

What is escrow and how does it work?

By Christa Buchanan

Oftentimes, the taxes and insurance are added to the mortgage payment via an escrow account.

"An escrow account is a budgeting tool used to collect money from a homeowner each month to pay the house's property taxes and homeowner's insurance. ... Typically, most lenders want to see coverage equal to the mortgage loan amount; however, we have been seeing a growing trend of lenders requiring 100 percent replacement coverage to replace the home," said Matthew Adler, branch sales manager of North Star Home Lending in Bingham Farms.

The amount paid into escrow is initially based on a "good faith estimate," in which the lender takes the home insurance costs provided by the buyer's insurance company and property tax estimates to determine the monthly amount to be paid into escrow - it's typically recommended to have those costs estimated higher than expected so that the new homeowner isn't shocked by an increase after the first year.

"Every lender has a different practice of how they disclose taxes and insurance on a good faith estimate. Our practice is to over-estimate the collection of taxes and insurance to give the buyer the highest potential cost in order to prepare them for the worst-case scenario," said Adler, noting that if a homeowner's insurance is cancelled due to lack of payment or if their coverage amount is less than the current mortgage balance, lenders will then force "lender-placed" homeowner's insurance.

"(This) is typically substantially more expensive than any insurance a homeowner finds on their own," he said.

While an escrow account is mandatory for those with Federal Housing Administration, Department of Veteran's Affairs and United States Department of Agriculture mortgage loans, Adler said, people with Fannie Mae- or Freddie Mac-insured conventional mortgages can either opt for an escrow account or waive an escrow account - to waive escrow the buyer must put at least 20 percent down on a purchase or have 20 percent equity on a refinance.

"Plain and simple: It is easier to budget. I always recommend that a first-time homebuyer establish an escrow account, when possible. It eliminates the surprise of receiving a large tax bill twice a year and homeowner's insurance renewal notice and not having the money available to pay it," Adler said of the benefits of escrow accounts.