ABA Stonier Graduate School
Capstone Strategic Project

“To Escrow…. or not to Escrow, that is the Question”

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EXECUTIVE SUMMARY

The Bank of Holland is a closely held community bank that was founded in 1893 with 3 locations in Western New York. Holland (1893), East Aurora (2003) and Elma (2016) all offer full bank services that continue to leverage a true community bank philosophy with a primary focus on customer deposit and lending relationships. There are no immediate plans to open a fourth branch location as recent emphasis has been placed on capturing additional commercial banking opportunities and strengthening overall risk management.

The bank recently surpassed $100 million in total assets, of which the loan portfolio accounts for $69 million. The portfolio percentages below help depict the strategy of the bank over this time:

- Residential Real Estate – 75.57%
- Commercial Real Estate – 17.40%
- Consumer Installment Loans – 4.73%
- Commercial & Industrial – 2.30%

The Bank of Holland has never operated a real estate tax or hazard insurance escrow management program for mortgages on either the residential or commercial loan portfolios. To date as part of the bank note and mortgage agreement the borrower or borrowing entity is responsible for payment of taxes and insurance as they are due with payment going directly to receiver of taxes or insurance company. A delinquency of either payment is considered a default of said mortgage and could result in foreclosure of the collateral. This specific loan portfolio maintenance decision over time has alleviated the bank of providing the required resources to manage an escrow program and subsequent compliance oversight and
investment. However, this choice has unintentionally on occasion inflated loan to value percentages on existing loans when delinquent taxes exist. This occurs as unpaid real estate taxes take lien precedent over the bank’s title position. In the event the bank would need to recover the collateral, any tax lien owed to the respective town, village or county must be satisfied or order to cleanse the lien even if the bank is in first lien position prior to the tax liability being incurred. The immediate monetary risk to the bank is that delinquent taxes are a direct liability and must be satisfied in order to take ownership of the collateral.

Implementing a real estate tax escrow program within the bank would reshape the bank’s previous mindset and provide opportunities for future income while shifting to a proactive approach of further controlling the portfolio’s tax liabilities. This does come with expense as the roll out of this service would be an initial $5,600 investment and an ongoing net annual cost after year 1 of approximately $15,000. This yearly figure will be static for some time but eventually increase as the escrow portfolio grows in size. With this decision also comes an added regulatory burden as the bank would be subject to routine escrow related audits to assure compliance.

In addition to controlling tax liabilities, the successful launch of this administrative service will provide the bank with the opportunity to originate Higher Priced Mortgage Loans (HPML’s). The importance of this is that bank may then price a loan segment according to the associated risk as long as the product is disclosed and reported properly. To date the bank has not had this option due to the lack of escrow and has been required to price certain loans at a more aggressive rate than what the risk rating would indicate. Providing escrow on mortgages would also place the bank one step closer in having the ability of selling loans on the secondary
market to both Fannie Mae and Freddie Mac. This would be a long term project but one that would be enacted on a quicker timeline with an escrow module already in place.

As the above outlines a strong case for establishing escrow, the continuing question over time on whether the service should be offered has typically been initiated either during, or after a lengthy foreclosure in which the bank has lost some equity due to tax obligations. If the bank would like to further limit that liability without adding the additional operational expenses (estimated at an initial $15,000 per year), it is believed that this question may be simply answered by establishing tighter collection and recovery guidelines for both the Credit/Collections Analyst and the bank’s collection attorney. Accountability of adhering to stricter parameters will move up the time frame in the event the bank takes ownership for those distressed properties and further limit equity loss after collateral recovery. Additionally this will not place a further burden on the Compliance Department of the bank.

When evaluating both options it is recommended that the bank pursue the establishment of the escrow function. This is a legacy decision that will be a requirement in the future as the Loan Administration Department looks to align their offerings with the bank’s current growth strategy of expanding the loan mortgage portfolios. Refining this process in the short term will allow for simpler product expansion in the coming years while further controlling the existing and impending tax obligations.
INTRODUCTION AND BACKGROUND

Bank History
The Bank of Holland was founded and incorporated in 1893 in the town of Holland, NY which is 20 miles southeast of the city of Buffalo, NY. Operating under a New York State Charter, the bank currently has 3 retail locations but functioned as a 1 branch financial institution from 1893 until 2003. That year a second branch and back office operations were moved to a new facility in the village of East Aurora, NY which is 10 miles north and closer to the city of Buffalo. Most recently a third location was opened in March of 2016 moving further north towards the City in the suburb of Elma (see map below). At this point the bank does not have any immediate plans to open a fourth branch location as focus been placed on capturing additional commercial banking opportunities and overall risk management.

Bank of Holland - Western New York - 3 Branches
The Bank of Holland is a privately, closely held bank that has relied and leveraged a true community bank philosophy since inception focusing on customer deposit relationships and lending. The bank recently surpassed $100 million in total assets, of which the loan portfolio accounts for $69 million. The portfolio percentages below help depict the strategy of the bank over this time (as of 9/30/16)¹:

- Residential Real Estate – 75.57%
- Consumer Installment Loans – 4.73%
- Commercial Real Estate – 17.40%
- Commercial & Industrial – 2.30%

While the bank has entertained venturing into additional financial services in the past of wealth management and insurance there are no immediate plans to offer these products as the strategy is to continue with what the bank knows best, establishing customer relationships and lending within that same arena.

The Western New York area and particularly the City of Buffalo and Erie County have seen a steady resurgence as the economy has strengthened since the economic downturn. This has lent to increased opportunities in the commercial lending area and the bank’s immediate focus is now on managing existing, and cultivating new business relationships. As increased sales are becoming a point of concentration the bank has also understood the overall risk management challenges of the current loan portfolio and the need to continue its sound underwriting practices and evaluate ways to further lessen the risk of the assets.

Bank of Holland continues to have sound regulatory compliance in all three facets of Safety and Soundness, Consumer Compliance and under the Community Reinvestment Act. The traditional conservative nature of the bank weathered many peaks and valleys in the economy over the last century but management realizes that further steps must be taken as asset size grows to maintain quality and compliance.

**Current Loan Policy and Delinquencies**

The bank’s loan policy is somewhat unique as Bank of Holland is one of the few institutions that does not credit score on consumer or personal guarantees for commercial loans. The policy outlines standard Loan to Value (LTV) and Debt to Income/Debt Service Coverage thresholds but the overall external credit quality as dictated by the credit report is reviewed and taken into account without the credit score as a factor. This allows the bank to review the entire credit opportunity and employ a customer centric outlook without an automatic exclusion or denial due to the credit score. Past credit slowness is evaluated on a case by case basis through the interview and underwriting process. This is an asset to the bank as many walk in opportunities present themselves due to another institutions denial based on credit score as one of, or the main factor. While this is an asset from a sales standpoint, this has also lent to a reduction in evaluated delinquency performance vs. other banks of like size as loans over 90 days past due *(table 1)* and non-accrual loans *(table 2)* trail the peer group. Credit policy in conjunction with a community bank outlook on continuously working with a distressed borrower may show increased 90 day delinquency figures vs. the group but when

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reviewing the next two tables against the peers, the non-accrual comparison reveals that the spread between 90 day and non-accrual loans lessens significantly.

**Table 1 Loans 90+ Days Past Due Peer Group Comparison**

<table>
<thead>
<tr>
<th></th>
<th>9/30/2016</th>
<th>9/30/2015</th>
<th>9/30/2014</th>
<th>9/30/2013</th>
<th>9/20/2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>BOH Peer</td>
<td>1.17</td>
<td>0.06</td>
<td>0.2</td>
<td>0.34</td>
<td>0.08</td>
</tr>
</tbody>
</table>

**Table 2 Non-Accrual Loans Peer Group Comparison**

<table>
<thead>
<tr>
<th></th>
<th>9/30/2016</th>
<th>9/30/2015</th>
<th>9/30/2014</th>
<th>9/30/2013</th>
<th>9/20/2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>BOH Peer</td>
<td>1.07</td>
<td>0.8</td>
<td>1.23</td>
<td>1.34</td>
<td>1.01</td>
</tr>
</tbody>
</table>

As evidenced above the delinquency figures are over peer but the bank performs well from a net interest margin standpoint as it is able to gain interest income for the risk of the slower credit applicants *(table 3)*. This coupled with a strong base of core deposits has kept the cost of funds down and margin within striking distance of the group.

**Table 3 Interest Income Peer Group Comparison**

<table>
<thead>
<tr>
<th></th>
<th>9/30/2016</th>
<th>9/30/2015</th>
<th>9/30/2014</th>
<th>9/30/2013</th>
<th>9/20/2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>BOH Peer</td>
<td>4.08</td>
<td>3.97</td>
<td>4.19</td>
<td>4.23</td>
<td>4.33</td>
</tr>
</tbody>
</table>

Also of importance and from a reserve and write-off position the loan portfolio has historically performed well vs. the peer group as the bank is highly leveraged in consumer (75.57%) and commercial real estate (17.40%). The bank pays strict adherence to loan policy with loan to value limits of no more than 80% residential and 75% LTV for commercial loans

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which provide the needed margin in the event of a distressed loan or loss. Loss percentages vs. peer from this standpoint historically are comparable or better, however, the last two reported years do slightly trail the group (table 4)\textsuperscript{5}. The 5 year average weighs heavily in favor of the Bank of Holland at .23 to 1.06 for the peer.

\textit{Table 4 Net Losses to Loans & Leases Peer Group Comparison}

<table>
<thead>
<tr>
<th></th>
<th>9/30/2016</th>
<th>9/30/2015</th>
<th>9/30/2014</th>
<th>9/30/2013</th>
<th>9/30/2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>BOH</td>
<td>0.11</td>
<td>0.2</td>
<td>0.03</td>
<td>0</td>
<td>0.09</td>
</tr>
<tr>
<td>Peer</td>
<td>0.07</td>
<td>0.12</td>
<td>0.2</td>
<td>0.28</td>
<td>0.39</td>
</tr>
</tbody>
</table>

As the bank’s loan policy officially employs a sub 80% loan to value and enjoys manageable credit losses, it has been apparent for some time that areas of the loan portfolio and historic collection practices need a true Cost/Benefit analysis to evaluate if software or methodology improvements are needed. This Capstone project provides management with a significant opportunity to perform such an evaluation that has been discussed many times previously.

**STRATEGY/IMPLEMENTATION**

\textbf{Investment and change being considered - Real Estate Escrow}

Since incorporation the Bank of Holland has never operated a real estate tax or hazard insurance escrow management program for mortgages on either the residential or commercial loan portfolios. To date as part of the bank note and mortgage agreement the borrower or borrowing entity is responsible for payment of taxes and insurance as they are due with payment going directly to receiver of taxes or insurance company. A delinquency of either

\textsuperscript{5} Uniform Bank Performance Report. FFIEC / Bank of Holland. 2016
payment is considered a default of said mortgage and could result in foreclosure of the collateral.

This specific loan portfolio maintenance decision over time has alleviated the bank of providing the required resources to manage an escrow program and subsequent compliance oversight and investment. However, due to this decision it has unintentionally on occasion inflated loan to value percentages on existing loans when delinquent taxes exist. This occurs as unpaid real estate taxes take lien precedent over the bank’s title position. In the event the bank would need to recover the collateral, any tax lien owed to the respective town, village or county must be satisfied or order to cleanse the lien even if the bank is in first lien position prior to the tax liability being incurred.

It is important to note that while the bank does not account for the tax risk in the initial loan to value evaluations there is continuous management of the loan loss reserve and all associated risk calculations that surround a distressed loan due to delinquent property taxes. Tax liabilities are taken into account on a case by case basis and the reserve ratios are performed accordingly.

In summary and as outlined above the bank’s overall credit losses are comparable to peer but a detailed evaluation and analysis is required to provide an accurate analysis of originating an in-house escrow program to control all tax and insurance associated risks. The financial impact study of this project will include the costs and investment needed for:

- Software implementation
- Labor for ongoing management of program
- Direct and indirect project related costs
- Loan delinquency ratio expected change
- Underlying regulatory compliance risk and impact

**Why the bank is evaluating this project**

This project is being considered as the bank would like to shift the outlook from a reactionary stance to a proactive approach. The bank preliminarily expects that while there will be an initial and ongoing monetary investment, the amount of risk to be controlled should offset that amount and justify the decision to move forward. This change will also provide an easier focus for the Credit/Collection Analyst and the bank’s collection attorney as they would then concentrate directly on delinquent monthly payments. At present there is a comingling on certain accounts of delinquent monthly principal and interest payments in addition to delinquent taxes.

As the main objective of this analysis and project is to decrease tax related risk, the addition of escrow services to consumer mortgages may also provide the bank with a future option to originate Higher Priced Mortgage Loans (HPML’s) should they determine to venture into that loan segment. Additionally an escrow program will also provide an avenue to sell consumer related mortgages on the secondary market to both Fannie Mae and Freddie Mac.

**Author’s role**

The author’s role in this endeavor is that of Project Manager during implementation and then to assume ultimate responsibility of this process as Vice President of Loan Operations. Ownership of this project will reside with the author from incubation through maturity with oversight of those tasked with the day to day function moving forward. The author has
experience in various roles throughout the bank as the position of Credit/Collections Analyst, Compliance Officer, CRA Officer and Security Officer have all been held. These previous roles have provided the author with a vast knowledge of the inner workings of the bank and should allow for an easier anticipation of potential speed bumps throughout the process.

**Organizational fit**
This project will be a significant one for the bank as it will shift a long standing focus of non-escrow mortgages to one of escrow. The end result will satisfy the bank’s internal need to mitigate tax risk but also fulfill an ongoing customer request to provide escrow services. The addition of adding this mortgage feature is expected to be an easy fit for both the organization and more importantly the customer as there would be little disturbance to the client base. As a true community bank, the Board of Directors, management and staff are always eager to listen to requests and review such requests to see if they will fit within the bank’s blueprint. Blocking and tackling is what community banks do best and is why the possibility of adding this option to the bank’s mortgage services is not anticipated to create a negative change to the portfolio.

**Competitive advantage**
This new offering will not necessarily provide the bank with an immediate competitive advantage but will lay the ground work for an easier transition of additional products and services to be added in the future as discussed below.

**Future opportunities**
The addition of adding real estate tax escrow and homeowners insurance to the consumer real estate mortgage portfolio will satisfy 1 of the 4 requirements in order to offer Higher Priced Mortgage Loans (HPML’s) as dictated under the Truth In Lending Act (TILA -
Regulation Z\(^6\). The 3 other components for offering HPML’s are processes the bank has
adopted previously as part of the overall mortgage underwriting and maintenance. These 3
steps\(^7\) in addition to the escrow accounts briefly stated are:

1. Specifics on required interior appraisal inspections
2. The Ability to Repay (ATR) Rule
3. Mortgage prepayment penalties

The importance of the ability to offer HPML’s is that the bank may then price loans over 1.50%
(Annual Percentage Rate) of the weekly Average Prime Offer Rate (APOR) as dictated by the
Federal Financial Examinations Council (FFIEC)\(^8\) for certain first lien real estate based or primary
home lending. The threshold rises to 3.50% for second lien transactions. These rates are
published weekly by the FFIEC and adjusted accordingly by the bank to ensure that the HPML
threshold is not crossed.

The reason for this significance is that as a small community lender the bank has a
liberal credit policy and the ability to finance both residential real estate and mobile homes that
some regional and larger lenders prefer to avoid. This loan segment over time have become
less attractive for the bank as the interest rate has been capped by the HPML rule and
therefore the risk does not necessarily equal the reward. The addition of escrow to the lending
process will provide an avenue for the bank to explore offering HPML’s as that service is one of
the 4 mandatory requirements as set forth under the regulation rules. It is important to note

\(^8\) FFIEC Website - [https://www.ffiec.gov/ratespread/aportables.htm](https://www.ffiec.gov/ratespread/aportables.htm)
the bank will only need to escrow hazard insurance for the mobile home loan in order to offer HPML’s. The hazard insurance portion of escrow service will be rolled out once the real estate tax portion has been tested thoroughly and is live for a period of time.

A secondary opportunity is that the establishment of escrow moves the bank closer to fine tuning the requirements to sell mortgage loans to Fannie Mae or Freddie Mac. This option has been discussed in general terms previously by management but it has always been known that escrow must be established first before any talks or focus would be placed on selling into the secondary market. This may be a difficult decision as the bank has always taken pride that all mortgage loans remain in the bank’s loan portfolio and they are not sold into the marketplace. It is also known that in the event that either Fannie Mae or Freddie Mac loans are offered that the bank would most likely be able to offer much more competitive interest rates as the loans that are in portfolio now are typically up to 1.25% higher than the competitors market rates in the region as loans are held within the bank’s portfolio.

This new product offering will accomplish the before mentioned and further enhance the bank’s true community bank feel with another option for the customer. The final approval for this project would come from the bank’s President/CEO with input from the Board of Directors.

**Process change**

The bank has used Fiserv Premier as the core banking system for both deposit and loan relationships since 1993. There are no immediate plans to change from Fiserv to another core provider as Fiserv is one of the leaders in banking solutions and offers various software.

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modules for every product or service the bank may like to offer in the future. This is important because it will allow the technology portion of this project if approved to be added with little difficulty as there is a high level of confidence with the core by the IT Department and Operations personnel.

The current monitoring of the loan portfolio’s real estate property tax payments is contracted to and monitored by a national third party vendor that specializes in real estate tax tracking, escrow assistance, flood zone determinations and property insurance tracking called Lereta. Lereta presently provides to the bank monthly, quarterly and annual updates as to delinquency status of real estate tax issues to the Credit/Collection Analyst who then initiates the bank’s initial collection response. If the Analyst is unsuccessful with collection efforts to rectify the tax delinquency the Analyst will then provide notice to the bank’s collection attorney to pursue recovery efforts. Presently the Credit/Collection Analyst is responsible for all consumer and commercial collections for the bank in addition to commercial credit analysis and other various duties. The delinquent real estate tax recovery portion is estimated to account for 20% of the Credit/Collection Analyst’s time while performing the overall collection function for the bank.

The proposed process change would be to launch a real estate tax escrow program for new customers initially and then eventually offer this service to the existing loan portfolio base. This project, focus and implementation plan is solely geared for new mortgages and the escrowing of real estate taxes. Until further notice the bank will continue to track property insurance internally and force place hazard policies when necessary. Once the escrow process

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for real estate taxes is established, tested and deemed successful, the bank would then look to add on the hazard insurance portion to the escrow procedure.

Initiation of a real estate tax escrow process would be accomplished with a great deal of assistance from Lereta in addition to the services they already perform. Once initiated, Lereta will provide exact tax liabilities for each loan with specified time frames for repayment. This is accomplished with reporting to the bank the amounts owed for each customer, typically by municipality, the type of tax due (town/county or school tax and/or usages fees) and time frames involved. The bank then will review said reports, issue a check or ACH payment directly to Lereta for those loans and associated municipalities. To close the process, Lereta will then in turn submit those funds to the associated taxing authority. Please see the below flow chart of the process as provided by Lereta:\(^{11}\):

\(^{11}\) Process Flow Chart – C. Palmer, Lereta Tax Services
While the majority of the process change will take place in Loan Operations there will also be a slight variation to the current process of Loan Estimate disclosures. The portion impacted is the quotation of estimated closing costs for lenders with regard for a prospective customer due to real estate taxes. Presently there is a loose evaluation of real estate taxes during the initial Loan Estimate process as the proposed borrowers ultimately understand that the amount needed for closing a mortgage is not indicative of the necessity of creating a cushion for real estate tax escrow reserves. In direct terms the customer’s closing costs will increase at inception in order to fund the upcoming real estate tax liability versus what they
currently need for closings without escrow. The next change will come with the additional responsibility of Loan Operations to fine tune the Loan Estimate and then eventually the Closing Disclosures for the bank’s attorney. This will lend to a modest increase of 5 to 10 minutes of time spent in that area as the bank will be required to perform an additional calculation for the closing disclosure. This portion will require attention to detail in order to achieve proper compliance and fund the tax escrow properly going forward.

**Implementation Schedule**

<table>
<thead>
<tr>
<th>Task</th>
<th>Responsibility</th>
<th>Date for Completion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Presentation of proposed project to President/CEO and Board at Board of Directors Meeting</td>
<td>Loan Administration VP</td>
<td>August 7, 2018</td>
</tr>
<tr>
<td>Review of proposal by Compliance and associated recommendations</td>
<td>Compliance Officer</td>
<td>Sept. 30, 2018</td>
</tr>
<tr>
<td>Purchase Escrow Module from FISERV / Installation</td>
<td>Loan Administration VP IT Manager</td>
<td>Oct. 15, 2018</td>
</tr>
<tr>
<td>Execute add on services contract for escrow function from Lereta</td>
<td>Loan Administration VP President/CEO</td>
<td>Oct. 15, 2018</td>
</tr>
<tr>
<td>Hire new associate for Loan Admin Dept. (move current employee to “Escrow Specialist” position /backfill with new)</td>
<td>Human Resources Loan Administration VP</td>
<td>Oct. 31, 2018</td>
</tr>
<tr>
<td>Create Implementation Committee and schedule first meeting</td>
<td>Loan Administration VP</td>
<td>Nov. 15, 2018</td>
</tr>
<tr>
<td>Provide initial update and brief training/overview to impacted personnel</td>
<td>Loan Administration VP Compliance Officer</td>
<td>Nov. 30, 2018</td>
</tr>
<tr>
<td>Implementation Committee Meeting</td>
<td>Loan Administration VP, Compliance Officer, Senior Lender, Branch Administration VP, various staff</td>
<td>Dec. 15, 2018</td>
</tr>
<tr>
<td>Test various escrow loans/accounts and process with Loan Operations and Lereta</td>
<td>Escrow Specialist Loan Administration VP</td>
<td>Dec. 31, 2018</td>
</tr>
<tr>
<td>Fine tune reports &amp; testing with Lereta, Loan Operations and closing attorney paralegal</td>
<td>Escrow Specialist Loan Administration VP</td>
<td>Jan. 31, 2019</td>
</tr>
<tr>
<td>Final testing and review of reports,</td>
<td>Escrow Specialist Loan Administration VP</td>
<td>Feb. 28, 2019</td>
</tr>
</tbody>
</table>
amounts, escrow statements, etc. | Compliance Officer
---|---
Final Implementation Committee Meeting and Training | Loan Administration VP, Compliance Officer, Senior Lender, Branch Administration VP, various staff | Mar. 15, 2019
Go live date for new applications initiated after this date | All Staff | Apr. 1, 2019
Follow up meeting – questions, concerns, outlook | Escrow Specialist Loan Administration VP | Apr. 15, 2019
Set Date for new project of converting existing mortgages to escrow | Escrow Specialist Loan Administration VP | Apr. 15, 2019
Set Date for new project of adding hazard insurance to escrow process | Escrow Specialist Loan Administration VP | May 1, 2019

**FINANCIAL IMPACT**

**Initial Costs**

The initial costs to start the process and form this service offering will be minimal in overall terms but just enough to anticipate a spirited debate on when, if at all necessary to act on this project. The exposure from this research will come more from a bank strategy and regulatory standpoint for the future as once escrow is initiated and offered for mortgage related products, the bank must move forward down that path. Once initiated, it would be extremely difficult to withdraw the escrow option and establish a sunset period. This section will operate under the premise that escrow will be offered and limit the financial impact to the main items of hard costs to form such a process, the ongoing costs to support escrow servicing and the effect it will have on the current delinquent tax collection process.

**Revenue**

The increased revenue projection as a result of this project in regards to real estate mortgages would be minimal and difficult to estimate as this is a risk mitigation technique designed to limit exposure of unpaid real estate tax delinquencies. While the offering of tax
services may be appealing to certain customers the bank has not experienced a loss of prospective borrowers due to the lack of this service up to this point in time. The bank has previously, and continues to offer a voluntary escrow service to which the customer may initiate an automatic funds transfer each month to the deposit product of their choice to cover the estimated tax and insurance amounts. This option has worked well for those who have elected to enroll but the bank does not make this a mandatory requirement.

The bank also currently does not offer risk based pricing on any loan products so there is one set rate for specific loan segments regardless of credit risk. An application is either approved or declined but the interest rate will not fluctuate on consumer related loans according to the risk rating. It is anticipated in the future that if the bank does venture into selling mortgages to both Fannie Mae and Freddie Mac that this would be required and also allow the bank to stagger interest rates and hold those with a higher return in portfolio and under the HPML designation if necessary.

The most probable immediate form of revenue increase by adding the escrow option is the ability to charge a higher interest rate on mobile home loans in parks. Mobile homes are considered a principal dwelling and are covered under the HPML rule even though real estate taxes are not paid. It is required under the regulation that the hazard insurance is escrowed and the associated disclosures are provided at initiation and throughout the loan term. It is important to note that while the initial launch will be geared to only newly originated mortgages, the bank will quickly move to provide a conversion option for existing customers in addition to commencing the hazard insurance portion.
As of 9/30/16 the bank has 100 mobile home loans in portfolio with a principal balance of $1.8M. This loan segment may carry up to a 15 year payment amortization depending on the age of the unit and the average interest rate yield of these loans as of that date was 4.87%. From the period of 9/30/15 through 9/30/16 the bank originated 18 new mobile home loans. Using an average principal balance of $18,882, an increase of 1.00% on the 4.87% to 5.87% would provide additional interest income of almost $3,400 per year on these loans.

While the addition of an Escrow Specialist will move the portfolio to a proactive stance it is not anticipated the Credit/Collection Analyst’s time devoted to real estate collections will lessen much in the first 2 to 3 years as the majority of the delinquency issues are routinely the same customers. It is further expected that while there will be a time savings in labor spent on delinquent tax collection, it is anticipated that this savings will merely shift to the projected delinquency increase of monthly payments including escrow (see page 28 – Loan Delinquency Ratios).

Expense

The expense portion of this undertaking will produce year one hard costs that include the purchase of the escrow payment processing module from Fiserv as a bolt on to the current core banking system. The cost for this module is an initial $3,600 for implementation with an anticipated additional cost of $2,000 for training from Fiserv to Bank of Holland employees. Year one and then ongoing cost for the software is $.007 per escrow account for up to 15,000 accounts or a minimum of $125 per month. The bank currently has less than 1,200 mortgage

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related loans in portfolio and will budget for the Fiserv minimum of $1,500 ($125 per month) annually as software maintenance going forward.

The largest expense will be the addition of labor to support this process. Current staff in the Loan Administration Department handle multiple operational processes due to the bank’s size but this new position will account for 30% of an employee (Escrow Specialist) that will be devoted to solely managing the escrow process. This position in addition to overseeing escrow will lend support to loan documentation both in an initial disclosure and closing loan documents capacity. This time allocation figure was derived by querying 3 other local banks that conduct escrow. Their responses varied but estimated that 1 full time employee was necessary if they were handling the escrow function from incubation to maturity each year for up to 2,500 accounts if using a tax tracking and payment service such as our current vendor, Lereta. Due to the size of the bank’s loan portfolio and anticipated growing pains it is estimated that the 30% figure is conservative and will allow for a worst case scenario once the project is introduced. The anticipation is that this position will initially be fully devoted to the roll out, testing and management of the project and then settle in to the 30% maintenance allocation.

The new position of Escrow Specialist while using a 30% time figure yields an annual cost of $15,484 after employee benefits towards this expense allocation. See Appendix A for calculations but it anticipated that this position will command a $30,000 salary with associated benefits. This will be an annual ongoing expense and the duties of this new position will have ownership of the entire escrow process from the loan origination through maturity with oversight of the annual statements, reconciliations and mailings if necessary. Additional duties
will be assigned as workload dictates but this position will be viewed as the escrow expert within the organization. It important to note that the additional 70% of this salary and duties will be absorbed by the overall Loan Administration Department as various roles and responsibilities will shift. As indicated earlier it is also expected that Credit/Collection Analyst’s labor time will merely shift from the collection of delinquent taxes to the anticipated increase in monthly principal and interest payment delinquencies with the addition of escrow.

The next largest expense will be the interest expense paid per year as New York State Banking law\(^\text{13}\) mandates that the financial institution must pay at least 2.00% interest on the amount held in escrow and paid out to the customer quarterly. This expense will be limited during the initial roll out but will evolve into a larger itemization as additional loans are added into the escrow process. A sampling of 60 current real estate tax delinquent loans and the taxes associated with those properties yield an average annual tax liability of $4,433 in Town, County and School taxes. The annual interest expense of the 12 month average balance in an escrow account for the amounts associated above requires the bank to pay approximately $38.77 annually to the customer. Please see Appendix B for the escrow analysis. Escrow worksheet provided by Bankers Compliance Consulting\(^\text{14}\).

While the annual expense for those funds results in $38.77 per loan the bank also has use of those funds with interest income possibilities which will lower the net expense. With an

\(^{13}\) NY Banking Law 14-b Part 10 of the Regulations. Also reference GOL 5-601 & 602 for percentage information.

\(^{14}\) http://www.bankerscompliance.com/
analysis date of 9/30/16 being used, the bank had a Loan to Deposit ratio of 67.77%\textsuperscript{15}. At this point the excess funds from a loan escrow product would only earn the prevailing Federal Funds Rate of .29%\textsuperscript{16} as of that investment date. This figure will fluctuate as rates increase and other investments are pursued with the additional deposits on hand but this analysis is looked at as a worst case scenario. The net of the .29% earnings versus the 2.00% payout would then yield a net interest expense of $33.15 per loan. Please see Appendix B for analysis.

In the first 3 quarters of 2016 the bank originated 43 first lien attorney closed mortgages over the same period. If annualized over 12 months the bank will have originated 57 first lien real estate escrow eligible loans for the period. It is important to note that at the time of this paper the bank is aggressively pursuing the addition of new loan officers to increase mortgage related volume. Due to such a figure of 100 loans will be used for ease of reader interpretation and the expected results of the ongoing marketing campaign to increase the consumer and commercial mortgage loan portfolio. The annual interest expense for the bank when using the $33.15 net average per loan would be $3,315 (on 100 loans). The actual interest paid is not expected to reduce over the lifetime of the loan due the long standing New York State Escrow regulation and also because Western New York property taxes continue to be one of the highest in New York State and the County\textsuperscript{17}. While the true expense is not expected to diminish during the loan, the ability to earn a higher rate than the analyzed Effective Federal Funds Rate of .29% is highly likely and will further offset the expense.

\textsuperscript{15} Bank of Holland ALCO Report – 9/30/16
\textsuperscript{16} https://apps.newyorkfed.org/markets/autorates/fed-funds-search-page
\textsuperscript{17} http://buffalonews.com/2015/03/18/wnys-property-taxes-highest-study-confirms/
The cost of Lereta’s portion of the escrow servicing is a third party fee that is passed directly on to the borrower and paid for as part of the closing costs for all attorney closed first lien mortgages. The fee from Lereta is currently $99 per loan and the contract requires that they track that specific loan for up to a period of 30 years for tax delinquencies. The existing agreement executed in 2014 also includes the escrow payment portion so there will be no additional cost from the vendor in assisting with this service. Recent discussions with the bank’s account representative also confirmed and validated this agreement going forward.

The last expense to be evaluated is the mailing of the initial escrow disclosure and annual computation statements. The Operations Department has furnished a cost of approximately $1.50 per mailing which covers the printing, envelope and postage. When using the 100 account figure, initial mailings will cost $150 in year one along with $150 for the annual disclosure for a total of $300. Annually thereafter the cost will be $150 per year but increase as volume increases. This is a minimal cost of maintenance and no further analysis will be conducted on this portion.

**Revenue vs. Expense**

Projected increased revenue over time is coming from the likelihood the bank will offer and originate HPML’s on mobile home loans in parks and continue in that market segment. That offering would not take place until almost 1 year after escrow initiation due to the implementation timeline provided within this project. The estimated revenue increase over time would yield approximately $3,400 annually in year 2 to 3 and increase over time.

The expense portion is clearer as year 1 hard costs include: Software module - $3,600 and Training/Implementation - $2,000 for a total of **$5,600**.
Annual and On-going costs include: Labor - $13,000 (30% of new employee); Net Escrow Interest Expense - $3,315; Fiserv Escrow Module Annual Maintenance - $1,500; Mailings/Statements - $300 for a total of $18,100.

The initial investment of $5,600 and ongoing maintenance expense of $18,100 per year will cost the bank $23,700 in year 1. Moving forward and after the first year, costs are further offset as the projected gain in interest income of $3,400 results in a net ongoing annual expenditure of roughly $14,700 to operate this function. Again, the 30% allocation figure is only an option if the Loan Administration Department is in need of an additional employee with a budgeted time of 50%-70%. If the time needed for escrow maintenance increases, this labor expense line item would rise as well. Based the above figures there is a cost of $147 per loan for every 100 accounts to have this option.

Risk Based Gain

While the above financial impact yields an estimated cost of $14,700 annually, a large reason for the evaluation of adding escrow is to lessen the potential loss of equity due to delinquent real estate property taxes. As of 12/31/16 the bank’s loan portfolio has 60 loans with a total of $338,934 in delinquent real estate taxes owed to various municipalities. These issues account for $5.5M in principal balance of the portfolio. The combined value of delinquent taxes liabilities and loan principal balances total $5.839M in exposure (taxes + principal). The appraised values of real estate collateral securing these properties total just over $10M which yields an overall 58% Loan to Value (LTV) ratio. While the $338,934 is a sizeable figure past history with this function and various repeat customers provide an
expected repayment of almost all delinquencies or enough equity to weather a possible foreclosure.

An issue with the foreclosure process in New York State is the length of duration in order to recover the collateral for residential properties. The New York State Department of Financial Services has estimated the average time from the first missed payment date to foreclosure sale at 445 days\(^\text{18}\) however the bank’s personal experience has put this closer to 500 days once initiated. This is an arduous process that the bank’s attorney must navigate through as there are various protections and court proceeding opportunities that are afforded to the customer.

The collection process at present for a loan that is current on principal and interest payments but falls delinquent on real estate taxes most likely will not see the foreclosure process initiated by the bank’s attorney until 2 full years of taxes are due. At that point and upon the bank’s determination that the issue will not be resolved using all other workout remedies available, the legal process will commence. Therefore if the 445 day duration is added to the already owing 2 years of taxes or approximately 365 days after the first year of taxes is due, the foreclosure sale timeline moves past 800 days to which the bank may be responsible for a minimum of $15,000 and up to $20,000 of tax payments or that much less in property equity when adding municipality late fees, interest and collection costs. Depending on the equity involved these figures continue to place stress on the final outcome and have caused an internal belief that escrow may avoid some residual losses.

\(^{18}\) [http://www.dfs.ny.gov/consumer/hetptimeline.htm](http://www.dfs.ny.gov/consumer/hetptimeline.htm)
The comparison for loans with escrow is that the bank may commence the foreclosure process after the customer is 90 days delinquent and the bank would be further motivated to initiate this timeline quickly as it will run into a negative escrow situation if payments are not made by the borrower. A best case recovery scenario would be the 90 days plus the 445 day duration for a total time of 535 days which will span less than 2 full tax cycles versus the 800 day timeline without escrow. While the 535 day time span is somewhat aggressive it would result in securing the property almost 9 months earlier with less expense exposure and the ability to remarket the property quicker.

**Loan Delinquency Ratios**

It is difficult to ascertain as to how the addition of escrow will impact the overall loan repayment delinquency figures but if it was assumed that any loan with delinquent taxes would be over 90 days delinquent on principal and interest payments as well, the analysis from earlier in this paper in Table 1 (page 8) indicating that the bank’s current 90+ Days Past Due Group Comparison of 1.17% (90+ day loans) in the loan portfolio would then inflate to a highly exaggerated figure of 7.53%. A more realistic approach is to make the assumption that any loan with more than 1 year of delinquent taxes be moved into the 90 day delinquency category if not already present in this classification for principal and interest payments. Of the 60 loans with delinquent taxes there are 17 that owe multiple years. Of those 17 loans, 4 have already been accounted for in the earlier Table 1 computation and removed from this analysis resulting in the addition of 13 loans with a principal balance of $815,507. The addition of these loans to this segment moves the 90+ Days Past Due Group Comparison by over 1 full percentage point.
from 1.17% to 2.23%. Therefore the expected delinquency ratio would change this ratio to 2.23% for the same period.

**Investment**

The answer to whether this is a sound investment for the bank will lie directly with the President and Board of Directors with regard to the appetite for an added expense and the overall 3 to 5 year growth strategy for the bank. The author can make the argument both for and against this option as it relates to a sizeable bank expense at a time when the bank is looking to expand the revenue stream and increase overall income.

A line of reasoning against adding this service can relate directly to the expense line of item of $14,700 annually and the underlying discussion that the current collection efforts of both the bank and bank’s attorney could be more efficient and provide greater results. If tighter time frames were created on the actionable items of collection it is believed that a large reduction in the days to foreclosure completion could be reduced by anywhere from 3 to 9 months for the tax related issues and force quicker remediation. While there is exposure on the tax side the bank is quite familiar with the borrowers and distressed properties involved and tend to act quicker on those with a volatile equity position.

There are various discussion points for the addition of escrow and that while the bank is adding an annual expense they are further expanding their product offering and laying the groundwork for additional products to be added at a later date all while limiting the ultimate tax delinquency exposure over the coming years. The addition of escrow with the expected type of employee to be hired would not only increase the knowledge base in the Loan Administration Department but give greater credence that the Bank of Holland, as a true small
community bank is on par with all the regional and large banks from a mortgage product standpoint. This all would take place while slowly developing a standardized department while providing various options to the bank and the loan portfolio in terms of HPML’s, selling loans the secondary market and the potential creation of risk based pricing.

**NON-FINANCIAL IMPACT**

**Structural & Organizational Obstacles - Historic Thinking**

The origination of an escrow program will cause a large shift in the bank’s previous outlook and back end servicing of mortgages. This will result in changes from both a structure and cultural standpoint as the Loan Administration Department will take on the sizeable and ongoing task of servicing the escrow portion of mortgages. This will be a deviation in the bank’s ongoing theory up to this point that escrow would be more of a burden than it was worth and cause various compliance and administrative issues. The lack of expertise in the arena of administering an escrow program with current staff has also lent to the continuing resistance in pursuing this avenue. The bank continues to have a satisfactory to excellent compliance rating under the various exam structures from both a Safety and Soundness and Compliance standpoint and generally is considered to have an overall strong Compliance Management Program.

The advent of creating an escrow process will place an added stress on the Compliance Officer as the bank will now take on the risk of performing an escrow function according to federal and state regulations. The author can appreciate this risk as the position of Compliance Officer was held previously within the institution. As escrow has been an on and off again topic of conversation over the years, a white paper and background information document was researched and provided to Senior Management in 2010 outlining the escrow requirements.
from a regulatory standpoint. This document continues to have merit as the fundamental premise under both the Federal and New York State escrow regulations remain unchanged. Please see Appendix C for additional information.

**Executive Support**

Support from the top down within the organization will be crucial in the successful roll out of this program. Due to the bank’s size there is frequent and direct contact from virtually all staff with the President/CEO and Board of Directors on a monthly, weekly and daily basis. An environment of uncertainty would easily be created and send mixed signals which in turn could undermine the entire effort if the process was not fully supported by the entire organization.

**Resources**

This portion of the project is the second most critical obstacle behind Executive Support as many of the other items may be overcome if the appropriate resources are dedicated to the function. As the expenses for the labor portion evaluated within use a conservative number of 30% to 50% of a full time employee, there is room for an additional percentage without the requirement to hire additional staff. The commitment to dedicate the necessary funds behind this effort will stand paramount in just how successful this project would be.

**Training**

Appropriate training of staff will also be a highly visible obstacle in order to create a knowledgeable and confident atmosphere for all of those involved with the process. This will lend to establishing a belief within the bank that while this effort may be new and now a different method of servicing the mortgage loans, it will be done in an efficient and well informed manner for both internal and more importantly external customers.
Customer Impact

The bank continues to have a highly reputable brand as a true community bank that focuses on personal relationships with their customers. The impact with the borrowers would be positive in nature by furnishing a service that has been previously requested.

CONCLUSION

The decision on whether or not to move forward will rest solely with Executive Management and the Board of Directors. With that I present two distinct options in order to satisfy the question that has been raised for many years within the bank, “To Escrow, or not to Escrow, that is the Question”.

Option 1 – No Escrow

The primary motive and justification for pursuing this topic of real estate tax escrow was to evaluate the cost of establishing a program in order to lessen the bank’s delinquencies and ultimately reduce the amount of money lost on tax related foreclosures due to tax liabilities. If it is decided the bank is in a cost controlling environment and additional staff is not warranted it is believed that the bank may use the existing resources to further enhance the current collection efforts of those with tax liability exposure without adding the escrow option. This would be accomplished by following a monitored approach and creating effective collection guidelines to which the Credit/Collection Analyst must follow. In essence phase 1 will speed up the timeline in order to pursue the tax delinquency and expedite the account transfer to the bank’s attorney if necessary. The second phase is that the bank’s collection attorney will also in turn have a set timeline in order to generate letters and initiate legal proceedings if there were no other options for remediation. The management and accountability of adherence of both
phase 1 and 2 will be the only way to lessen the risk and assure positive results versus the current methods.

**Option 2 – Establishing Escrow**

As this project took shape it became apparent quickly that the establishment of an escrow process would be a sizeable expense for the bank but have the ability to alter future product offerings and change the bank’s legacy moving forward. If there is an appetite to add a year one and minimum ongoing expense of $14,700, the author is confident that a successful launch of escrow can be initiated, managed and controlled efficiently. The tax liability risk of foreclosures would be further regulated in time and options to expand the product offering with the potential to earn additional interest income due to loan pricing options will be present. Another accomplishment of adding this function is that one of the requirements in selling loans into the secondary market would be satisfied. This would place the bank in a closer position to truly evaluating the option of marketing consumer related mortgages to Fannie Mae and Freddie Mac.

It is the author’s recommendation “To Escrow”. The establishment of this function is a true legacy decision that will provide the necessary framework for product expansion in the future. This addition will not only strengthen but more importantly expand the bank’s approach to current loan portfolio risk methodologies.
## Appendix A – Labor Cost Analysis

### Escrow Specialist

* It is anticipated that 30% of this new employee will be devoted to the Escrow Function in years 1-3
* Using a 30% average over this time period

<table>
<thead>
<tr>
<th>Escrow Specialist</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Bank Cost</td>
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<tr>
<td>Hourly Wage</td>
<td>14.42</td>
</tr>
<tr>
<td>Annual Salary</td>
<td>30,000.00</td>
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<td><strong>Benefits</strong></td>
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<td>Family Medical Insurance (bank cost)</td>
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<td>Family Dental Insurance (bank cost)</td>
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<td>401k - Retirement Plan</td>
<td>900.00</td>
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<tr>
<td>Long Term Disability Insurance</td>
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<tr>
<td>Short Term Disability Insurance</td>
<td>120.00</td>
</tr>
<tr>
<td><strong>Total Annual Bank Cost:</strong></td>
<td>43,211.50</td>
</tr>
<tr>
<td><strong>30% of Annual Bank Cost for Escrow:</strong></td>
<td>12,963.45</td>
</tr>
<tr>
<td><strong>Hourly wage after benefits:</strong></td>
<td>20.77</td>
</tr>
</tbody>
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## Appendix B – Real Estate Tax Escrow Computation

### Escrow Computation Example

<table>
<thead>
<tr>
<th>Name(s):</th>
<th>Escrow Test Case</th>
<th>Loan #:</th>
<th>Example</th>
<th>Date:</th>
<th>Example</th>
<th>1st Pmt Month:</th>
<th>January</th>
</tr>
</thead>
</table>

* Pertinent Information highlighted in yellow.
* Average Property Tax of $4,433.00 is used in below real estate tax escrow analysis, derived from sampling of sixty (60) current mortgages.
* Town/County and School taxes are being evaluated.
* 1/6th or 2 month cushion being used in analysis below.

### LOAN ESTIMATE DISCLOSURE

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<td>School Property Taxes</td>
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<td>Wind &amp; Hail Insurance</td>
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<tr>
<td>Flood Insurance</td>
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<tr>
<td>Aggregate Adjustment</td>
<td></td>
<td>-$955.33</td>
<td>$1,477.67</td>
</tr>
</tbody>
</table>

| Initial Deposit (deposits minus adjustment) | $1,477.67 |

### AGGREGATE ANALYSIS

**Monthly Payment**

- Hazard Insurance: $0.00
- Mortgage Insurance: $0.00
- Town/Cty Property Taxes: $1,433.00
- School Property Taxes: $3,000.00
- Wind & Hail Insurance: $0.00
- Flood Insurance: $0.00

**Select Cushion**

- (0, 1, or 2)

**Monthly Cushion**

- $0.00

**Month Due**

- January
- February
- March
- April
- May
- June
- July
- August
- September
- October
- November
- December

**Annual Payment**

- Hazard Insurance: $0.00
- Mortgage Insurance: $0.00
- Town/Cty Property Taxes: $1,433.00
- School Property Taxes: $3,000.00
- Wind & Hail Insurance: $0.00
- Flood Insurance: $0.00

**Total:**

- $4,433.00

**Pay In:**

- $369.42
- $0.00
- $0.00
- $0.00
- $1,433.00
- $3,000.00
- $0.00
- $0.00

**Pay Out:**

- $0.00
- $0.00
- $0.00
- $0.00
- $0.00
- $0.00
- $0.00
- $0.00

**Balance:**

- $369.42
- $0.00
- $0.00
- $0.00
- $1,433.00
- $3,000.00
- $0.00
- $0.00

**Initial Deposit:**

- $1,477.67

### STEP #1 INITIAL TRIAL BALANCE

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<th>PAY OUT</th>
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### STEP #2 ADJUSTED TRIAL BALANCE

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### STEP #3 TRIAL BAL WITH CUSHION

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</tr>
<tr>
<td>November</td>
<td>$369.42</td>
<td>$0.00</td>
<td>$369.42</td>
</tr>
<tr>
<td>December</td>
<td>$369.42</td>
<td>$0.00</td>
<td>$369.42</td>
</tr>
</tbody>
</table>

### Average Monthly Escrow Balance with Cushion: $1,938.43

**NYS Mandated Minimum Interest to be paid:** 2.00%

**Annual Interest to be paid by bank to customer:** $38.77

**Fed Funds Rate as of 9/30/16:** 0.29%

**Annual Interest earned by bank per customer:** $5.62

**Net interest expense less interest income:** $33.15

This Escrow Verification program has been designed by Banker’s Compliance Consulting 800-847-1653

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**NET INTEREST INCOME/EXPENSE**

- Net interest income less interest income: $33.15
Appendix C – NYS Escrow Requirements

Escrow Requirements

October 2010

White Paper/Background – Authored by D. Musielak

Initial Escrow Statement
An initial escrow statement must be provided to the customer within 45 calendar days of establishing the escrow account. This initial escrow statement will include (per 6-1360.2 of FRRS):

1. An itemization of the estimate taxes, insurance premiums, and other charges that are reasonably anticipated to be paid from the escrow account during the 12-month period that begins with the borrower’s initial payment date (the escrow account computation year) and anticipated dates of such payments.

Annual Escrow Statement
An annual escrow account statement is required. For each escrow account, we must submit an annual escrow account statement to the borrower within 30 days of the completion of the escrow account computation year. We must conduct an escrow account analysis before submitting an annual escrow account statement to the borrower.

Our bank will be sending three documents to the borrower in addition to the statement:

1. Next year’s projection
2. Last year’s history
3. Copy of last year’s projection

The annual escrow account statement must include, at a minimum, the following:

1. The amount of the borrower’s current monthly mortgage payment and the portion of the monthly payment going into the escrow account.
2. The amount of the past year’s monthly mortgage payment and the portion of the monthly payment that went into the escrow account.
3. The total amount paid into the escrow account during the past computation year.
4. That total amount paid out of the escrow account during the same period for taxes, insurance premiums, and other charges
5. The balance in the escrow account and the end of the period
6. An explanation of the any surplus is being handled by the servicer.
7. An explanation of how any shortage or deficiency is to be paid by the borrower.
8. If applicable, the reason(s) why the estimated low monthly balance was not reached.

Annual statements do not need to be sent in the case of default, foreclosure or bankruptcy.

Short Year Escrow Statement
A short year statement should be sent when:

1. The loan is sold or paid off
2. Upon the transfer of servicing
3. To change the escrow computation to a different 12 month period
4. When adding items to the account that change the payment amount.

Administration of Escrow Accounts
All disbursements should made to third parties in a timely manner, before the deadline to avoid penalty (as long as the
borrower’s payment is not more than 30 days past due). In addition, so long as the borrower’s payment is not more than 30 days overdue, we must advance funds to make disbursements in a timely manner (state law indicates no later than 21 days). Upon advancing funds to pay a disbursement, we may require the borrower to repay the deficiency under certain deficiency options.

**Cushion or Reserve**
Throughout the life of the escrow account, the servicer may charge the borrower a monthly sum equal to 1/12 of the total annual escrow payments which the servicer reasonably anticipates paying from the account. In addition, the servicer may add an amount to maintain a cushion no greater than 1/6 of the estimated total annual payments from the account. If state law or mortgage documents allow for a lesser amount, the lesser amount prevails.

**Interest paid on Escrow Accounts**
Per New York State Law, interest must be paid on funds held in escrow, in connection with a mortgage on any one to six family owner occupied residence or any property owned by a cooperative apartment corporation. The rate of interest paid is not less than **two percent per annum**, credited quarterly. Refer to section 14-b of the NY Banking Law and Part 10 of the Regulations. Also reference GOL 5-601 & 602 for percentage information.

**Discretionary payments**
Any borrower’s discretionary payment (such as credit life or disability insurance) made as part of a monthly mortgage payment is to be noted on the initial and annual statements. If a discretionary payment is established or terminated during the escrow account computation year, this change should be noted on the next annual statement. A discretionary payment is not part of the escrow account unless the payment is required by the lender, in accordance with the definition of “settlement service” in Sec. 3500.2 or the servicer chooses to place the discretionary payment in the escrow account. If a servicer has not established an escrow account for a federally related mortgage loan and only receives payments for discretionary items, this section is not applicable.

**Surplus, Shortage, or Deficiency**
In the annual analysis determines that a surplus, shortage, or deficiency exists in the escrow account, the bank may take the steps when applicable.

**Surplus**
1. All surpluses of $50 or more will be refunded to the borrower within 30 days of the analysis if the borrower is current in regard to escrow payments.
2. All surpluses of less than $50 will either be refunded to the customer or credited to the customer’s escrow payments in the coming year if the borrower is current in regard to escrow payments.
3. If the borrower is not current (payment not received within 30 days of payment due date) in regard to escrow payments, the bank has the option of retaining surpluses according to terms of the loan contract.

**Shortage**
If a shortage of **less than one** month’s escrow account payment is present at the time of the account analysis, our bank may choose to do any one of the following:

1. Allow the shortage and do nothing to change it.
2. Require the borrower to pay the shortage amount within 30 days.
3. Require the borrower to pay the shortage in equal monthly payments over at least a 12 month period.

If a shortage **greater than or equal to one** month’s escrow account payment is present at the time of account analysis, the bank may choose to do any one of the following:
1. Allow the shortage and do nothing to change it.
2. Require the borrower to pay the shortage in equal monthly payments over at least a 12 month period.

**Deficiency**

If the account analysis reveals a deficiency (a negative balance) of less than one month’s escrow payment in the account, the bank may choose to do any one of the following:

1. Allow the shortage and do nothing to change it.
2. Require the borrower to pay the shortage amount within 30 days.
3. Require the borrower to pay the shortage in two or more equal monthly payments.

If the account analysis reveals a deficiency (a negative balance) greater than or equal to one month’s escrow payment in the account, the bank may choose to do any one of the following:

1. Allow the shortage and do nothing to change it.
2. Require the borrower to pay the shortage in two or more equal monthly payments.

**Record Keeping**

Five year retention on statements sent, payment history and disbursements.

**Areas/items impacted of the bank:**

- Escrow must be listed on loan estimate
- Escrow amounts must be disclosed on closing disclosure under lines specified
- Initial escrow statement
- Annual escrow statement/analysis
- Management of payments to insurance companies

**New York Banking Law, Article 1, section 6k Real Property Insurance and Escrow Accounts.**

Duties of institution (6-k(2))

(a) Every institution must make payments in a timely manner.
(b) Every institution shall pay at least the minimum rate of interest on each real property insurance escrow account as prescribed within.
(c) Not applicable
(d) An institution may debit a mortgagor’s real property insurance escrow account for payments of insurance premiums only if actual payment for such premiums is made within twenty one days after such debit.
(e) Every institution provide an annual statement to the mortgagor an analysis of the following:
   a. Interest earned
   b. The amount of the insurance premiums paid
   c. The account balance as of the beginning of the period covered by the analysis and the ending account balance as of the specified date within forty five days preceding the date of the analysis.
(f) The institution must provide a written disclosure, in at least eight point bold face type, to the mortgage with respect to the real property insurance escrow account. Such disclosure shall be provided at the time of the establishment of the real property insurance escrow account.

See the regulation for additional information.
SOURCES

Federal Financial Institutions Examination Council (FFIEC) Website / Uniform Bank Performance Reports


Federal Financial Institutions Examination Council (FFIEC) Website / Average Prime Offer Rates (APOR) / https://www.ffiec.gov/ratespread/aportables.htm (weekly access every Thursday for rate review).

Lereta Tax Services – Catrina Palmer / Process Flow Chart Visual. (Received January 23, 2017)

Escrow Requirement Whitepaper / Don Musielak / (October 2010) / Appendix C.


