalization on monthly tax and insurance payments and without notice adopting standard non-interest paying escrow accounts.

5.) In California, Nathaniel Colley, a Sacramento lawyer contends that 17 area S&Ls have conspired to withhold interest and is pressing for a refund of at least $400,000,000 in past earnings and an agreement to pay interest in the future. The suit has inspired similar class actions in Arizona, Arkansas, Florida, Illinois, Iowa, Nebraska, New York, Pennsylvania, and Wisconsin.

RECOMMENDATIONS

The first step in finding a remedy for this untenable situation is for consumers to begin receiving a fair interest on the money they are <u>forced</u> to deposit if they wish to buy a home.

1.) Alaska Public Interest Research Group is recommending that House Bill 115, introduced by Representative Fink, which calls for interest to be paid "at the rate established by the Federal Deposit Insurance Corporation as the maximum allowable rate on passbook savings accounts; or, if no rate is so established, at the rate paid by the financial institution on passbook savings accounts; or, for those financial institutions or lenders which do not provide passbook savings account services, at the rate established semi-annually by the commissioner as the prevailing passbook savings account rate" be amended to read, "at the rate then established quarterly by the commissioner, as one-half of one percent less than the prevailing rate of return from Federal Securities, U.S. Treasury Department Treasury Bills".

This proposed amendment assures the payment of interest to all homeowners required by lenders to maintain escrow account <u>at a rate commensurate with the investment value of the money being held</u>. The lender would be allowed to retain income derived from the one-half point interest rate differential to cover the cost entailed in performing the customer service of administering the escrow account. However, the earnings from the customers' money would go to the customer, not the lending institution as in the past.

2.) The local tax bodies should examine the costs involved in an improved method of collecting taxes that would minimize the practice of borrowing on Tax Anticipation notes. Those costs should be weighed against the cost to the taxpayers to continue as we are, having paid $200,000 last year alone in interest on Borough borrowing. The facts and costs should be made public.