DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 3500

[Docket No. FR–4079–P–01]

RIN 2502–AG75

Office of the Assistant Secretary for Housing-Federal Housing Commissioner Real Estate Settlement Procedures Act (Regulation X): Escrow Accounting Procedures

AGENCY: Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD.

ACTION: Proposed rule.

SUMMARY: This proposed rule addresses three problems that have arisen in applying HUD's current escrow accounting rule under the Real Estate Settlement Procedures Act (RESPA), proposes a minor additional change to the RESPA rule, and provides public notice of certain technical clarifications to the rule. This proposed rule includes several appendices, which in the final rule are likely to be published as Public Guidance Documents (rather than codified appendices), in the interests of regulatory streamlining. However, these materials are set forth in this proposed rule as appendices, for the convenience of commenters during the review period.

The first problem addressed in this rule involves the application of requirements respecting the method of servicers' disbursements from mortgage escrow accounts where the payee (i.e., the entity to which escrow items are owed, such as a taxing jurisdiction) offers a choice of disbursements on an annual or installment basis. Because of perceived ambiguities in the current rule, there have been disparities in performance among mortgage servicers. Some servicers switched to making annual disbursements for escrow items, such as property taxes, where discounts for these payments were available, while other servicers switched to installment disbursements for items where installments were allowed. The choice of disbursement methods has consequences for borrowers, including increasing or decreasing the amounts required to be deposited into the escrow account at closing and during the life of the escrow account. The disbursement method may also have income tax ramifications, depending on the timing of disbursements for deductible items. Because of these consequences, this rule proposes several alternatives for addressing this problem, including, as the preferred option, offering the borrower the choice of disbursement method.

The second problem involves cases where the servicer anticipates that disbursements for items such as property taxes will increase substantially in the second year of the escrow account. Because HUD's current escrow rule provides for calculating escrow payments based on the projection of escrow disbursements for a 12-month period, when escrow items increase substantially after the initial 12-month period, the result could be that the servicer may require of the borrower a substantial increase in monthly payments for the second year, not only to reflect the higher disbursements, but to make up a deficiency or shortage in the escrow account. To avoid this type of surprise for the borrower, who may not be prepared to make the higher payments, the rule proposes several solutions to this problem, including, as a preferred option, offering the borrower the choice at closing of how the account is to be calculated.

A third problem that this rule proposes to address, in the interest of avoiding confusion, is the means of disclosure on the HUD–1 and HUD–1A settlement forms of amounts required for the escrow account. HUD is also proposing a minor additional change to the RESPA rule and is clarifying existing regulations regarding matters that do not require substantive modifications to the regulatory language.

DATES: Comment due date: November 4, 1996.

ADDRESSES: Interested persons are invited to submit comments regarding this proposed rule to the Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410–0500. Communications should refer to the above docket number and title. Facsimile (FAX) comments are not acceptable. A copy of each communication submitted will be available for public inspection and copying between 7:30 a.m. and 5:30 p.m. weekdays at the above address.

FOR FURTHER INFORMATION CONTACT: David R. Williamson, Director, Office of Consumer and Regulatory Affairs, Room 5241, telephone 202–708–4560; or, for legal questions, Richard S. Bennett, Attorney; Grant Mitchell, Senior Attorney for RESPA; or Kenneth A. Markison, Assistant General Counsel for GSE/RESPA, Room 9262, telephone 202–708–3137 (these are not toll-free telephone numbers). For hearing- and speech-impaired persons, these telephone numbers may be accessed via TTY (text telephone) by calling the Federal Information Relay Service at 1–800–877–8339 (toll-free). The address for each of these persons is: Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410–0500.

SUPPLEMENTARY INFORMATION:

I. Background

Section 10 of the Real Estate Settlement Procedures Act of 1974 (RESPA) (12 U.S.C. 2609) establishes the statutory limits on the amounts that mortgage servicers [1] may require a borrower to deposit into an escrow account if the servicer chooses to establish one. (RESPA does not require the use of escrow accounts.) Section 10(a)(1) prohibits a servicer, at the time the escrow account is created, from requiring the borrower to make payments to the escrow account that exceed the maximum amounts calculated in accordance with the statute. These maximum amounts are calculated by analyzing how much money will be needed to cover disbursements for the mortgaged property, such as taxes and insurance, and to maintain a cushion no greater than one-sixth of the estimated total annual disbursements from the account. Section 10(a)(2) prohibits the lender, over the rest of the life of the escrow account, from requiring the borrower to make payments to the escrow account that exceed the amounts allowed under RESPA. The maximum monthly amount that may be collected from the borrower is equal to one-twelfth of the total annual escrow disbursements that the lender reasonably anticipates paying from that account during a year, plus the amount necessary to maintain the one-sixth cushion. No provision of Section 10 requires that the servicer collect the maximums allowable under the statute; the servicer may always collect less and is not required to collect any cushion at all.

Section 10 and section 6(g) of RESPA (12 U.S.C. 2605(g)) govern the timing of disbursements from escrow accounts. In choosing a disbursement date, section 10 requires that the servicer follow ''normal lending practices of the lender and local custom, provided that the selection of each such date constitutes prudent lending practice.'' Section 6(g)

[1] At times RESPA uses the term ''lender'' and at other times it uses the term ''servicer.'' A lender creates a loan obligation, but may or may not service the loan. Within this proposed rule, HUD uses the term ''servicer'' to include the lender when the lender performs the servicing function.

requires servicers to ''make payments from the escrow account for such taxes, insurance premiums, and other charges in a timely manner as such payments become due.''

On October 26, 1994 (59 FR 53890) (October 1994 rule), HUD published a final rule implementing sections 6(g) and 10 of RESPA and changes to RESPA made in section 942 of the National Affordable Housing Act (Pub. L. 101–625, approved November 28, 1990). The effective date of this rule was extended to May 24, 1995, as a result of a February 15, 1995, rulemaking (60 FR 8812), which also modified and clarified the October 1994 rule, because of questions on the rule. HUD issued further clarifications and corrections on December 19, 1994 (50 FR 65442); March 1, 1995 (60 FR 11194); and May 9, 1995 (60 FR 24734), and published a notice of software availability on April 4, 1995 (60 FR 16985). Further, HUD's RESPA regulations were streamlined on March 26, 1996 (61 FR 13232) to comply with the President's regulatory reform initiatives.

Today, HUD is proposing a rule primarily to address three problems under HUD's existing escrow accounting procedures. These problems, explained in greater detail below, are designated for purposes of discussion as:

1. Annual vs. Installment Disbursements;
2. Payment Shock; and
3. Single-item Analysis with Aggregate Adjustment.

These problems were brought to HUD's attention by borrowers, members of Congress, local government officials, and industry representatives.

This proposed rule is consistent with three principles articulated by the Secretary in the preamble to the October 1994 rule:

(1) Reduce the cost of homeownership, by ensuring that funds are not held in escrow accounts in excess of the amounts that are necessary to pay expenses for the mortgaged property and allowed by law;

(2) Establish reasonable, uniform practices for escrow accounting; and

(3) Provide servicers with clear, specific guidance on the requirements of Section 10.

With respect to the first two identified problems, HUD is proposing to revise the escrow rules in ways that would give borrowers more choices. For these two problems, HUD is proposing to require that disclosures be given to borrowers so that they can make informed choices as to their preferences. The proposal would require escrow accounts to be maintained according to those preferences. At the same time, HUD recognizes that providing borrowers this choice may impose additional burdens and costs on servicers, which are frequently passed on to borrowers. Thus, this proposed rule also highlights approaches that have been proposed by industry representatives. HUD seeks comments on all approaches and is also asking a number of questions that are designed to help HUD make decisions among alternatives for the final rule.

II. Annual vs. Installment Disbursements

A. Statement of Problem

The first problem HUD is proposing to address arises when a servicer is confronted with the option of disbursing escrow items, such as taxes, either in an annual lump sum or in installments during the year. In general, payments from an escrow account in installments work to the borrower's benefit, because, on average, they result in lower up-front payments to establish the account (*i.e.*, lower closing costs).[2] However, sometimes payees offer a discount to the borrower if disbursements are made on an annual basis. These discounts are most commonly offered by taxing jurisdictions, which may offer a discount for annual payments of property taxes.

After publication of HUD's October 1994 rule (discussed below in this preamble), many servicers who had been disbursing escrow payments in installments switched to annual disbursements where discounts were available. There were many consequences of the switch that have been described to HUD, and other consequences that HUD speculates may have resulted.

Most of these actual or expected consequences would affect borrowers, and it is borrowers who have expressed the greatest concern about this problem. After HUD issued the escrow rule, some borrowers may have been required by their servicers to make up substantial shortages in their escrow accounts (generally in increased monthly payments over a year), which arose when taxes were switched from installment disbursements to one annual lump sum disbursement. Some borrowers with loans that were switched from installments to annual disbursement may have faced financial hardship in meeting the higher payments. Some borrowers may have believed that the outlay to make up the shortage created with the switch to annual disbursements simply was not worth the discount offered. Other borrowers who were applying for loans may have been unable to come up with the cash required to close as a result of the escrow account being calculated based on annual disbursements instead of installments.

In contrast, some borrowers whose servicers switched from annual to installment disbursements may have preferred to pay more at closing or to have disbursements from an existing escrow account paid in annual disbursements, in order to receive a discount and thereby reduce the overall amount paid or to accelerate property tax deductions on their income tax. Some of these borrowers may have lost a significant portion of their property tax deductions for the year in which the switch was made and may have been unhappy with that consequence.

Of course, although some borrowers may have been adversely affected by a change in disbursement method, there may have been others who benefited, perhaps unknowingly, from such a change. For example, a change from installment to annual disbursements to take advantage of a discount lowered the total tax burden for many homeowners. Similarly, a change from annual to installment disbursements resulted in lower escrow payments and, possibly, refunds for many homeowners. HUD has not heard much about these positive effects. Finally, for many borrowers, HUD's rules apparently have not resulted in any change to the disbursement method for their escrow accounts.

Some taxing jurisdictions may also have been adversely affected by a change in disbursement method. As a result of the servicers changing from annual to installment disbursements, some taxing jurisdictions may have faced an unexpected temporary shortfall in receipts of property taxes. Other taxing jurisdictions may have found that servicers changed from installment payments to annual disbursements; this could have resulted in unexpected

[2] The choice of installment, rather than annual, disbursements often results in substantial reductions in up-front cash requirements for the buyer. For example, if two equal installments could be paid 6 months apart instead of paying the entire bill on one of the installment dates, then homebuyers who close on their loans less than 6 months before the date on which the entire bill would otherwise have been due could come to settlement with 6 months less in tax deposits to the escrow account. This results from the accrued taxes being a half-year's taxes less for those homebuyers. Assuming closings are evenly distributed throughout the year, households with the option of two equal installment payments 6 months apart, will, on average, be able to reduce the average up-front cash required at settlement by 3-months' worth of taxes. In general, as the number of installments grows, so does the average up-front savings.

changes to receipts of property taxes or could have led to shortfalls in income tax receipts as deductions increased for the year the switch was made.

HUD recognizes that promulgating new rules that result in switching accounts from one disbursement method to another could again affect borrowers and taxing jurisdictions and is seeking a way to clear up the problem that resulted from the prior rule while minimizing any further disruption.

B. HUD's Current Regulations

HUD's regulation at 24 CFR 3500.17(k)(1) provides: ''In calculating the disbursement date, the servicer shall use a date on or before the earlier of the deadline to take advantage of discounts, if available, or the deadline to avoid a penalty.'' *See also* §§ 3500.17(b) (definition of ''disbursement date''), 3500.17(c)(2) and (c)(3), and 3500.17(d)(1)(i)(A) and (2)(i)(A). Some mortgage servicers have interpreted this rule to require that a servicer, when offered an option of making a disbursement from the escrow account in installments or in an annual disbursement with a discount, choose the lump sum annual disbursement with a discount, no matter how small the discount is, even if the borrower and the servicer would otherwise agree to forego the discount and have the escrow account computed for disbursements on an installment basis.

On the other hand, other servicers have interpreted HUD's rule, in light of preamble language, to require installments where available and allow, but not require, annual disbursement at the servicer's discretion where a discount is offered for annual disbursement.[3] This approach is in keeping with HUD's intention that the regulations generally favor installment payments, because in many cases they result in lower up-front payments and lower average escrow balances for the borrower. HUD also sought for servicers to take advantage of discounts that would benefit borrowers.

In response to further questions on this issue, HUD indicated in its February 1995 clarifications of the rule that the rule's focus had been to deal ''with a practice, previously engaged in by some servicers, of collecting and paying a full-year's taxes in advance, although they were billed on an installment basis.'' 59 FR 8813. In the preamble to a May 1995 rule, HUD stated that ''servicers were permitted (but not required) to make disbursements on an annual basis if a discount were available.'' The preamble explained:

> [T]he Department received a number of questions regarding circumstances in which the payee offered an option of either installment payments or a one-time payment with a discount. The preamble to the October 26, 1994, and February 15, 1995, rules indicated that when a choice was available, servicers should make disbursements on an installment basis, rather than an annual basis; however, servicers were permitted (but not required) to make disbursements on an annual basis if a discount were available. Once the choice of payment basis is made, the disbursement date chosen for that basis depends on discount and penalty dates. Section 3500.17(k) states that ''[i]n calculating the disbursement date, the servicer shall use a date on or before the earlier of the deadline to take advantage of discounts, if available, or the deadline to avoid a penalty.'' This provision is consistent with the rule, which is designed to avoid excessive upfront payments and balances in escrow accounts and, therefore, favors installment payments, unless there are penalties or discounts that make annual payments advantageous for the consumer. Also, after settlement a servicer and borrower are not prevented by this rule from mutually agreeing, on an individual case basis, to a different payment basis (installment or annual) or disbursement date.

60 FR 24734.

HUD recognizes that the rule text and the preamble language may have created confusion. Until such time as HUD publishes a final rule on this subject, servicers should adhere to the following approach, consistent with HUD's prior guidance: Where a payee offers the option of installment disbursements or a discount for annual disbursements, the servicer should make disbursements on an installment basis, but may, at the servicer's discretion (but is not required by RESPA to), make annual disbursements, in order to take advantage of the discount for the borrower; HUD encourages (but does not require) servicers to follow the preference of the borrower. Where the payee offers the option of either annual disbursements with no discount or installment payments, the servicer is required to make installment payments.

C. Possible Revisions to Regulations to Address Problem

There are several rulemaking alternatives to address whether servicers are to make installment or annual disbursements. These alternatives propose to distinguish between escrow accounts for loans that settle on or after the effective date of a final rule and escrow accounts for loans that settle or settled before the effective date of a final rule.

Each alternative proposes that once a disbursement method has been selected in accordance with the requirements of the alternative, servicers would be prohibited from switching disbursement methods without the borrower's consent. This would mean that even where one servicer acquires servicing from another servicer, the second servicer would be required to apply the same disbursement method as the first servicer, as long as that option is offered by the payee, unless the borrower consents to changing disbursement methods. The reason for this approach is that many loans shifted disbursement dates as a result of the 1994 rule. HUD seeks to develop an approach with the minimum negative impact for borrowers, servicers, and third parties, such as taxing jurisdictions. HUD is concerned that, if the approach adopted results in a large number of additional shifts in the way escrows are disbursed, HUD will create new problems while attempting to solve old ones. HUD believes the approach proposed, if ultimately adopted, would be the approach that would minimize disruption.

If borrowers could be involuntarily switched from annual disbursements to installment disbursements as a result of a transfer of servicing or unilateral change by the servicer, some borrowers would face consequences they did not desire. A switch could result in a surplus that a servicer would be required to return to a borrower, but could also reduce the amount of the borrower's tax deduction for escrow items, such as property taxes, in the year of the switch. If a borrower could be involuntarily switched from installment disbursements to annual disbursements as a result of a transfer of servicing or unilateral change by the servicer, the transfer or change could increase the tax deductions for escrow items such as property taxes in the year of the switch, but could result in shortages for many borrowers.

The approach of prohibiting a servicer from switching disbursement methods without the borrower's consent, including requiring a servicer to use the disbursement method used by the former servicer when there is a transfer of servicing, does not mean that the borrower would have to consent to a transfer of servicing or would have veto authority over such a transfer. Transfer of servicing is governed by section 6 of RESPA and regulations at 24 CFR 3500.21. However, this approach would mean that a borrower would have to consent to a change in the disbursement

[3] The preamble to the October 1994 rule explained, ''Unless there is a discount to the borrower for early payments, the regulation does not allow servicers to pay installment payments on an annual or other prepayment basis.'' 59 FR 53893.

method, including a change proposed by a subsequent servicer. HUD seeks comments on whether this policy would adversely affect the value, and efficiency of the transfer, of servicing rights.

This proposed rule contains the main substance of proposed rule language to implement the various alternatives discussed. Additional conforming amendments to the rule, appropriate to whichever alternative is ultimately adopted, would be required.

Alternative 1: Consumer Choice

New loans. For escrow accounts on any loan closed on or after the effective date of a final rule, servicers would be required to give borrowers the choice of making disbursements of property taxes on an installment or on an annual basis, when those options are offered by the taxing jurisdiction. HUD's proposal does not currently address the choice between installments and annual disbursements for other escrow items, because the question has only been raised to HUD in the context of property taxes; however, HUD would consider addressing other escrow items, depending on comments received.[4]

This alternative would require servicers, at some time before settlement, to provide a disclosure form (in the format of Appendix F) to borrowers whose property taxes will be paid from an escrow account and whose taxing jurisdictions offer the choice between disbursements on an installment or an annual basis. The form indicates some of the advantages and disadvantages to the borrower of installment and annual disbursements and asks the borrower to make a choice between the two methods. If the borrower does not make a choice, the servicer will be required to make installment disbursements of property taxes.

This alternative also provides that once the consumer has made a choice (or installments are required because the consumer has failed to make a choice), the servicer and subsequent servicers are prohibited from changing the method of disbursement for property taxes, as long as the taxing jurisdiction offers a choice, without the borrower's prior written consent.

[4] If the servicer is given a choice between installment or annual disbursements for other escrow items (such as property or hazard insurance), HUD's rule would require the servicer to make disbursements by a date that avoids a penalty, but the servicer would otherwise be free to make disbursements on such date as complies with normal lending practice of the lender and local custom, provided that the selection of each such date constitutes prudent lending practice.

Existing loans. For loans that settled prior to the effective date of a final rule, the servicer and subsequent servicers would be prohibited from changing the method of disbursement for property taxes without the borrower's prior written consent where the taxing jurisdiction offers a choice between installments and annual disbursements. In addition, no later than the first escrow analysis for such escrow accounts performed after the effective date of a final rule, servicers would be required to offer borrowers, in writing, an opportunity to switch from one method of disbursement for property taxes to another.

This approach provides the greatest flexibility to the borrower. However, it may impose higher costs on servicers; servicers will likely need two different disbursement systems to reflect the disbursement preferences of borrowers.

Alternative 2: Servicer Flexibility

Under this alternative, HUD would revise the rule to provide that a servicer must make disbursements by a date that avoids a penalty, but the servicer is otherwise free to make disbursements on such date as complies with normal lending practice of the lender and local custom, provided that the selection of each such date constitutes prudent lending practice. Under this alternative, once the servicer has made a choice of the disbursement method, the servicer and subsequent servicers are prohibited from changing the method of disbursement, as long as a choice continues to exist in the taxing jurisdiction, without the borrower's prior written consent.

The benefit of this alternative is that it is the least-intrusive regulatory approach for HUD to take. In addition, it provides flexibility to servicers. This alternative would also leave servicers free to accommodate borrowers with a particular preference, as long as the borrower's preference is in accordance with normal lending practice of the lender and local custom and constitutes prudent lending practice. The disadvantage of this alternative is that it would not guarantee that servicers would accommodate the preferences of individual borrowers and, therefore, provides less choice for borrowers.

Alternative 3: Keep, But Clarify, Current Requirements

Under this alternative, HUD would clear up any inconsistencies between the regulatory text and the earlier preamble language that have created confusion, as discussed above in this preamble. The rule would be revised to provide that, generally, servicers must make disbursements from escrow accounts on an installment basis, where payees offer that option as an alternative to annual disbursements. Where a payee offers the option of installment disbursements or a discount for annual disbursements, the servicer may, at the servicer's discretion (but would not be required as a result of RESPA to), make annual disbursements, in order to take advantage of the discount for the borrower. Where the payee offers the option of annual disbursements with no discount or installment payments, the servicer would be required to make installment payments. Where a payee offers the option of installment disbursements or a discount for annual disbursements, the rule would provide that HUD encourages (but does not require) servicers to follow the preference of the borrower on whether to make disbursements on an annual or installment basis.

In addition, the servicer and subsequent servicers are prohibited from changing the method of disbursement, as long as a choice continues to exist in the taxing jurisdiction, without the borrower's prior written consent.

The advantage of this option is that, like Alternative 2 (discussed above in this preamble), it provides flexibility to servicers. It would also allow servicers to accommodate borrowers with a particular preference. The disadvantage of this alternative is that it would not guarantee that servicers would accommodate the preferences of individual borrowers, providing less choice for borrowers.

D. Questions for Commenters

While the description of each alternative discussed under the heading ''Annual vs. Installment Disbursements'' in this preamble, indicates some of the possible advantages and disadvantages, there could be other alternatives, as well as unanticipated negative consequences for the industry, borrowers, taxing authorities, or others. HUD seeks comments from the public on which, if any, of these alternative approaches should result from this rulemaking, or whether other permissible approaches under RESPA would better serve the interests of the public and the intent of the statute. HUD also invites commenters to comment on HUD's proposed regulatory language and to submit specific regulatory language to implement their proposals.

HUD is particularly interested in comments on the following issues:

1. How are servicers currently addressing the problem of setting the appropriate disbursement date when

given a choice of annual or installment disbursements?

2. What would be the impact of changing the requirements on particular servicers operating under existing RESPA regulations, particularly with respect to any changes in the requirements for loans settled before the effective date of a final rule?

3. What are the discounts obtained by servicers for borrowers? How large are the discounts? When must disbursements be made in order to receive the discounts?

4. What would be the impact on servicers of requiring them to provide borrowers with a choice? Should this be limited to a one-time choice at closing or should the borrower be free to switch disbursement methods during the life of the loan, and, if so, how often and under what circumstances?

5. What are the relative benefits and disadvantages of an approach that treats loans that settle on or after the effective date of a final rule differently from loans that have settled before the effective date of a final rule—e.g., minimizing the need for a servicer to switch from one method to another for existing loans, but potentially requiring servicers to use different disbursement methods for different borrowers within a single taxing authority?

6. Should the size of an available discount matter and, if so, how? Should HUD provide that once the discount meets a certain percentage or other threshold that: (a) Annual disbursements with a discount must be used; (b) it becomes the borrower's choice whether to make disbursements in that manner; or (c) it becomes the servicer's choice whether to make disbursements in that manner? Should the threshold that determines whether to take the discount be tied to a particular market rate that varies over time, *e.g.*, some percentage above or below the discount rate, the rate on 3-month Treasury Bills, etc.? Should a "reasonable servicer" standard be applied, *i.e.*, allowing a servicer to choose whether to take advantage of the discount if a reasonable person would make such a decision with his or her own money?

7. If an approach is adopted in which the borrower's preference for installments or annual disbursements is controlling, when should the servicer give the borrower the disclosure? If the borrower is required to designate which option is preferred before loan approval, how can the borrower be protected from pressure to select an option that is merely the lender's preference and not necessarily in the borrower's best interest? Because the method selected could affect escrow payments due at closing and each month thereafter, what timing would be necessary for the servicer to prepare the closing documents and perform related work? How will the option selected affect underwriting?

8. If an approach is adopted in which the borrower's preference for installments or annual disbursements is controlling, should HUD prescribe a disclosure format as proposed? Is the information HUD proposes to provide on the disclosure format appropriate for providing the borrower with a fair and informed choice?

9. If an approach is adopted in which the borrower's preference for installments or annual disbursements is controlling, what period of time is needed for the servicer to change the disbursement method?

10. The issue of annual or installment disbursements most often arises in the context of property taxes. If an approach is adopted in which the borrower's preference for installments or annual disbursements is controlling, should this approach apply only to disbursements for property taxes, as proposed, or should it extend to other escrow items for which a choice between installments and annual disbursements may be offered? What should be the rule for other escrow items when a choice is offered?

11. What rules should apply to loans that settle before the effective date of a final rule? What rules should apply to loans that settle after the effective date of the final rule, once those loans have settled? What rules should apply when there is a transfer of servicing?

III. Payment Shock

A. Statement of Problem

Another problem HUD is proposing to address arises when disbursements for escrow items such as property tax disbursements are expected by the servicer to be much higher in the second year of the escrow account than in the first year. As a result, the borrower will be faced with a substantial increase in the monthly escrow payment during the second year and, possibly, a lump sum payment to eliminate a deficiency from the account.[5] For purposes of this rule, a substantial increase is defined as an increase of 50 percent or more in the monthly escrow payment between the payment under the initial escrow accounting and the payment in the second year of the escrow account. A substantial increase in property taxes in the second year often occurs in cases of new construction. In many jurisdictions, the taxes the locality charges for the first year are based on the assessed value of the unimproved property, while for the second year the taxes are based on the improved value. A substantial increase in payments may also occur where a tax disbursement that would normally appear on the projection for the coming year is paid prior to the borrower's first regular payment, *i.e.*, these regularly occurring taxes do not appear in the projection. Reassessments after a property is sold may also cause a substantial second year increase. While the servicer could alert the borrower at closing that an increase will occur, if the servicer does not, the borrower may be unpleasantly surprised by the increase.

This situation results in several problems. Disclosures received at closing show low payment amounts throughout the first year when, in fact, the escrow payment will substantially increase for the second year, or even during the first year if a short year statement is issued at the point when the higher disbursement shows up in the 12-month projection.[6] Some borrowers may be unable to meet the increased escrow payments because the shortage will raise payments even more. A customer relations issue may be created for servicers who have to explain to borrowers why the payment is increased so much.

These concerns have come largely from industry representatives who have responded to numerous borrower inquiries and complaints about increases in escrow payments to reflect higher disbursements and make up shortages. Mortgage servicers have indicated that they would like to avoid any payment change in subsequent years by collecting more money in the first year of servicing.

[5] The increase in the monthly payment can be broken down into two components. Any time an escrow account disbursement increases, it will have the effect of raising the monthly borrower escrow payment by approximately one-twelfth of that increase. In addition, the projection for the coming year shows what the target balance (accruals plus the cushion) should be at the beginning of the coming year. To the extent that expected disbursements in the second year exceed what they were in the first, the beginning target balance for the second year may be in excess of the actual balance at the end of the first year. If so, then there is a shortage to be made up as well. If the 12-month approach is taken to eliminate the shortage, then monthly payments will also rise by approximately one-twelfth of the shortage. If a cushion is used, the payment increases will be slightly higher, until the cushion is built up.

[6] HUD regulations at 24 CFR 3500.17(f)(1) (i) and (ii) provide that, aside from conducting an escrow account analysis when an escrow account is established and at completion of the escrow account computation year, a servicer may conduct an escrow account analysis at other times. The escrow account analyses conducted at other times result in short-year statements.

B. Analysis Under HUD's Current Regulations

Consistent with Section 10 of RESPA, HUD regulations specify the maximum amount that a servicer may legally require borrowers to deposit in escrow accounts. HUD regulations prescribe that in conducting an escrow account analysis, the servicer considers only the disbursements that are expected to come due for a 12-month period. *See, e.g.*, §§ 3500.17(b) (definition of ''escrow account computation year'') and 3500.17(c) (limits on payments to escrow accounts). While the servicer can take into account expected changes to disbursements over the 12-month period,[7] even if the servicer knows that payments from an escrow account will substantially increase at a time more than 12 months in the future, the servicer cannot, when preparing the initial escrow account statement, calculate the borrower's payments to cover the expected increases. However, HUD's existing regulations (3500.17(f)(1)(ii)) allow the servicer to perform short year statements. The regulations also allow borrowers to make additional escrow payments voluntarily to avoid a shortage in the following year. HUD's existing regulations provide that if the borrower makes such additional payments, they must normally be returned to the borrower if they result in a surplus the next time the escrow account analysis is performed. *See* 59 FR 53893 (voluntarily escrowed funds not excluded from the trial running balance calculations).[8] If the additional payments do not result in a surplus the next time the escrow account analysis is performed (*i.e.*, where disbursements will substantially increase), the additional payments do not have to be returned to the borrower.

C. Possible Revisions to Regulations to Address Problem

There are many possible ways to respond to the Payment Shock problem identified. Just as in the case of the Annual vs. Installment Disbursements problem discussed above in this preamble, the Secretary believes that providing the consumer with information to make an informed choice, and allowing the consumer's choice to control, is likely the best approach for addressing this problem. Set forth below are three alternatives, some of which contain options within the alternatives. This proposed rule contains the main substance of proposed regulatory language to implement the various alternatives discussed. Additional conforming amendments to the regulations would be required, consistent with whichever alternative is ultimately adopted.

Alternative 1: Consumer Choice

Under this alternative, when the servicer expects that the bills paid out of the escrow account will increase substantially after the first year, the servicer would provide to the borrower, at some time prior to closing, a written disclosure in the format of appendix G to this proposed rule or a similar format. The borrower would make a choice from several accounting options for his or her account on a format that would indicate, under each option, the amount due at closing; the monthly escrow payments in the first, second, and third years; and the corresponding surpluses anticipated at the end of the first year.[9] The borrower would therefore have the opportunity to make a voluntary choice to limit payment changes in the second year of the escrow account. As would be explained on the disclosure format, if the borrower did not make a choice, the accounting method would ''default'' to the method prescribed under the current regulations (which may result in substantially increased payments in the second year). Once an escrow accounting method is selected by choice or default, that method may not be changed without the consent of the borrower, even if the servicing rights are transferred to another servicer.

Under this alternative, the following accounting methods (illustrated in ''The Payment Shock Problem,'' Appendix H–1 to this proposed rule) would be presented to the borrower for his or her selection:

Method A. Analysis of the account using the accounting method required under the current rule, which results in a shortage at the end of the first year and higher payments in the second year.

Method B. Analysis of the account using an accounting method that has the following characteristics:

—Requires an initial deposit of $0 into the escrow account at closing;
—Requires a monthly payment in the first year equal to one-twelfth of the estimated total annual disbursements from the escrow account for the second year;
—Causes surpluses or smaller shortages at the end of the first year, which causes escrow payments to increase in the second year less than under Method A or not at all.

Method C. Analysis of the account using an alternative accounting method[10] that has the following characteristics:

—Requires an initial deposit into the escrow account at closing greater than the initial deposits required under Method B;
—Requires the same monthly payment during the first year as under Method B, which is greater than under Method A;
—Generates month-end balances such that the lowest month-end balance for the first year equals one-sixth of the estimated total annual disbursements for the second year (the initial deposit is not considered in finding the lowest month-end balance);
—Requires an initial deposit into escrow at closing greater than the initial deposits required under Method B;
—Generates even larger balances at the end of the first year than under Method B, eliminating shortages and increasing surpluses that must be returned to the borrower;
—Causes no increase in escrow payments in the second year.

Note: If the consumer selects Methods B or C, the amounts held in escrow could be greater than allowed under Section 10. In order to permit these options, the Secretary would invoke his exemption authority under section 19(a) of RESPA, 12 U.S.C. 2617.

Alternative 2: Make No Change

Under this alternative, even where the servicer expects that the bills paid out of the escrow account will increase substantially after the first year, the current requirements for escrow

[7] HUD's current regulations address the issue of estimating disbursement amounts for the 12-month computation year:

To conduct an escrow account analysis, the servicer shall estimate the amount of escrow account items to be disbursed. If the servicer knows the charge for an escrow item in the next computation year, then the servicer shall use that amount in estimating disbursement amounts. If the charge is unknown to the servicer, the servicer may base the estimate on the preceding year's charge as modified by an amount not exceeding the most recent year's change in the national Consumer Price Index for all urban consumers (CPI, all items). In cases of unassessed new construction, the servicer may base an estimate on the assessment of comparable residential property in the market area.

24 CFR 3500.17(c)(7).

[8] Surpluses generated by voluntary borrower prepayments (frequently of principal, interest, and escrow account amounts) do not constitute a violation of the escrow account limits, even if they remain in the account in the next escrow account computation year. 60 FR 8813.

[9] Whether disbursements from escrow accounts will be made on an annual or installment basis and whether there is a discount for annual disbursement will affect the numbers to be filled in and, potentially, the number of calculations on the Escrow Accounting Method Selection Format.

[10] The Mortgage Bankers Association indicated to HUD that it favors this alternative in correspondence to HUD dated April 10, 1996.

analysis would continue to apply. This alternative would not specifically prevent the problems of shortages at the end of the first year of the escrow account and substantial escrow payment increases in the second year as a result of large increases in escrow disbursements during the second year of servicing. However, under the existing rule, servicers may disclose the problem to borrowers, and borrowers may make voluntary overpayments to escrow accounts. Servicers may also calculate short-year statements. Thus, under the existing rule, some methods are available to alleviate the payment shock problem, although they are not required.

Alternative 3: Mandate First Year Overpayment

Under this alternative, when the servicer expects that the bills paid out of the escrow account will increase substantially after the first year, HUD would require the servicer to calculate the escrow account under a procedure that has the characteristics described under Alternative 1, Method C, described above (illustrated in ''The Payment Shock Problem,'' Appendix H–2 to this proposed rule). This approach would result in requiring amounts held in escrow to be greater than allowed under Section 10. The Secretary could, however, mandate the use of this escrow accounting method pursuant to his exemption authority under section 19(a) of RESPA, 12 U.S.C. 2617.

D. Questions for Commenters

HUD seeks comments from the public on which, if any, of these alternative approaches should result from this rulemaking, or whether other permissible approaches would better serve the interests of the public and the intent of the statute. Other possible alternatives on which HUD would welcome comment include:

1. As variations on Alternative 2, either:

(A) Require servicers to disclose to borrowers that it is anticipated that they will have a substantial payment increase in the second year, so borrowers will be less surprised when such an increase occurs, but do not require servicers to indicate specifically to borrowers methods of avoiding the shortage; or

(B) Require servicers to disclose to borrowers that it is anticipated that they will have a substantial payment increase in the second year and to inform borrowers of the amount of the expected shortage at the end of the first year and of the opportunity to make additional payments to escrow ahead of schedule to avoid Payment Shock.

2. As a variation on Alternative 1, Method C, calculate the cushion as one-sixth of the estimated annual disbursements for the first year, instead of 2 months of the escrow payments for the first year.

3. For each new account for which it is anticipated that there will be a substantial payment increase in the second year for one or more escrow items, allow the servicer, with the consent of the borrower, the option of calculating the escrow payments on a 24-month basis. This would allow the servicer to look ahead to the second year and estimate the payment that would be due, thereby mitigating the deficiency or shortage after the first year, leaving a smaller deficiency or shortage after the second year. (Using an escrow account period of more than one year has precedent. *See* the treatment of flood insurance and water purification escrow funds in § 3500.17(c)(9).) Under this option, since the amounts held in escrow would be greater than allowed under Section 10, it would be necessary for the Secretary to invoke his exemption authority under section 19(a) of RESPA, 12 U.S.C. 2617.

HUD invites commenters to submit specific regulatory language to implement their proposals and to comment on HUD's proposed regulatory language. HUD is also interested in comments on the following issues:

1. How are servicers dealing with payment increases in the second year under the current rule?

2. How should mortgage servicers determine whether bills paid out of escrow accounts are expected to increase substantially after the first year? Is it appropriate to define a substantial increase as an increase of 50 percent or more in the monthly escrow payment between the payment under the initial escrow accounting and the payment in the second year of the escrow account, and is it appropriate for this threshold to trigger additional requirements? What method should be used in calculating the expected payments?

3. What, if any, impact would there be in changing the requirements regarding payment increases on servicers operating under existing RESPA regulations?

4. What, if any, impact would there be on servicers if they are required to provide borrowers a one-time choice at closing? What would be the impact on servicers of requiring them to provide borrowers a choice at other times? What would be the burden in having different procedures for different borrowers?

5. If the consumer choice option is adopted, what should be the timing of the servicer's inquiry to the borrower and the borrower's response? If the borrower is required to designate before loan approval which option he or she prefers, would the borrower be pressured into selecting an option that may not be in the borrower's best interest? Because the method selected could affect escrow payments due at closing and each month thereafter, what timing would be sufficient for the closing agent to prepare the closing documents and perform related work? How would the option selected affect underwriting?

6. If the consumer choice option is adopted, should HUD prescribe a disclosure format as proposed? Is the information HUD is proposing to provide on the disclosure format appropriate?

7. Should there be limits on the borrower's opportunity to switch escrow accounting methods? How frequently should the borrower be allowed to change methods and under what circumstances? Should the borrower be allowed to make only a one-time choice at closing?

8. Should any alternatives be offered to borrowers whose escrow payments are not expected to increase substantially after the first year?

IV. Single-Item Analysis With Aggregate Adjustment Problem

A. Statement of Problem and HUD's Current Regulations

The October 1994 escrow rule established a uniform nationwide standard accounting method known as aggregate accounting. This replaced the common method of accounting in the industry—treating each escrow account item as a separate or single item. The amounts on the HUD–1 in the 1000 series historically were shown in a single-item mode—that is, the reserve amount for each separate escrow account item was listed.

When the October 1994 rule was being developed, Federal Reserve Board staff indicated that it needed a single-item amount for private mortgage insurance (PMI) reserves in order to make annual percentage rate (APR) calculations under the Truth In Lending Act. For this reason, and in an effort to avoid altering the basic format of the HUD–1 or HUD–1A in the October 1994 rule, the Department required that an aggregate adjustment (either zero or a negative number) be made after each individual item was listed in the 1000 series, so that the reserve amount for escrow account items conformed to the aggregate accounting method. Before the October 1994 escrow rule, Section L of the HUD–1 and HUD–1A only showed positive numbers, that is, payments that were being allocated to various settlement costs. After publication of the October 1994 final rule, the Department received complaints that the itemization of the reserve amounts with an aggregate adjustment was confusing and the information was not useful to borrowers. Settlement agents and others indicated that individual itemization of reserves in the 1000 series imposed an additional paperwork and explanation burden, when the only relevant number for calculations is the aggregate deposit amount.

B. Possible Revisions to Address Problem

This rule proposes a method of correcting the problem: HUD would no longer require the single-item listing of escrow deposits on the HUD–1 or HUD–1A. The rule would create a new option in the instructions for the 1000 series of these forms to reflect the aggregate deposit. As proposed, the settlement agent could also continue to itemize the 1000-series reserves, at the settlement agent's discretion. If the charges are not itemized, an asterisk (*) would have to be placed next to each item in the 1000 series for which a reserve is taken. The amount collected would be described as ''Aggregate Escrow Deposit for Items Marked (*) Above'' on a line at the end of the 1000 series. In the discussion ''Clarifications of Existing Rule'' in Part V of this preamble, HUD has made clear that entries on the Good Faith Estimate may be based on single-item analysis, with a maximum 1-month cushion. The rule is proposed to be amended to make clear that the use of the estimating method remains available after the end of the phase-in period (October 24, 1997).

Federal Reserve Board staff has indicated that it generally concurs with this approach, inasmuch as the PMI number for APR calculations is otherwise available. HUD seeks comments from the public on this proposal, as well as other approaches that would be permissible under RESPA and might better serve the interests of the public and the intent of the statute. HUD also invites commenters to submit specific regulatory language to implement their proposals.

V. Additional Proposed Change

HUD proposes to add information to the Good Faith Estimate format to help make purchasers of pre-1978 residential dwellings aware that, pursuant to 42 U.S.C. 4852d (implemented by HUD in regulations published on March 6, 1996, 61 FR 9064), they have the right to arrange for a timely paint inspection or risk assessment for the presence of lead-based paint or lead-based paint hazards before becoming obligated under a sales contract. Generally, a prospective purchaser has 10 days to conduct such a lead-based paint evaluation of the property. A prospective purchaser, however, may waive in writing the opportunity to conduct this evaluation. Therefore, HUD proposes to add language to the Good Faith Estimate format (appendix C) to reference a lead-based paint inspection or risk assessment and to add a reference to such inspections or assessments in the instructions for completing the 1300 series of the HUD–1 or HUD–1A. HUD anticipates that a more detailed explanation of purchasers' rights in this regard will be contained in the next revision of the HUD Settlement Costs booklet.

VI. Clarifications to Existing Rule

The following paragraphs discuss clarifications of the escrow rule that do not require substantive modifications to language in the existing provisions. These clarifications are in response to questions that have been raised about the escrow rule.

(a) *Question:* Does the rule permit a cushion to be taken on private mortgage insurance (PMI) premium payments?

Answer: Yes. Nothing in the rule distinguishes these payments from any other payments into the escrow account and, thus, a cushion may be based on such payments. The question arises because Federal Housing Administration (FHA) program rules *do* prohibit a cushion on the FHA Mortgage Insurance Premium (MIP), but the FHA limitation is applicable only to the FHA mortgage insurance.

(b) *Question:* During the phase-in period under the escrow rule for accounts existing prior to May 24, 1995, there is an alternative approach permitted for disclosing potential escrow charges under § 3500.8(c)(2), involving the use of single-item analysis with a 1-month cushion. In the final rule of February 15, 1995 (60 FR 8812), the clarifications indicated that for Good Faith Estimate purposes, as well as for the HUD–1 or HUD–1A, a single-item analysis with a maximum 1-month cushion is acceptable. *See* 60 FR at 8812 and 8813. Is the single-item analysis with a 1-month-cushion approach acceptable on the Good Faith Estimate, even when the aggregate approach is subsequently used on the HUD–1 or HUD–1A, and will this be true after the phase-in period ends?

Answer: Yes. The good faith estimate is an *estimate* and HUD does not impose strict methodologies for delivering information that frequently is unavailable or difficult to obtain. As long as the estimates are developed in good faith, the use of single-item analysis with a maximum 1-month cushion to establish a range or amount for Good Faith Estimate purposes will be acceptable. The Good Faith Estimate instructions in § 3500.7(c)(2) are proposed to be amended to clarify that this method of estimation is available after the phase-in period has passed.

(c) *Question:* Appendix E assumes that the same cushion applies to all escrow items. However, lenders may prefer to use, for instance, a 2-month cushion for hazard insurance and a 1-month cushion for property taxes. Is that permissible?

Answer: Yes. The rule does not require that the cushion be the same fraction of annual anticipated disbursements for each escrow item, provided, of course, that no cushion exceeds the limit of 2 months' disbursements.

(d) *Question:* When filling out the HUD–1, it is necessary to calculate the aggregate adjustment so that the amount the borrower has to pay into the escrow account at closing will not exceed the RESPA limits (which are defined in terms of aggregate accounting, whereas the rest of the 1000 series of the HUD–1 is reported using single-item accounting). The aggregate adjustment is the difference between the deposit calculated under the aggregate accounting method and the sum of the deposits that would be calculated using single-item accounting. Must the same cushion be used when making the aggregate calculations as was used when making the single-item calculations?

Answer: Yes. So, for example, if a 1-month cushion were taken for taxes and a 2-month cushion were taken for insurance in making the single-item entries, then the cushion in making the aggregate calculations would be the sum of one-twelfth of the projected taxes and one-sixth of the projected insurance.

Other Matters

Paperwork Reduction Act Statement

The proposed information collection requirements contained in § 3500.17 and Appendices A and C of this rule will be submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520).

(a) In accordance with 5 CFR 1320.5(a)(1)(iv), the Department is setting forth the following concerning the proposed collection of information:

(1) Title of the information collection proposal: Escrow account tax disbursement method disclosure; escrow account tax calculation procedure disclosure; and changes to lines pertaining to lead-based paint risk assessments or inspections in settlement statements and good faith estimates.

(2) Summary of the collection of information: The escrow account tax disbursement method disclosure will allow the consumer to choose whether taxes are paid on an annual, a semiannual, or other basis. The escrow account tax calculation procedure disclosure allows consumers to choose the procedure that is used to calculate the escrow account, when it is anticipated that the second-year charges for an item will be substantially higher than the first-year charges.

(3) Description of the need for the information and its proposed use: *(i) Escrow account tax disbursement method disclosure.* The Real Estate Settlement Procedures Act (RESPA) at 12 U.S.C. 2609 provides for escrow accounts. The implementing regulations at 24 CFR 3500.17(k) provide that the servicer shall use as the disbursement date a date on or before the earlier of the deadline to take advantage of discounts, if available, or the deadline to avoid a penalty. Consequently, some lenders changed disbursement methods and some borrowers were adversely affected by the change. The proposed rule suggests three alternatives in addressing this problem. One alternative will require an escrow tax disbursement method disclosure which will allow the consumer to choose whether taxes are paid on annual, semi-annual or other basis. The other two alternatives do not require a new disclosure.

(ii) Escrow account tax calculation procedure disclosure. Another problem the rule addresses is where the charges for an item are expected to be substantially higher the second year than in the first year. The increased charges may result in payment shock as well as a deficiency in the escrow account and substantially increased escrow payments the following year. For example, in the case of new construction, the real estate tax amount may be estimated on the unimproved value of the property. Frequently, borrowers are then required to pay taxes based on the improved value of the property.

Current regulations limit the amount that the lender may require the borrower to deposit in an escrow account at settlement and the amount the lender may require the borrower to maintain in an account. The regulations at 24 CFR 3500.17 prescribe the method for determining these amounts. The proposed rule offers three alternative solutions. One alternative requires a disclosure that allows the consumer to choose the procedure for calculating escrow payments. Another alternative would require lenders to calculate the escrow under a new procedure which is also a consumer choice under the first alternative. Both of these alternatives would require lenders to make adjustments to escrow calculation software. The third alternative does not require an additional burden.

(iii) Changes for lead-based paint. In addition, information is proposed to be added in the Good Faith Estimate format to make purchasers of pre-1978 residential dwellings aware that, pursuant to 42 U.S.C. 4852d, they have the right to arrange for a lead-based paint inspection or risk assessment.

(4) Description of the likely respondents, including the estimated number of likely respondents, and proposed frequency of response to the collection of information: The 2,000 respondents for both disclosures are mortgage lenders/servicers. (i) It is estimated that respondents must give a one-time disclosure to 34.9 million borrowers who establish or maintain mortgage loan escrow accounts. (ii) It is estimated that respondents must give a one-time disclosure to 1 million borrowers who are identified as having a substantially increased tax charge the second year of the loan. (iii) Settlement statements and good faith estimates currently provide for inclusion of costs associated for lead-based paint inspection costs, but not as a discrete line item. The number of respondents will not change as a result of this rule.

(5) Estimate of the total reporting and recordkeeping burden that will result from the collection of information: (There is no additional burden expected to result from specifying a discrete line for lead-based paint risk assessment or inspection costs in the settlement statements (appendix A) or good faith estimate format (appendix C).)

REPORTING BURDEN

Reference	Number of respondents	Frequency of response	Est. ave. response time (hrs.)	Annual burden hrs.
Disbursement Disclosure	34.9 mill	1	0.0833	2,908,332
Method C Calculation	2,000	1	10	20,000
Calculation and Disclosure (Borrower Choice)	1.0 mill	1	0.3333	333,000

RECORDKEEPING BURDEN

No. recordkeepers	Hrs. per recordkeeper	Annual burden hours
Disbursement Disclosure: 2,000	1,454	2,908,000
Calculation Disclosure: 2,000	42	84,000
Total Burden Hours		6,253,332

(b) In accordance with 5 CFR 1320.8(d)(1), the Department is soliciting comments from members of the public and affected agencies concerning the proposed collection of information to:

(1) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;

(2) Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information;

(3) Enhance the quality, utility, and clarity of the information to be collected; and

(4) Minimize the burden of the collection of information on those who are to respond; including through the use of appropriate automated collection techniques or other forms of information technology, e.g., permitting electronic submission of responses.

Interested persons are invited to submit comments regarding the information collection requirements in this proposal. Under the provisions of 5 CFR part 1320, OMB is required to make a decision concerning this collection of information between 30 and 60 days after today's publication date. Therefore, a comment on the information collection requirements is best assured of having its full effect if OMB receives the comment within 30 days of today's publication. This time frame does not affect the deadline for comments to the agency on the proposed rule, however. Comments must refer to the proposal by name and docket number (FR–4079) and must be sent to:

Joseph F. Lackey, Jr., HUD Desk Officer, Office of Management and Budget, New Executive Office Building, Washington, DC 20503

and

Reports Liaison Officer, Office of the Assistant Secretary for Housing, Federal Housing Commissioner, Department of Housing and Urban Development, 451—7th Street, SW, Room 9116, Washington, DC 20410

Status: Extension of currently approved collection (2502–0501).

Executive Order 12866

The Office of Management and Budget reviewed this proposed rule under Executive Order 12866, Regulatory Planning and Review. Any changes made to the rule as a result of that review are clearly identified in the docket file, which is available for public inspection at the Office of the Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410–0500.

Regulatory Flexibility Act

The Secretary, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)), has reviewed this rule before publication and by approving it certifies that this proposed rule does not have a significant economic impact on a substantial number of small entities. There are no anticompetitive discriminatory aspects of this proposed rule with regard to small entities, nor are there any unusual procedures that would need to be complied with by small entities. The requirements of RESPA must be uniformly adhered to by all lenders and servicers. To the extent that small entities are affected by any of the provisions in the proposed rule, the impact is expected to be relatively insignificant and will be reviewed in developing the final rule.

However, this proposed rule describes possible alternative requirements and seeks comments to help the Department make a final decision regarding these alternatives. Although a complete and thorough analysis of all the possible permutations in the rule is impractical, the proposed rule provides sufficient information for the public to provide the Department with informed comments and, to the extent feasible, otherwise addresses areas that would be included in a regulatory flexibility analysis.

Environmental Impact

A Finding of No Significant Impact with respect to the environment has been made in accordance with HUD regulations in 24 CFR part 50 that implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332). The finding is available for public inspection during regular business hours in the Office of the General Counsel, Rules Docket Clerk, room 10276, 451 Seventh Street, SW, Washington, DC 20410.

Executive Order 12612, Federalism

The General Counsel, as the Designated Official under section 6(a) of Executive Order 12612, *Federalism*, has determined that the policies contained in this proposed rule will not have substantial direct effects on States or their political subdivisions, or the relationship between the Federal Government and the States, or on the distribution of power and responsibilities among the various levels of government. As a result, the rule is not subject to review under the Order. Promulgation of this rule expands coverage of the applicable regulatory requirements pursuant to statutory direction.

Executive Order 12606, The Family

The General Counsel, as the Designated Official under Executive Order 12606, *The Family*, has determined that this proposed rule does not have potential for significant impact on family formation, maintenance, and general well-being, and, thus, is not subject to review under the order. No significant change in existing HUD policies or programs will result from promulgation of this rule, as those policies and programs relate to family concerns.

List of Subjects in 24 CFR Part 3500

Consumer protection, Condominiums, Housing, Mortgages, Mortgage servicing, Reporting and Recordkeeping requirements.

For the reasons stated in the preamble, part 3500 of Title 24 of the Code of Federal Regulations is proposed to be amended as follows.

PART 3500—REAL ESTATE SETTLEMENT PROCEDURES ACT

1. The authority citation for part 3500 continues to read as follows:

Authority: 12 U.S.C. 2601 *et seq.;* 42 U.S.C. 3535(d).

2. Appendix A is amended in Section L under the text heading ''Line Item Instructions'' as follows:

a. By revising the paragraph beginning with the phrase ''Lines 1301 and 1302'';

b. In the paragraph beginning with the phrase ''Lines 1303–1305'', by removing the number ''1303'' and adding in its place the number ''1304''; and

c. By adding a new paragraph after the paragraph beginning with the phrase ''Lines 1301 and 1302'', to read as follows:

Appendix A to Part 3500—Instructions for Completing HUD–1 and HUD–1A Settlement Statements; Sample HUD–1 and HUD–1A Statements

* * * * *

Lines 1301 and 1302 are used for fees for survey, pest inspection, radon inspection, or other similar inspections.

Line 1303 is used for lead-based paint hazard risk assessments, lead-based paint inspections, or other lead-based paint evaluations.

* * * * *

3. Appendix C, Sample Form of Good Faith Estimate, is amended in the chart by adding a new row, with three columns, after the row with the phrase ''Pest inspection......'' in the first column, to read as follows:

Appendix C to Part 3500—Sample Form of Good Faith Estimate

* * * * *

Item [2]	HUD–1 or HUD–1A	Amount or range
* * * * *	*	*
Lead-based paint inspection	1303	$
* * * * *	*	*

[2] Footnote remains unchanged.

Annual Vs. Installment Disbursements [Items 4–5]

4. Section 3500.17 is amended by revising the definition of ''disbursement date'' in paragraph (b) and by revising paragraphs (c)(2) and (3), to read as follows:

§ 3500.17 Escrow accounts.

* * * * *

(b) * * *

Disbursement date means the date on which the servicer actually pays an escrow item from the escrow account.

* * * * *

(c) * * *

(2) *Escrow analysis at creation of escrow account.* Before establishing an escrow account, the servicer shall conduct an escrow account analysis to determine the amount the borrower shall deposit into the escrow account, subject to the limitations of paragraph (c)(1)(i) of this section and the amount of the borrower's periodic payments into the escrow account, subject to the limitations of paragraph (c)(1)(ii) of this section. In conducting the escrow account analysis, the servicer shall estimate the disbursement amounts according to paragraph (c)(7) of this section. Pursuant to paragraph (k) of this section, the servicer shall use a date on or before the deadline to avoid a penalty as the disbursement date for the escrow item. Upon completing the initial escrow account analysis, the servicer shall prepare and deliver an initial escrow account statement to the borrower, as set forth in paragraph (g) of this section. The servicer shall use the escrow account analysis to determine whether a surplus, shortage, or deficiency exists since settlement and shall make any adjustments to the account pursuant to paragraph (f) of this section.

(3) *Subsequent escrow account analyses.* For each escrow account, the servicer shall conduct an escrow account analysis at the completion of the escrow account computation year to determine the borrower's monthly escrow account payments for the next computation year, subject to the limitations of paragraph (c)(1)(ii) of this section. In conducting the escrow account analysis, the servicer shall estimate the disbursement amounts according to paragraph (c)(7) of this section. Pursuant to paragraph (k) of this section, the servicer shall use a date on or before the deadline to avoid a penalty as the disbursement date for the escrow item. The servicer shall use the escrow account analysis to determine whether a surplus, shortage, or deficiency exists and shall make any adjustments to the account pursuant to paragraph (f) of this section. Upon completing an escrow account analysis, the servicer shall prepare and submit an annual escrow account statement to the borrower, as set forth in paragraph (i) of this section.

* * * * *

5. Section 3500.17 is further amended and, if applicable, Appendix F is added to part 3500 in accordance with one of the following alternatives:

a. Under ALTERNATIVE 1 (Consumer Choice): By revising paragraph (k) and adding Appendix F to part 3500, to read as follows; or

b. Under ALTERNATIVE 2 (Servicer Flexibility): By revising paragraph (k), to read as follows; or

c. Under ALTERNATIVE 3 (Keep, But Clarify, Current Requirements): By revising paragraph (k), to read as follows:

§ 3500.17 Escrow accounts.

* * * * *

[Alternative 1 (Consumer Choice)]

(k) *Timely payments.* (1) If the terms of any federally related mortgage loan require the borrower to make payments to an escrow account, the servicer shall pay the disbursements in a timely manner, that is, on or before the deadline to avoid a penalty, as long as the borrower's payment is not more than 30 days overdue.

(2) The servicer shall advance funds to make disbursements in a timely manner, as long as the borrower's payment is not more than 30 days overdue. Upon advancing funds to pay a disbursement, the servicer may seek repayment from the borrower for the deficiency pursuant to paragraph (f) of this section.

(3) For those borrowers whose property taxes will be paid from an escrow account where the applicable taxing jurisdiction offers the choice between disbursements on an installment or an annual basis, at some time before closing the servicer shall provide to the borrower an Escrow Account Property Tax Disbursement Alternatives Selection sheet in the format of Appendix F to this part and shall provide the borrower with an opportunity to make a selection.

(4) For a loan that settles on or after [*INSERT EFFECTIVE DATE OF FINAL RULE*], when the taxing jurisdiction offers the servicer the option of making disbursements for property taxes on an installment or an annual basis, the servicer must make disbursements for property taxes on an installment basis, unless the borrower has indicated on the Escrow Account Property Tax Disbursement Alternatives Selection sheet that disbursements for property taxes are to be made on an annual basis. The servicer and subsequent servicers are prohibited from changing the method of disbursement for property taxes from the method the borrower selected on the Escrow Account Property Tax Disbursement Alternatives Selection sheet, without the borrower's prior written consent.

(5) For a loan that has settled prior to [*INSERT EFFECTIVE DATE OF FINAL RULE*], when the taxing jurisdiction offers the servicer the option of making disbursements for property taxes on an installment or an annual basis, the servicer and subsequent servicers are prohibited from changing the method of disbursement for property taxes from the method that was used on [*INSERT DATE OF PUBLICATION OF FINAL RULE*] or the date of settlement (whichever is later), without the borrower's prior written consent, as long as such method of disbursement complies with normal lending practice of the lender and local custom and constitutes prudent lending practice. In addition, no later than the first escrow account analysis performed after [*INSERT EFFECTIVE DATE OF FINAL RULE*], a servicer shall offer a borrower, in writing, the opportunity to switch from one disbursement method for property taxes to the other.

(6) If the payee for escrow items other than property taxes offers the servicer

the option of making disbursements on an installment or an annual basis, the servicer must make disbursements by a date that avoids a penalty, but may otherwise make disbursements on either an installment or an annual basis as the servicer prefers, as long as such method of disbursement complies with normal lending practice of the lender and local custom and constitutes prudent lending practice.

* * * * *

Appendix F—Escrow Account Property Tax Disbursement Alternatives Selection Format

Your property taxes will be disbursed out of your escrow account by your loan servicer. Your jurisdiction provides the option of paying the property taxes in installment payments spread out over the year, or in one annual lump sum payment.

You are being offered alternative methods for these property taxes to be paid. They are described below.

As shown by the choices below, if you choose installment payments, the amount you have to deposit into your escrow account at closing may be less. On the other hand, if you choose annual payments, the total amount of property taxes you will pay may be less if your taxing jurisdiction provides a discount for annual payments. The alternative you choose could also affect the amount of your tax deductions during the first year of the loan, if you itemize—you may wish to consult a tax advisor.

If you do not make a selection, disbursements will be made on an installment basis.

ESCROW ACCOUNT PROPERTY TAX DISBURSEMENT ALTERNATIVES

	Installment payments	Annual payments
Property tax bill for next 12 months.	________	________
Due at closing	________	________
Monthly escrow payment first year.	________	________

I prefer the indicated option (check one and sign below)

☐ Installment Payments

☐ Annual Payments

____

Borrower's Signature

[*Or* Alternative 2 (Servicer Flexibility)]

(k) *Timely payments.* (1) If the terms of any federally related mortgage loan require the borrower to make payments to an escrow account, the servicer shall pay the disbursements in a timely manner, that is, on or before the deadline to avoid a penalty, as long as the borrower's payment is not more than 30 days overdue.

(2) The servicer shall advance funds to make disbursements in a timely manner as long as the borrower's payment is not more than 30 days overdue. Upon advancing funds to pay a disbursement, the servicer may seek repayment from the borrower for the deficiency, pursuant to paragraph (f) of this section.

(3) If the payee for escrow items (including property taxes) offers the servicer the option of making disbursements on an installment basis or a lump sum annual basis, the servicer must make disbursements by a date that avoids a penalty, but may otherwise make disbursements on either an installment basis or a lump sum annual basis as the servicer prefers, as long as such method of disbursement complies with normal lending practice of the lender and local custom and constitutes prudent lending practice.

(4) The servicer and subsequent servicers are prohibited from changing the method of disbursement as long as a choice continues to exist, without the borrower's prior written consent.

* * * * *

[*Or* Alternative 3 (Keep, But Clarify, Current Requirements)]

(k) *Timely payments.* (1) If the terms of any federally related mortgage loan require the borrower to make payments to an escrow account, the servicer shall pay the disbursements in a timely manner, that is, on or before the deadline to avoid a penalty, as long as the borrower's payment is not more than 30 days overdue.

(2) The servicer shall advance funds to make disbursements in a timely manner as long as the borrower's payment is not more than 30 days overdue. Upon advancing funds to pay a disbursement, the servicer may seek repayment from the borrower for the deficiency pursuant to paragraph (f) of this section.

(3) If the payee for escrow items (including property taxes) offers the servicer the option of making disbursements on an installment or a lump sum annual basis, the servicer shall make disbursements by a date that avoids a penalty. If such payee does not offer a discount for disbursements on a lump sum annual basis, the servicer must make disbursements on an installment basis. If, however, the payee offers a discount for disbursements on a lump sum annual basis, the servicer may, at the servicer's discretion (but is not required by RESPA to), make lump sum annual disbursements in order to take advantage of the discount for the borrower, as long as such method of disbursement selected by the servicer complies with normal lending practice of the lender and local custom and constitutes prudent lending practice. Where the payee offers the option of installment disbursements or a discount for lump sum annual disbursements, HUD encourages, but does not require, the servicer to follow the preference of the borrower as to whether to make disbursements on a lump sum annual or installment basis, if such preference is known to the servicer.

(4) The servicer and subsequent servicers for an escrow account are prohibited from changing the method of disbursement as long as a choice of disbursement methods exists, without the borrower's prior written consent.

* * * * *

Payment Shock [Item 6]

6. Except with respect to Alternative 2 in this amendatory instruction, § 3500.17 is further amended and, if applicable, appendices are added to part 3500, in accordance with either Alternative 1 or Alternative 3, as follows:

a. Under ALTERNATIVE 1 (Consumer Choice): By adding, in alphabetical order, a definition of ''Substantial increase''; by revising the introductory text of paragraph (c); by revising paragraph (d); by adding new paragraphs to be designated later; and by adding Appendices G and H–1, to read as follows; or

b. ALTERNATIVE 2 (Make No Change); or

c. Under ALTERNATIVE 3 (Mandate First Year Overpayment): By adding, in alphabetical order, in paragraph (b), a definition of ''Substantial increase''; by revising the introductory text of paragraph (c); by revising paragraph (d); by adding new paragraphs, to be designated later; and by adding Appendix H–2, to read as follows:

§ 3500.17 Escrow accounts.

* * * * *

Alternative 1 (Consumer Choice)

(b) * * *

Substantial increase means an increase of 50 percent or more in the monthly escrow payment in the second year of an escrow account is projected as compared to the payment under the initial escrow accounting.

* * * * *

(c) *Limits on payments to escrow accounts; acceptable accounting methods to determine limits.* Except as otherwise provided in paragraph (__) of this section, the following applies:

* * * * *

(d) *Methods of escrow account analysis.* Paragraph (c) of this section prescribes acceptable accounting methods except as otherwise provided in paragraph (__) of this section. The following sets forth the steps servicers shall use to determine whether their use of an acceptable accounting method conforms with the limitations in paragraph (c)(1) of this section. The steps set forth in this section derive maximum limits. Servicers may use accounting procedures that result in lower target balances. In particular, servicers may use a cushion less than the permissible cushion or no cushion at all. This section does not require the use of a cushion.

* * * * *

(__) *Rules of special applicability when servicer expects a substantial increase in bills paid out of escrow account after the first year for loans that settle on or after [INSERT EFFECTIVE DATE OF FINAL RULE].*

(X) *Opportunity for Selection of Escrow Account Method.* When a servicer expects that there will be a substantial increase in the bills paid out of an escrow account after the first year, at some time before closing, the servicer shall provide to the borrower an Escrow Accounting Method Selection sheet in the format of Appendix G to this part and shall provide the borrower with an opportunity to make a selection. The servicer must perform the escrow accounting in accordance with the method selected by the borrower. If the borrower does not make a selection, the servicer must perform the escrow accounting in accordance with Method A.

(XX) *No Change in Escrow Accounting Method without Borrower Consent.* (1) Once an escrow accounting method is determined by the process in paragraph (X) of this section, the servicer and subsequent servicers are prohibited from changing the escrow accounting method unless either paragraph (__)(XX) (i) or (ii) applies:

(i) The borrower provides his or her prior written consent; or

(ii) The servicer no longer projects that there will be a substantial increase in bills paid out of the escrow account after the 12-month period covered in the projection for the coming year.

(2) If the servicer changes escrow account methods in reliance on paragraph (__)(XX)(ii) of this section, the servicer may switch only to the escrow accounting procedure in paragraph (d) of this section.

(XXX) *Limits on payments to escrow accounts; acceptable accounting methods to determine limits when servicer expects substantial increase in bills paid out of escrow account after the first year for loans which settle on or after [INSERT EFFECTIVE DATE OF RULE].* When the servicer expects a substantial increase in bills paid out of the escrow account after the first year, the servicer may deviate from the requirements of paragraph (c) of this section to the extent necessary to comply with paragraph (XXXX) of this section.

(XXXX) *Methods of escrow account analysis for the initial statement when the servicer expects a substantial increase in bills paid out of the escrow account after the first year.* When the servicer expects a substantial increase in the bills paid out of the escrow account after the first year, the servicer shall use the following steps in producing the projection for the initial statement:

(1) *Method A.* When a servicer uses Method A in conducting the initial escrow account analysis, paragraph (d) of this section applies.

(2) *Method B.* When a servicer uses Method B in conducting the initial escrow account analysis, the target balances may not exceed the balances computed according to the following arithmetic operations: The servicer projects a trial balance for the account as a whole over the next computation year (a trial running balance) with a beginning balance of 0. The servicer may include as disbursements only those amounts that are expected to be paid in the 12-month period covered by the projection. In doing so, the servicer assumes that it will make estimated disbursements on or before the deadline to avoid a penalty. The servicer does not use pre-accrual on the disbursement dates. The servicer also assumes that the borrower will make monthly payments equal to one-twelfth of the estimated total annual escrow account disbursements for the second year.

(3) *Method C.* When a servicer uses Method C in conducting the initial escrow account analysis, the target balances may not exceed the balances computed according to the following arithmetic operations:

(i) The servicer first projects a trial balance for the account as a whole over the next computation year (a trial running balance). The servicer may include as disbursements only those amounts that are expected to be paid in the 12-month period covered by the projection. In doing so, the servicer assumes that it will make estimated disbursements on or before the deadline to avoid a penalty. The servicer does not use pre-accrual on these disbursement dates. The servicer also assumes that the borrower will make monthly payments equal to one-twelfth of the estimated total annual escrow account disbursements for the second year.

(ii) The servicer then examines the monthly trial balances and adds to the initial deposit an amount just sufficient to bring the lowest monthly trial balance (not considering the initial deposit) to zero, and adjusts all other monthly balances and the initial deposit accordingly.

(iii) The servicer then adds to the initial deposit the permissible cushion. The cushion is one-sixth of the estimated total annual escrow account disbursements for the second year or a lesser amount specified by State law or the mortgage document.

(4) The steps set forth in this paragraph (XXXX) derive maximum limits. Servicers may use accounting procedures that result in lower target balances. In particular, servicers may use a cushion less than the permissible cushion or no cushion at all. This paragraph (XXXX) does not require the use of a cushion.

* * * * *

Appendix G—Sample Escrow Accounting Method Selection Format

The bills paid out of your escrow account are expected to increase substantially after the first year. Under normal escrow practices, your monthly escrow payment in the second year could be much higher than in the first, both to pay the larger bills and to make up for a shortage at the end of the first year. (*See* Method A.) You may voluntarily choose to make higher payments during the first year to reduce or eliminate the monthly payment increase in the second year. (*See* Methods B or C.) You are being offered alternative escrow payment schedules. They are described below. If you do not make a selection, Method A will be used.

ESCROW ACCOUNT ALTERNATIVES

	Method A	Method B	Method C
Due at closing	______	______	______
Monthly escrow payment first year	______	______	______
Estimated surplus refunded at end of first year	______	______	______
Estimated monthly escrow payment second year	______	______	______

ESCROW ACCOUNT ALTERNATIVES—Continued

	Method A	Method B	Method C
Estimated monthly escrow payment third year	______	______	______

I prefer the indicated method (check one and sign below)

A ☐
B ☐
C ☐

____
Borrower's Signature

Appendix H–1—The Payment Shock Problem

Instructions and Sample Mathematical Calculations for Completing Escrow Accounting Method Selection Format

Assumptions

Disbursements

Year 1

$720 for insurance—disbursed in April
$288 for property taxes—disbursed in November

Year 2

$720 for insurance—disbursed in April
$2,880 for property taxes—disbursed in November

First Payment: June 15

Method A

[Demonstrates calculation for completing Method A of Escrow Accounting Method Selection Format (Appendix G).]

Assumption: Cushion selected by servicer equals one-sixth of estimated total annual disbursements.

Step 1.—Projection for Year 1

See 24 CFR 3500.17(k) for instructions and Appendix E to Part 3500 for sample calculation (example below uses aggregate analysis).

Year 1	Payment	Disburs	Balance
Initial deposit:			252
Jun	84	0	336
Jul	84	0	420
Aug	84	0	504
Sep	84	0	588
Oct	84	0	672
Nov	84	288	468
Dec	84	0	552
Jan	84	0	636
Feb	84	0	720
Mar	84	0	804
Apr	84	720	168
May	84	0	252

Step 2.—Projection for Year 2

Year 2	Payment	Disburs	Balance
Starting balance:			1680
Jun	300	0	1980
Jul	300	0	2280
Aug	300	0	2580
Sep	300	0	2880
Oct	300	0	3180
Nov	300	2880	600
Dec	300	0	900
Jan	300	0	1200
Feb	300	0	1500
Mar	300	0	1800
Apr	300	720	1380
May	300	0	1680

Shortage (or surplus) = Desired starting balance—Actual starting balance
= 1680 − 252
= 1428

Additional Monthly Escrow Payment = Shortage/12
= 1428/12
= 119

Monthly escrow payment = Shortage/12 + Disbursements/12
= 119 + 300
= 419

Step 3.—Projection for Year 3

Same as year 2. Since there is no shortage or surplus, the monthly payment is $300 per month.

Method A Summary To Appear on Disclosure

Due at closing = $252
Monthly escrow payment first year = $84/month
Estimated surplus refunded at end of first year = $0
Estimated monthly escrow payment second year = $419
Estimated monthly escrow payment third year = $300

Method B

[Demonstrates calculation for completing Method B of Escrow Accounting Method Selection Format (Appendix G).]

Assumption: On the initial statement, the initial deposit equals $0 and the monthly deposit equals 1⁄12 of second year's estimated total annual disbursements. Any subsequent analysis uses the escrow accounting technique in 24 CFR 3500.17(c)(3).

Step 1.—Projection for Year 1

Year 1	Payment	Disburs	Balance
Initial deposit:			0
Jun	300	0	300
Jul	300	0	600
Aug	300	0	900
Sep	300	0	1200
Oct	300	0	1500
Nov	300	288	1512
Dec	300	0	1812
Jan	300	0	2112
Feb	300	0	2412
Mar	300	0	2712
Apr	300	720	2292
May	300	0	2592

Step 2.—Projection for Year 2

Projection same as for Method A.

Shortage/Surplus = Desired starting balance − Actual balance
= 1680–2592
= −912 (912 surplus)

This $912 surplus is refunded to borrower at end of Year 1. Thus, the borrower starts Year 2 with the desired starting balance of 1680 and the monthly payment is $300.

Step 3.—Projection for Year 3

Same as year 2. Since there is no shortage or surplus, the monthly payment is $300 per month.

Method B Summary To Appear on Disclosure

Due at closing = $0
Monthly escrow payment first year = $300/month
Estimated surplus refunded at end of first year = $912
Estimated monthly escrow payment second year = $300
Estimated monthly escrow payment third year = $300

Method C

[Demonstrates calculation for completing Method C of Escrow Accounting Method Selection Format (Appendix G).]

Assumption: On the initial statement, the cushion selected by servicer equals 1⁄6 of estimated total annual disbursements for the second year and the Monthly deposit equals 1⁄12 of estimated total annual disbursements for the second year. Any subsequent analysis uses the escrow accounting technique in 24 CFR 3500.17(c)(3).

Step 1.—Projection for Year 1

Year 1	Payment	Disburs	Balance
Initial deposit:			300
Jan	300	0	600
Feb	300	0	900
Mar	300	0	1200
Apr	300	0	1500
May	300	0	1800
Jun	300	288	1812
Jul	300	0	2112
Aug	300	0	2412
Sep	300	0	2712
Oct	300	0	3012
Nov	300	720	2592
Dec	300	0	2892

Step 2.—Projection for Year 2

Projection same as for methods A and B.

Shortage/Surplus = Desired starting balance − Actual balance
= 1680–2892
= −1212 (1212 surplus)

This $1212 surplus is refunded to borrower at end of Year 1. Thus, the borrower starts Year 2 with the desired starting balance of $1680 and the monthly payment is $300.

Step 3.—Projection for Year 3

Same as year 2. Since there is no shortage or surplus, the monthly payment is $300 per month.

Method C Summary To Appear on Disclosure

Due at closing = $300
Monthly escrow payment first year = $300/month
Estimated surplus refunded at end of first year = $1212
Estimated monthly escrow payment second year = $300
Estimated monthly escrow payment third year = $300

Comparative Illustrations

1. The escrow account methods for the example shown in the text, with insurance disbursed in the eleventh month and taxes disbursed in the sixth month of the escrow cycle, are shown below:

	Methods		
	A	B	C
Due at closing ...	252	0	300
Monthly escrow payment first year	84	300	300
Estimated surplus refunded at end of first year	0	912	1212
Estimated monthly escrow payment second year ...	419	300	300
Estimated monthly escrow payment third year	300	300	300

2. The following set of options shows the resulting values if, as before, insurance were disbursed in the eleventh month of the escrow cycle, but taxes were disbursed in the first rather than the sixth month of the escrow cycle. Note how payments change as the month in which the taxes are disbursed changes and all other factors remain constant.

	Methods		
	A	B	C
Due at closing ...	372	0	588
Monthly escrow payment first year	84	300	300
Estimated surplus refunded at end of first year	0	0	0
Estimated monthly escrow payment second year ...	534	349	300
Estimated monthly escrow payment third year	300	300	300

3. The final set of options shows the resulting values if, as before, insurance were disbursed in the eleventh month of the escrow cycle, but taxes were disbursed in the last month of the escrow cycle.

	Methods		
	A	B	C
Due at closing ...	168	0	300
Monthly escrow payment first year	84	300	300
Estimated surplus refunded at end of first year	0	1992	2292
Estimated monthly escrow payment second year ...	336	300	300
Estimated monthly escrow payment third year	330	300	300

[*or* Alternative 3 (Mandate First Year Overpayment)]

(b) * * *

Substantial increase means an increase of 50 percent or more in the monthly escrow payment in the second year of an escrow account is projected as compared to the payment under the initial escrow accounting.

* * * * *

(c) *Limits on payments to escrow accounts; acceptable accounting methods to determine limits.* Except as provided in paragraph (__) of this section, the following applies:

* * * * *

(d) *Methods of escrow account analysis.* Paragraph (c) of this section prescribes acceptable accounting methods except as otherwise provided in paragraph (__) of this section. The following sets forth the steps servicers shall use to determine whether their use of an acceptable accounting method conforms with the limitations in paragraph (c)(1) of this section. The steps set forth in this section derive maximum limits. Servicers may use accounting procedures that result in lower target balances. In particular, servicers may use a cushion less than the permissible cushion or no cushion at all. This section does not require the use of a cushion.

* * * * *

(__) *Rules of special applicability where servicer expects substantial increase in bills paid out of escrow account after the first year for loans which settle on or after [INSERT EFFECTIVE DATE OF FINAL RULE].*

(X) *Limits on payments to escrow accounts; acceptable accounting methods to determine limits when servicer expects substantial increase in bills paid out of escrow account after the first year for loans which settle on or after [INSERT EFFECTIVE DATE OF FINAL RULE].* When the servicer expects a substantial increase in bills paid out of escrow account after the first year, the servicer may deviate from the requirements of paragraph (c) of this section to the extent necessary to comply with paragraph (XX) of this section.

(XX) *Methods of escrow account analysis for the initial statement when the servicer expects a substantial increase in the bills paid out of the escrow account after the first year.* When the servicer expects a substantial increase in the bills paid out of the escrow account after the first year, the servicer shall use the following steps in producing the projection for the initial statement:

(1) When a servicer uses this method of escrow accounting in conducting the initial escrow account analysis, the target balances may not exceed the balances computed according to the following arithmetic operations:

(i) The servicer first projects a trial balance for the account as a whole over the next computation year (a trial running balance). The servicer may include as disbursements only those amounts that are expected to be paid in the 12-month period covered by the projection. In doing so, the servicer assumes that it will make estimated disbursements on or before the deadline to avoid a penalty. The servicer does not use pre-accrual on these disbursement dates. The servicer also assumes that the borrower will make monthly payments equal to one-twelfth of the estimated total annual escrow account disbursements for the second year.

(ii) The servicer then examines the monthly trial balances and adds to the initial deposit an amount just sufficient to bring the lowest monthly trial balance (not considering the initial deposit) to zero, and adjusts all other monthly balances and the initial deposit accordingly.

(iii) The servicer then adds to the initial deposit the permissible cushion. The cushion is one-sixth of the estimated total annual escrow account disbursements for the second year or a lesser amount specified by State law or the mortgage document.

(2) The steps set forth in this paragraph (XX) derive maximum limits. Servicers may use accounting procedures that result in lower target balances. In particular, servicers may use a cushion less than the permissible cushion or no cushion at all. This paragraph (XX) does not require the use of a cushion.

* * * * *

Appendix H–2

The Payment Shock Problem

Instructions and Sample Mathematical Calculations for Alternative Escrow Accounting Method

Assumptions

Disbursements:

Year 1

$720 for insurance—disbursed in April
$288 for property taxes—disbursed in November

Year 2

$720 for insurance—disbursed in April
$2,880 for property taxes—disbursed in November

First Payment: June 15

Assumption: On the initial statement, the cushion selected by servicer equals 1⁄6 of estimated total annual disbursements for the second year and the Monthly deposit equals 1⁄12 of estimated total annual disbursements for the second year. Any subsequent analysis uses the escrow accounting technique in 24 CFR 3500.17(c)(3).

Step 1.—Projection for Year 1

Year 1	Payment	Disburs	Balance
Initial deposit	....	....	300
Jan	300	0	600
Feb	300	0	900
Mar	300	0	1200
Apr	300	0	1500
May	300	0	1800
Jun	300	288	1812
Jul	300	0	2112
Aug	300	0	2412
Sep	300	0	2712
Oct	300	0	3012
Nov	300	720	2592
Dec	300	0	2892

Step 2.—Projection for Year 2

Year 2	Payment	Disburs	Balance
Starting balance:	....	....	1680
Jun	300	0	1980
Jul	300	0	2280
Aug	300	0	2580
Sep	300	0	2880
Oct	300	0	3180
Nov	300	2880	600
Dec	300	0	900
Jan	300	0	1200
Feb	300	0	1500
Mar	300	0	1800
Apr	300	720	1380
May	300	0	1680

Shortage/Surplus = Desired starting balance − Actual balance
= 1680 − 2892
= − 1212 (1212 surplus)

This $1212 surplus is refunded to borrower at end of Year 1. Thus, the borrower starts Year 2 with the desired starting balance of $1680 and the monthly payment is $300.

Step 3.—Projection for Year 3

Same as year 2. Since there is no shortage or surplus, the monthly payment is $300 per month.

Single-Item Analysis With Aggregate Adjustment Problem [Items 7–9]

7. Section 3500.7 is amended by revising paragraph (c)(2), to read as follows:

§ 3500.7 Good Faith Estimate.

* * * * *

(c) * * *

(2) The borrower will normally pay or incur at or before settlement, based upon common practice in the locality of the mortgaged property. Each such estimate must be made in good faith and bear a reasonable relationship to the charge a borrower is likely to be required to pay at settlement and must be based upon experience in the locality of the mortgaged property. Reserves to be deposited with the lenders for the 1000 series in the HUD–1 and HUD–1A may be estimated using a 1-month single item amount for each item. For each charge for which the lender requires a particular settlement service provider to be used, the lender shall make its estimate based upon the lender's knowledge of the amounts charged by such provider.

8. Section 3500.8 is amended by revising paragraph (c), to read as follows:

§ 3500.8 Use of HUD–1 and HUD–1A settlement statements.

* * * * *

(c) *Aggregate Accounting At Settlement.* Servicers may choose Option 1 or Option 2 of this paragraph:

(1) *Option 1.* The servicer may choose the method in either paragraph (c)(1)(i) or (ii) of this section:

(i) After computing individual deposits in the 1000 series using single-item accounting, the servicer shall make an adjustment based on aggregate accounting. This adjustment equals the difference in the deposit required under aggregate accounting and the sum of the deposits required under single-item accounting, with both sets of calculations using the same cushion. The computation steps for both accounting methods are set out in § 3500.17(d). The adjustment will always be a negative number or zero (–0–). The settlement agent shall enter the aggregate adjustment amount on a line at the end of the 1000 series of the HUD–1 or HUD–1A statement.

(ii) The settlement agent may initially calculate the 1000-series deposits for the HUD–1 and HUD–1A settlement statement using single-item analysis with a maximum 1-month cushion (unless the mortgage loan documents indicate a smaller amount). In the escrow account analysis conducted within 45 days of settlement, however, the servicer shall adjust the escrow account to reflect the aggregate accounting balance. Appendix A to this part contains instructions for completing the HUD–1 or HUD–1A settlement statements using single item analysis with an aggregate adjustment and the alternative process during the phase-in period. Appendix E to this part illustrates the arithmetic steps for aggregate analysis.

(2) *Option 2.* The servicer may complete the aggregate computation, as set forth in 24 CFR 3500.17(d), and record the aggregate deposit by inserting the words ''Aggregate Escrow Deposit for Items Marked (*) Above'' on a line at the end of the 1000 series and placing the total on that line. While no individual deposits are to be recorded on the other lines of the 1000 series, an asterisk (*) shall be placed next to each item in the 1000 series for which a reserve has been collected.

9. Appendix A is amended in Section L, under the text heading ''Line Item Instructions,'' by revising in the discussion of ''Lines 1000–1008'' the second paragraph and the second sentence of the third paragraph and by adding a new fourth paragraph, to read as follows:

Appendix A to Part 3500—Instructions for Completing HUD–1 and HUD–1A Settlement Statements; Sample HUD–1 and HUD–1A Statements

* * * * *

Lines 1000–1008. * * *

The servicer shall pick Option 1 or Option 2. *Option 1.* After itemizing individual deposits in the 1000 series using single-item accounting, the settlement agent shall make an adjustment based on an aggregate analysis to reflect the difference between the deposit required under aggregate accounting and the sum of the deposits required under single-item accounting, with both sets of calculations using the same cushion. The computation steps for both accounting methods are set out in 24 CFR 3500.17(d). The adjustment will always be either a negative number or zero (-0-). The servicer shall enter the aggregate adjustment amount on a final line in the 1000 series of the HUD–1 or HUD–1A statement.

* * * If a servicer has not yet conducted the escrow account analysis to determine the aggregate accounting starting balance, the settlement agent may initially calculate the 1000 series deposits for the HUD–1 and HUD–1A settlement statement using single-item analysis with a maximum 1-month cushion (unless the mortgage loan documents indicate a smaller amount). * * *

Option 2. The servicer may complete the aggregate computation, as set forth in 24 CFR 3500.17(d), and record the aggregate deposit by inserting the words ''Aggregate Escrow Deposit for Items Marked (*) Above'' on a line at the end of the 1000 series and placing the total on that line. While no individual deposits are to be recorded on the other lines of the 1000 series, an asterisk (*) shall be placed next to each item in the 1000 series for which a reserve has been collected.

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Dated: July 5, 1996.

Nicolas P. Retsinas,

Assistant Secretary for Housing—Federal Housing Commissioner.

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