DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 3500

[Docket No. FR–4079–F–02]

RIN 2502–AG75

Amendments to Real Estate Settlement Procedures Act Regulation (Regulation X)—Escrow Accounting Procedures

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

ACTION: Final rule.

SUMMARY: In this final rule, the Department of Housing and Urban Development is revising Regulation X, which implements the Real Estate Settlement Procedures Act of 1974 (RESPA). This rule addresses problems that were raised in applying escrow accounting requirements under Regulation X. The first problem, designated as ''Annual vs. Installment Disbursements,'' involves whether disbursements from mortgage escrow accounts must be made on an annual or installment basis when the payee offers a choice. To address this problem, this rule maintains the current requirements under Regulation X, but clarifies them.

The second problem, designated as ''Payment Shock,'' involves the proper accounting method to calculate escrow payments where the servicer anticipates that disbursements for items such as property taxes will increase substantially in the second year of the escrow account and where ''payment shock''—the consumer's experiencing of a substantial rise in escrow payments—will result. The Department has chosen to address this matter by recommending (but not mandating) a best practice for servicers: a voluntary agreement to accept overpayments. A consumer disclosure format has been provided to disclose this information. This rule contains a new provision covering procedures for voluntary overpayments.

The Department has determined not to adopt two other changes that were proposed. The Department will continue to require the single-item listing of escrow deposits on the HUD–1 or HUD–1A. Also, the Department is not revising the requirements for listing a lead-based paint inspection or risk assessment on the Good Faith Estimate (GFE) format and HUD–1 and HUD–1A, but is clarifying the instructions for these formats.

EFFECTIVE DATE: February 20, 1998.

FOR FURTHER INFORMATION CONTACT: David R. Williamson, Director, Office of Consumer and Regulatory Affairs, Room 9146, or Rebecca J. Holtz, Director, RESPA/ILS Division, telephone (202) 708–4560; or, for legal questions, Kenneth A. Markison, Assistant General Counsel for GSE/RESPA, Room 9262, telephone (202) 708–1550, or Grant Mitchell, Senior Attorney for RESPA, telephone (202) 708–1552 (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 (800) 877–8339 (toll-free). The address for these persons is: Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410–0500.

SUPPLEMENTARY INFORMATION:

I. Background

The Department's 1994–1995 escrow accounting rules [1] included significant new requirements for servicers maintaining an estimated 35 million mortgage escrow accounts for American homeowners. These rules, promulgated under the Real Estate Settlement Procedures Act (RESPA) (12 U.S.C. 2601–2617), as amendments to Regulation X (24 CFR part 3500), limited the amounts that servicers may hold in escrow accounts by establishing new uniform accounting and disbursement requirements and by requiring meaningful disclosure to each homeowner at the account's inception and annually thereafter.

The 1994–1995 escrow rules represented a notable achievement. As a result of the escrow rules, the amounts in homeowners' escrow accounts have been reduced substantially. At the time the rules were promulgated, the Department estimated that homeowners would save as much as $1.5 billion by virtue of the new rules. This savings is now being used by homeowners for down payments, to keep and maintain homes, or to fill other needs.

Because the 1994–1995 escrow rules implemented new accounting requirements, they required major changes by mortgage servicers. As the rule's requirements were applied to individual accounts, members of Congress, local government officials, industry representatives, and homeowners brought to the Department's attention certain problems concerning the 1994–1995 rules. In this final rule, the Department is clarifying the rules and identifying ''best practices'' [2] of mortgage servicers in an effort to resolve two of these problems.

As detailed below, the first problem, designated as ''Annual vs. Installment Disbursements,'' is whether disbursements from mortgage escrow accounts should be made on an annual or installment basis if the payee offers a choice. In some cases, a switch from installment to annual disbursements, required under certain circumstances under the rule, resulted in servicers requiring greater payments to escrow accounts for some borrowers and adverse tax consequences for some borrowers. The second problem, designated as ''Payment Shock,'' was asserted to occur when borrowers were required to make significantly increased payments into their escrow accounts when disbursements for items such as property taxes would increase substantially in the second year of the escrow account and the rule did not allow servicers to require escrowing for the next year's payments. The Department also became aware of two additional concerns involving the disclosure of amounts required for escrow using single-item accounting and involving the possible need for a new disclosure of lead-based paint inspection fees.

All of these matters led the Department to issue a proposed rule on September 3, 1996 (61 FR 46511) to seek public comment on these issues. In the

[1] The Department issued several escrow rules during 1994–1995. On October 26, 1994 (59 FR 53890), the Department published a final rule implementing sections 6(g) and 10 of RESPA and changes to RESPA made in section 942 of the Cranston-Gonzalez National Affordable Housing Act (Pub. L. 101–625, approved November 28, 1990). Because of the magnitude of the change brought about by this rule, soon after its publication it became evident that further clarification of the rule was needed. The Department issued a February 15, 1995 rule (60 FR 8812) that modified and clarified the October 1994 rule and delayed its effective date until May 24, 1995. The Department issued further rules to clarify and correct the October 1994 rule 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). These rules are referred to in this preamble collectively as the 1994–1995 escrow rules.

The Department's RESPA regulations were streamlined on March 26, 1996 (61 FR 13232) to comply with the President's regulatory reform initiatives. On September 3, 1996 (61 FR 46510), the Department published a correction to 24 CFR 3500.17. The Department published further revisions to Regulation X on September 24, 1996 (61 FR 50208) and November 15, 1996 (61 FR 58472).

[2] Generally, the Department has characterized ''best practices'' in other programs as those practices that are in accordance with a law's purposes, that are widely replicable, that show creativity in addressing a problem or problems, and that have a significant positive impact on those whom they are intended to serve. The Department identifies best practices operating successfully in the marketplace that support the regulatory principles involved in order to encourage their use. For example, the Department has identified best practices in furtherance of its responsibilities under the Fair Housing Act (42 U.S.C. 3601 *et seq.*).

proposed rule, the Department offered a variety of approaches to address these matters in the most economical and efficient way. The Department recognized that the rules were new and industry and consumer adjustments were underway. Consequently, the choices included keeping the requirements the same, but clarifying them, or doing nothing.

In the Department's proposal, the Secretary pointed out that any amendments to the rule must further the following three principles:

(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 of the Real Estate Settlement Procedures Act of 1974 (RESPA), which governs escrow accounting procedures.

Following receipt of comments under the proposed rule, as detailed below, the Department determined that many of the initial problems in implementing the escrow rules were being resolved as the industry and the public adjusted to the new requirements. Specifically with respect to the choice of annual vs. installment disbursements, consumers' accounts that had been changed as a result of the implementation of the rule had stabilized and had not been changed again. However, there remains a need for the Department to clarify and elucidate current requirements in this final rule.

With regard to the ''payment shock'' problem, the Department determined, based on the comments, that extensive additional regulatory changes are not required and could prove detrimental to consumers. Instead, the Department determined that this problem would be better resolved by identifying and sharing best practices of servicers. In this context, servicers should, as a best practice, provide a simple notice to consumers to allow them voluntarily to increase their payments to their accounts. A new provision in 24 CFR 3500.17(f)(2)(iii) sets forth procedures if voluntary overpayment agreements are obtained.

The Department also determined not to adopt other changes to the Good Faith Estimate (GFE), HUD–1, and HUD–1A that were proposed to address the other matters raised in the proposed rule. Based on the comments received, the Department determined that new requirements on these subjects were not necessary. Current disclosure requirements are generally useful and sufficient; more significant changes at this time could serve to confuse matters while the market is still adjusting to the relatively new rules. Moreover, the Department has recently issued a new settlement booklet for consumers entitled ''Buying Your Home, Settlement Costs and Helpful Information,'' published on June 11, 1997 (62 FR 31982), which includes guidance on lead inspections during the homebuying process. To complement these new materials, the Department is making one minor clarification to the instructions for the HUD–1 regarding lead-based paint disclosures.

In sum, the regulatory record, described in detail below, makes very clear that this subject involves complex matters that in many cases are better resolved by allowing time for accounting systems and consumers alike to adjust. In this final rule, the Department continues to protect homeowners by maintaining escrow accounting requirements and limits without change. At the same time, in the interest of reducing homeownership costs, establishing uniform practices, and providing clear specific guidance, the rule makes modest clarifications to ensure that servicers do not unnecessarily incur additional costs that would ultimately be passed on to American homeowners.

In applying the significant protections under RESPA—including the limits on the amounts in mortgage escrow accounts—the Department is mindful that it must carry out RESPA's important requirements in a manner that is true to RESPA's consumer protection purposes. These purposes include ensuring that consumers are protected from unnecessarily high costs that may come from abusive practices by servicers.

This preamble continues with a background discussion of the legal requirements under section 10 of RESPA and the Department's prior rulemakings. Following the background discussion, the preamble discusses the issues addressed in the proposed rule and details the many comments received on the proposed rule. These comments informed the Department and shaped today's rule. Finally, the preamble discusses this final rule.

II. Legal Context

Section 10 of RESPA (12 U.S.C. 2609) establishes the statutory limits on the amounts that mortgage servicers or lenders may require a borrower to deposit into an escrow account if the mortgage documents require one or the servicer chooses to establish one.[3] RESPA does not require the use of escrow accounts. Section 10(a)(1) of RESPA does prohibit a servicer, at the time the escrow account is created, from requiring the borrower to make a payment to the escrow account in excess of the maximum amounts calculated in accordance with the statute. These maximum amounts are calculated by analyzing how much money will be needed to cover expected disbursements, such as taxes and insurance, ''beginning on the last date on which each such charge would have been paid under the normal lending practice of the lender and local custom, provided that the selection of each such date constitutes prudent lending practice, and ending on the due date of the first full installment payment under the mortgage'' relating to the mortgaged property, plus a cushion no greater than one-sixth of the estimated total annual disbursements from the account (one-sixth cushion). 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 one-twelfth of the total annual escrow disbursements that the lender reasonably anticipates paying from the escrow account during the year, plus the amount necessary to maintain a one-sixth cushion. Section 10 does not require that the servicer collect the maximums allowed 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) 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.''

[3] As stated in footnote 1 to the preamble to the Department's September 3, 1996 proposed rule on escrow accounting (61 FR 46511, 46511 n.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. As in the proposed rule, within this final rule the Department uses the term ''servicer'' to include the lender when the lender performs the servicing function.

III. Explanation of Problems Addressed in September 3, 1996 Proposed Rule and Proposed Solutions

On September 3, 1996 (61 FR 46511), the Department published a proposed rule, primarily to address three problems in implementing the 1994–1995 escrow rules. These problems, explained below, were designated as:

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

In addition, the Department proposed revising the GFE format and HUD–1 and HUD–1A to refer specifically to a lead-based paint inspection or risk assessment.

A. Annual vs. Installment Disbursements Problem

1. Explanation of the Annual vs. Installment Disbursements Problem

The first problem that the proposed rule addressed involved the servicers' disbursements from mortgage escrow accounts if the payee (i.e., the entity to which escrow disbursements are paid, such as a taxing jurisdiction) offers a choice of disbursements on an annual or installment basis. Sometimes payees offer a discount to the borrower if disbursements are made on an annual basis. These discounts are commonly offered by taxing jurisdictions, which may offer a discount for annual payments of property taxes.

The Department's regulation at 24 CFR 3500.17(k)(1) has provided, ''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). The preamble to the October 1994 final 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. The preamble explained that this approach is consistent with the Department's intention that the regulations generally favor installment disbursements, because in many cases they result in lower up-front payments (closing costs). The Department also sought for servicers to take advantage of discounts that would benefit borrowers.

In response to further questions on this issue, however, the Department indicated in its February 1995 final rule clarifying the escrow rules that the October 1994 rule's focus had been to address ''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 further clarification to the rules, the Department stated that ''servicers were permitted (but not required) to make disbursements on an annual basis if a discount were available.'' The preamble to the May 1995 rule 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.

In the preamble to the September 3, 1996 proposed rule, the Department indicated that the rule text and the preamble language may have created confusion. As explained in the preamble to the proposed rule, some mortgage servicers have interpreted the 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, must 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 the Department's rule, in light of preamble language, to require installments when available and allow, but not require, annual disbursement at the servicer's discretion when a discount is offered for annual disbursement.

As indicated in the preamble to the proposed rule, some borrowers were affected by the changes brought about by the 1994–1995 escrow rules. Concerns raised to the Department regarding the annual vs. installment disbursements problem came from borrowers and members of Congress who were concerned about the effect of the 1994–1995 escrow rules on their constituents.

As explained in the preamble to the proposed rule, 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. In general, disbursements 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). Footnote 2 of the proposed rule (61 FR 46512) explained:

> 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.

The disbursement method may also have income tax ramifications for the consumer, depending on the timing of disbursements for deductible items.

The preamble to the proposed rule explained that after publication of the 1994–1995 escrow rules, many servicers that had been disbursing in installments switched to annual disbursements if discounts were available. There were many consequences of the switch that have been described to the Department, mostly affecting borrowers, and other consequences that the Department speculates may have resulted. After the Department 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.

The preamble to the proposed rule also noted other adverse consequences that might have arisen from the 1994–1995 escrow rules. For example, some borrowers whose servicers switched from annual to installment disbursements may have lost a significant portion of their income tax deductions for property taxes in the year in which the switch was made and may have been unhappy with that consequence. Some taxing jurisdictions may have faced an unexpected temporary shortfall in receipts of property taxes as a result of servicers changing from annual to installment disbursements.

The preamble to the proposed rule also noted that although some borrowers may have been adversely affected by a change in disbursement method, many others likely 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 or credits for many homeowners. Finally, for many borrowers, the Department's rules apparently have not resulted in any change to the disbursement method for their escrow accounts.

2. Alternatives Proposed to Address Annual vs. Installment Disbursements Problem

In response to the Annual vs. Installment Disbursements problem, the Department proposed alternative ways of revising the escrow rules, including requiring that disclosures be given to borrowers so that they could make informed choices as to how their accounts were to be set up and maintained and require servicers to follow those preferences. At the same time, the Department recognized that providing borrowers choices may impose additional burdens and costs on servicers, which are frequently passed on to borrowers. Thus, the proposed rule also highlighted approaches that had been proposed by industry representatives. The Department sought comments on all approaches and also asked a number of questions that were designed to help the Department make decisions among alternatives for the final rule.

a. Consumer Choice. The first alternative contained in the proposed rule, Consumer Choice, distinguished between new loans and existing loans. Under this alternative, for new loans (loans that settled 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. The Department's proposal did not address the choice between installments and annual disbursements for other escrow items, because the question has only been raised to the Department in the context of property taxes. The preamble indicated that the Department would consider addressing other escrow items, depending on comments received.[4]

This alternative would have required servicers, at some time before settlement, to provide a disclosure, in the format of Appendix F in the proposed rule, 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 proposed format indicated some of the advantages and disadvantages to the borrower of installment and annual disbursements and asked the borrower to make a choice between the methods. The preamble explained that if the borrower did not make a choice, the servicer would be required to make installment disbursements of property taxes. As discussed below, this alternative also would have provided that once the consumer had made a choice (or installments were required because the consumer did not make a choice), the servicer and subsequent servicers would be prohibited from changing the method of disbursement for property taxes without the borrower's prior written consent, as long as the taxing jurisdiction continued to offer a choice.

For existing loans (loans that were settled prior to the effective date of a final rule), this alternative would have prohibited the servicer and subsequent servicers 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.

b. Servicer Flexibility. Under the second alternative presented in the proposed rule, the Department would have revised 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. As discussed below, under this alternative, once the servicer had made a choice of the disbursement method, the servicer and subsequent servicers would have been prohibited from changing the method of disbursement without the borrower's prior written consent, as long as the payee continued to offer a choice.

c. Keep, But Clarify, Current Requirements. The third alternative offered in the proposed rule was that the Department would revise the rule to keep, but clarify the current requirements. Under this alternative, the regulations would have been revised to provide that servicers must make disbursements from escrow accounts on an installment basis, if payees offer that option as an alternative to annual disbursements. If a payee offers the option of installment disbursements or a discount for annual disbursements, however, the servicer 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; the Department encourages (but does not require) servicers to follow the preference of the borrower. If the payee offers the option of installment disbursements or annual disbursements with no discount, the servicer must make installment disbursements.

d. Prohibition Against Switching Disbursement Methods Without Borrower's Consent. Each of the alternatives proposed—Consumer Choice; Servicer Flexibility; and Keep, But Clarify, Current Requirements—provided 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 if 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

[4] The preamble to the proposed rule noted that if the servicer is given a choice between installment or annual disbursements for other escrow items (such as property or hazard insurance), the Department'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.

option is offered by the payee, unless the borrower consents to changing disbursement methods.

The preamble to the proposed rule explained that the reason for this approach was that many loans shifted disbursement dates as a result of the 1994–1995 escrow rules. The Department was seeking to develop an approach with the minimum negative impact for borrowers, servicers, and third parties, such as taxing jurisdictions.

The preamble to the proposed rule explained the adverse consequences, discussed above, that can occur when borrowers' disbursement methods are switched. The preamble to the proposed rule explained that 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, would not mean that the borrower would have to consent to a transfer of servicing or would have veto authority over such a transfer. However, this approach would mean that a borrower would have to consent to a change in the disbursement method, including a change proposed by a subsequent servicer. The Department sought comments on whether this policy would adversely affect the value, and the efficiency of the transfer, of servicing rights.

B. Payment Shock Problem

1. Explanation of Payment Shock Problem

The second problem that the proposed rule addressed involved cases in which the originator or servicer [5] anticipates that disbursements for escrow items such as property taxes will increase substantially 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 when 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.

The preamble to the proposed rule explained that, consistent with section 10 of RESPA, the Department's regulations have specified the maximum amount that a servicer may legally require borrowers to deposit in escrow accounts at the creation of the escrow account and during the life of the escrow account. The Department's regulations prescribe that in conducting an escrow account analysis, the servicer considers only the disbursements that are expected to come due during the next 12-month period. See §§ 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,[6] even if the servicer knows that disbursements 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 beyond that 12-month period.

However, the Department's existing regulations (§ 3500.17(f)(1)(ii)) allow the servicer to conduct escrow account analyses at other times during the escrow computation year, which can result in changes to what the borrower must deposit in the escrow account. Some servicers conduct escrow account analyses when bills for escrow items increase.

Since the Department'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 is likely to be a substantial increase in a borrower's monthly payments for the second year and/or a lump sum payment, not only to reflect the higher disbursements, but to make up a shortage in the escrow account.[7] While the originator or servicer could alert the borrower at closing that an increase will occur, if that is not done, the borrower may be unpleasantly surprised by the increase. The preamble to the proposed rule explained that this situation could result in several problems. While disclosures received at closing show low payment amounts throughout the first year, 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.[8] Some borrowers may be unable to meet the increased escrow payments and paying off 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.

As indicated in the preamble to the proposed rule, the concerns raised to the Department regarding payment shock came largely from industry representatives who told the Department that they have had to respond to numerous borrower inquiries

[5] Three originators/servicers criticized the Department's proposed rule because it identified the ''servicer'' as the person who would be in a position to determine whether the bills paid out of the escrow account will increase substantially after the first year. These commenters indicated that it is the originator (loan officer, processor, settlement agent) who communicates with borrowers prior to closing, not the servicer, and that it should be the originators who would be in the position of determining at closing whether payments will substantially increase, not the servicer. The Department intended to use the terms interchangeably and explained in footnote 1 of the proposed rule (61 FR 46511) that the term ''servicer'' included the lender when the lender performs the servicing functions. The Department intended that the term ''servicer'' also would include the originator in this context.

[6] The preamble to the proposed rule (61 FR 46511, 46516 n.7) explained that the Department'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).

[7] The preamble to the proposed rule explained that an 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.

[8] The Department's 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.

and complaints about increases in escrow payments to reflect higher disbursements and payments to make up shortages. Mortgage servicers had indicated that they wanted to avoid any payment change in subsequent years by collecting more money in the first year of servicing.

2. Alternatives Proposed to Address Payment Shock Problem

The proposed rule offered three rulemaking alternatives, some of which contained variations within the alternative, to address the payment shock problem. The purpose of the alternatives was to develop a consumer-friendly way to avoid the payment shock surprise for the borrower, who may not be prepared to make the higher payments to his or her escrow account that would result from a substantial increase in the amounts needed for disbursements from the account. At the same time, the proposals sought to minimize the burden on the industry.

a. Consumer Choice. The first alternative contained in the proposed rule, Consumer Choice, would have provided that when the servicer expected that the bills disbursed from the escrow account would increase substantially after the first year, the servicer would provide to the borrower, at some time prior to closing, a written disclosure. The proposed format for the disclosure was set forth in Appendix G to the proposed rule. The borrower would make a choice from several accounting options for his or her account on a format that would indicate, under each option: (1) the amount due at closing; (2) the monthly escrow payments in the first, second, and third years; and (3) the corresponding surpluses anticipated at the end of the first year.[9]

The proposed rule explained that 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). This alternative, as proposed, contained the additional restriction that once an escrow accounting method was selected by choice or default, that method could not be changed without the consent of the borrower, even if the servicing rights were transferred to another servicer.

The preamble to the proposed rule explained that, under this alternative, the following accounting methods (illustrated in ''The Payment Shock Problem,'' Appendix H–1 to the 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:

—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; and
—Causes surpluses or smaller shortages at the end of the first year, which causes escrow payments to increase in the second year by an amount less than under Method A or not at all.

Method C. Analysis of the account using an alternative accounting method that:

—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);
—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; and
—Causes no increase in escrow payments in the second year.

The preamble to the proposed rule noted that if the consumer were to select Methods B or C, the amounts held in escrow could be greater than allowed under section 10 of RESPA. In order to permit these options, the Secretary would invoke his exemption authority under section 19(a) of RESPA (12 U.S.C. 2617).

b. Make No Change. The second alternative in the proposed rule was to continue the current requirements for escrow analysis, even when the servicer expected that the bills disbursed from the escrow account would increase substantially after the first year. This alternative would not prevent payment shock in all instances. However, under this alternative, servicers could continue to disclose voluntarily the problem to borrowers and borrowers could make voluntary overpayments to escrow accounts. Servicers could also calculate short-year statements. Thus, even if no change were made to the regulations, some methods would continue to be available, although not required, to alleviate the payment shock problem.

c. Mandate First Year Overpayment. Under the third alternative in the proposed rule, Mandate First Year Overpayment, the Department would have provided that when the servicer expected that the bills disbursed from the escrow account would increase substantially after the first year, the servicer would be required to establish the escrow account under a procedure that had the characteristics described under Consumer Choice, Method C, above (illustrated in ''The Payment Shock Problem,'' Appendix H–2 to the proposed rule). The preamble to the proposed rule explained that this approach would result in requiring amounts held in escrow to be greater than allowed under section 10 of RESPA. 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).

C. Single-Item Analysis With Aggregate Adjustment Problem

1. Explanation of Single-Item Analysis With Aggregate Adjustment Problem

A third problem that the proposed rule addressed was the means of disclosure on the HUD–1 and HUD–1A settlement forms of amounts required for deposit at settlement in the escrow account. The 1994–1995 escrow rules established aggregate accounting (i.e., analyzing the escrow account as a whole) as the uniform nationwide standard escrow accounting method to be used to compute borrowers' escrow accounts. In establishing this standard, the rules supplanted single-item accounting, the accounting method that had been used at settlement up until that time to compute required escrow account balances. Historically, under single-item accounting, the reserve amount for each escrow account item on the HUD–1 or HUD–1A in the 1000 series was computed for the borrower and listed separately. Either zero, one, or two months worth of payments for

[9] The preamble to the proposed rule noted that whether disbursements from escrow accounts would be made on an annual or installment basis and whether there were a discount for annual disbursement would affect the numbers to be filled in and, potentially, the number of calculations on the Escrow Accounting Method Selection Format.

each escrow item was set forth on the HUD–1 or HUD–1A in the 1000 series as necessary to establish the escrow account.

When the Department was developing the 1994–1995 escrow rules, Federal Reserve Board staff indicated that even if aggregate accounting were used it also 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 (TILA). For this reason, and in an effort to avoid altering the basic format of the HUD–1 or HUD–1A in the 1994–1995 escrow rules, the Department required that an aggregate adjustment (either zero or a negative number) be made after all of the individual items were listed separately in the 1000 series, so that the total amount for escrow account items conformed to the aggregate accounting method. Before the 1994–1995 escrow rules, 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 1994–1995 escrow rules, 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 total deposited.

2. Revision Proposed to Address Single-Item Analysis With Aggregate Adjustment Problem

In response to the Single-Item Analysis with Aggregate Adjustment problem the Department proposed to make more flexible the requirements for the provision of information to consumers. In the proposed rule, the Department proposed that to relieve confusion it would no longer require the single-item listing of escrow deposits or reserves 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 amounts to be deposited. As proposed, the settlement agent could also have continued to itemize the 1000-series reserves, at the settlement agent's discretion. If the charges were not itemized, an asterisk (*) would have had to be placed next to each item in the 1000 series for which a reserve was taken. The amount collected would have been 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 VI of the preamble to the proposed rule, the Department had clarified that entries on the GFE may be based on single-item analysis, with a maximum 1-month cushion. The proposed rule also clarified that the use of the estimating method remained available after the end of the phase-in period (October 24, 1997).

D. Lead-Based Paint Disclosure Issue

1. Explanation of Lead-Based Paint Disclosure Issue

The proposed rule also addressed a concern that consumers should get information about their 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. The preamble to the proposed rule explained that a prospective purchaser generally 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. The proposed rule addressed ways that consumers could receive this information in addition to existing disclosure requirements.

2. Revision Proposed to Address Lead-Based Paint Disclosure Issue

In response to the Lead-based Paint Disclosure issue, the Department proposed to require additional information to be provided to the consumer on the GFE and the HUD–1 or HUD–1A. The Department proposed to add information to the GFE format to help make purchasers of pre-1978 residential dwellings aware that, pursuant to 42 U.S.C. 4852d (implemented by the Department in regulations published on March 6, 1996, 61 FR 9064), purchasers have the right to arrange for a paint inspection or risk assessment for the presence of lead-based paint or lead-based paint hazards before becoming obligated under a sales contract. The Department proposed to add language to the GFE format (Appendix C to part 3500) specifically to refer to a lead-based paint inspection or risk assessment and designate a separate line in the 1300 series of the HUD–1 and HUD–1A for lead-based paint inspections or assessments and to revise the instructions for completing the HUD–1 and HUD–1A accordingly. The preamble to the proposed rule indicated that the Department anticipated that a more detailed explanation of purchasers' rights in this regard would be contained in the next revision of the HUD Settlement Costs booklet. See section 5 of RESPA (12 U.S.C. 2604); 24 CFR 3500.6.

IV. Overview of Public Comments

A. Description of the Commenters

The Department received a total of 141 comments on the proposed rule. Of the 141 comments, some were duplicates. Thus, the Department places the number of different comments received at 134.[10] The Department analyzed all the comments in detail and gave them careful consideration.

One-hundred two of the comments came from originators/servicers.[11] Fourteen comments came from trade associations. Four came from individual consumers, three from tax service providers, two from members of Congress, four from financial software companies, one from a state lending agency, one from a mortgage insurer, one from a builder, and two from persons whose professional interest in the rule could not be determined.

B. What Commenters Commented On

The Annual vs. Installment Disbursements problem attracted the most comments. One-hundred twenty-eight commenters, including all but one of the trade associations and all but two of the originators/servicers, commented on this issue. The Payment Shock Problem received the second highest number of comments, with one-hundred

[10] Seven comments were identical letters submitted by various officials of the same mortgage corporation; they were counted as one comment. Two other comments were substantially similar letters submitted by different offices of the same bank and mortgage lending subsidiary; they also were counted as one comment, but minor variations between the two were considered.

Twenty-one comments were duplicate comments submitted by various originators and servicers, including the United States Department of Agriculture. One bank and trust submitted nearly identical comments as the Mortgage Bankers of America (MBA), while the Oregon Bankers Association submitted nearly identical comments as the American Bankers Association (ABA). The Mortgage Bankers Association of Minnesota adopted with one small addition the comments of Norwest. Since these comments were submitted by separate entities, they are all counted as separate comments.

One commenter simply summarized the proposed rule without taking a position on any of the proposals.

[11] In some cases, the precise nature of the business was not clear from the comment. Moreover, it did not appear that the comments differed markedly depending on the precise nature of the business. For example, it did not appear that the comments from retail lenders differed markedly from those from mortgage brokers, or that the comments from one type of retail lender differed from those or other types of retail lenders. Thus, all businesses that originate, service, and/or broker loans are designated as ''originators/servicers'' in this preamble.

sixteen commenters, including ninety-six originators/servicers and all but two of the trade associations. The Single-Item Analysis With Aggregate Adjustment problem also attracted a significant number of comments, seventy-eight in all, including sixty-five originators/servicers and ten trade associations. Only seventeen commenters, twelve originators/servicers and five trade associations, commented on the additional proposed change concerning lead-based paint.

C. Overview of Positions

The overwhelming majority of originators, servicers and mortgage brokers opposed those options for the first two issues that were designed to provide borrowers more choices, citing the costs and burdens of such an approach. Three commenters, including Norwest, criticized those options as being inconsistent with the principles the Department had articulated, asserting that the Consumer Choice options would increase the cost of homeownership. In contrast, the few consumers and members of Congress who commented on the first issue supported Consumer Choice approaches; these commenters did not comment on the Payment Shock problem.

On the Single-Item Analysis With Aggregate Adjustment problem, more commenters supported the proposed change than opposed it. Opinion was nearly evenly divided on the additional proposed change concerning lead-based paint.

Nine commenters, including the American Bankers Association (ABA), commented that no changes should be made at this time and instead, the Department should wait several years before considering further changes to Regulation X, at least until the changes made under the 1994–1995 escrow rules are fully implemented. (Those provisions took effect May 24, 1995 but provided for a three-year phase in for existing escrow accounts which expires October 27, 1997.)

The reasons given by the ABA, which were echoed by the Oregon Bankers Association, for not making any changes to the rule were that the rule would alter the escrow accounting systems at the very time the Department's new rules are bring fully implemented, causing major problems and an excessive burden for banks and other mortgage servicers. The New York Credit Union League agreed, emphasizing the costly changes that are already being made as a result of that earlier rule.

A bank holding company, in terms echoed by other originators and servicers, commented that there was no need to change the rules now as those borrowers with existing accounts have already benefited from or suffered the consequences of the 1994–1995 escrow rules and have subsequently adjusted to the changes and many of the problems created by that rule are over. Thus, it would be premature to make further changes, and doing so may only again create the same sort of initial problems that were created by the 1994–1995 escrow rules. GE Capital recommended waiting at least two years before revisiting the need for any changes. Another servicer and originator recommended waiting 24 to 36 months before making further changes. A bank compliance officer and a bank holding company also recommended against changes being made at this time.

Several other commenters recommended that the Department hold off action on specific portions of the rule. Those comments are analyzed separately under the portion of the preamble discussing that aspect of the rule.

In contrast, many commenters emphasized the importance of making changes to address their particular issues of concern, particularly the Payment Shock problem. These comments are summarized under the particular issues discussed later in this summary.

V. Annual vs. Installment Disbursements Problem—Comments Received, Approach Adopted in Today's Final Rule, Basis for Approach Adopted, Basis for Rejecting Alternative Approaches, Clarifications

A. Comments Received

Through the comments received on the proposed rule, the Department gained a better understanding of the Annual vs. Installment Disbursements problem. The Department learned more about how servicers have been addressing the problem of setting the appropriate disbursement date when given a choice of annual or installment disbursements. The comments received indicated that practices have not been uniform and that in some cases, originators/servicers have been using creative approaches to meeting consumer's needs. Five originators/servicers and two tax services indicated that they were disbursing in installments unless a discount was offered for annual disbursements that the servicer thought was a large enough discount to be in the borrower's interest, in which case the disbursements were made annually; one trade association indicated this was the approach of most of its members as well. One savings and loan indicated that its practice was to accommodate individual borrowers by switching people who complain to whichever method they prefer.

Other originators/servicers are using practices that do not provide as much flexibility for the consumer. In many cases, the originators/servicers indicated that they believed such practices were compelled by the existing RESPA regulations. For example, thirteen originators/servicers indicated that when such a choice is offered, they currently disburse in installments unless a discount is offered for annual disbursements, in which case they always disburse annually regardless of how insignificant the discount may be. Two originators/servicers and one tax service indicated that if no discount is offered for annual disbursements but a service fee is charged for installment disbursements, they disburse annually, no matter how insignificant the service fee may be.

A few commenters noted that in many jurisdictions, the installment option is only available for individuals, not servicers. Other commenters noted special rules that apply in particular States, such as Wisconsin, where the practice is to pay taxes in the year levied, even though they do not have to be paid until the following year, and Maryland, where a law provides that first time homebuyers may choose between annual and installment disbursements with a consumer disclosure highlighting differences between the two methods.

The Department also learned more about the discounts obtained by servicers for borrowers, e.g., how large the discounts are and when disbursements must be made in order to receive the discounts. Commenters estimated the size of the discounts to range from around 1–5 percent of the property tax bill, with only two commenters indicating that discounts ranged up to 10 percent, and only one commenter indicating they tended to be less than one percent. Several commenters—three consumers, two members of Congress, two originators/servicers, one trade association—expressed the view that discounts are small and not in the borrower's interest to disburse in order to collect them. Two originators/servicers expressed the opposite view that discounts tended to be large and in the borrower's interest to obtain. The Department notes that, under reasonable assumptions,[12] a

[12] The assumptions are that if, for example, the entire tax bill is paid on January 1, the discount

Continued

discount of 1 percent of the annual tax bill converts to approximately a 4 percent annualized return; a 5 percent discount converts to approximately a 23 percent annualized return.

Several commenters commented on the extent of the problem. Two consumers from New York asserted that borrowers whose servicers switched from installments to annual disbursements were adversely impacted. One, a senior citizen, explained that she and her husband were required by their servicer either to make a lump sum payment of almost $1,500 with a monthly increase of over $150 or no lump sum payment but a monthly increase of over $200, to obtain a discount of only 1 percent. Another reported that his mortgage payment was increased over $100 for a mere $8 discount for annual tax payments.

Other commenters, however, challenged the Department's perspective that the issue of Annual vs. Installment Disbursements was a problem in need of fixing. Some questioned the Department's evidence that there was a problem. One bank expressed doubt about how many borrowers were actually affected, and to what extent, by the 1994–1995 escrow rules, indicating that the impact of the rule change had already been absorbed. Four originators/servicers, including Citicorp and First American Real Estate Tax Service, Inc., a large tax service, specifically asserted that there was no current problem. Citicorp asserted that there were few problems with the existing rule for borrowers or industry and that it was premature to change the 1994–1995 escrow rules until there was more experience operating under it. Citicorp recommended waiting until 1998 to make further changes. Ten commenters in the origination and servicing industry, including NationsBank and GE Capital, as well as the Mortgage Bankers Association (MBA), also asserted that the impact of the 1994–1995 escrow rules had already been absorbed, and any impacts on consumers with existing loans had already taken place.

Most of the commenters commented on one or more of the specific alternative proposals for addressing the problem.[13] The overwhelming majority of originators, servicers, and mortgage brokers opposed Consumer Choice; there was some division of opinion on what alternative approach to take. A modified version of the ''Keep But Clarify Current Requirements'' alternative garnered the most consistent support; the modification was that the restriction on servicers switching disbursement methods when servicing is transferred be eliminated. Opinion was fairly evenly divided on the merits of the ''Servicer Flexibility'' alternative.

1. Comments on Consumer Choice Alternative

Only seven commenters supported Consumer Choice. The California Association of Realtors (CAR) specifically supported applying the Consumer Choice option to new loans as well as existing loans. CAR commented that the benefits would outweigh the marginal costs and that it favored approaches that provide consumers with as much information as possible and the opportunity, when fully informed, to make choices about the servicing of their loans and the related impound/escrow accounting. The CAR added that if the consumer failed to make a choice, disbursements should be made on an installment basis.

Two comments from elected officials, one from Representative Peter King of New York and one joint letter from Senator Alphonse D'Amato, Representative King, and Representative Dan Frisa also endorsed the Consumer Choice approach, focusing on its application to existing loans. Both letters expressed deep concern for homeowners who were negatively impacted when servicers switched disbursement methods and urged the Department to allow homeowners to have the choice to return to their prior disbursement method. Representative King's letter stated that consumers, not financial institutions, will be able to determine which method of tax payment is best for them and that allowing such a choice would further the goals of RESPA. Senator D'Amato's letter stated that ideally homeowners should be given the option to return to their previous disbursement methods with the excess of any escrow accounts returned and, at a minimum, their servicers must inquire as to the homeowners' preference.

Four homeowners in New York advocated allowing homeowners to have the right to decide whether they wish to forego a discount for annual disbursements and instead have their taxes disbursed in installments. All focused on the benefits of applying Consumer Choice to existing loans, complaining that they were left with a shortage in their account and suffered severe financial hardship trying to make up the shortage when their servicers switched disbursement methods.

In addition, one federal credit union's comments gave tepid support to the Consumer Choice option if it were limited to new loans. The credit union indicated that offering the choice to new loans would only entail the burden of preparing and explaining the form. It indicated, however, that for existing loans Consumer Choice would be costly in terms of staff, time, and the mailing of the selection format, and would be confusing to borrowers. The credit union also indicated that since borrowers could refinance anyway, there was no apparent need to offer existing borrowers a choice.

In contrast, 107 commenters opposed the adoption of Consumer Choice (91 originators/servicers, 11 trade associations, 3 tax services, 2 financial software companies, and 1 person whose professional interest was not known). Only one commenter, a credit union, appeared to limit its opposition to the Consumer Choice alternative to its application to existing loans. All of the other commenters appeared to oppose the application of Consumer Choice regardless of whether it extended to both new and existing loans, or only to new loans.

Most commenters did not separate out their objections to Consumer Choice as it would apply to new loans as opposed to existing loans. Whether the commenters separated out their objections or not did not affect the objections raised. Accordingly, all objections are discussed together below,

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applies to the entire bill. Otherwise, half of the bill is due on January 1 and half is due on July 1.

[13] In contrast, one commenter, a Wisconsin bank holding company, seemed to question the Department's legal authority to propose any solution to the problem. The commenter asserted that the Department can prohibit over-escrowing and pre-accrual or other servicer practices ''that require borrowers to have more than the amount of the projected property tax plus the permissible cushion in the escrow account before the tax lien attaches, but it was not the purpose of Congress that RESPA limit a lender's right to keep mortgaged property free of liens, and the authority of the Department to interpret RESPA so as to do so is questionable.'' The commenter criticized any proposal that would establish detailed rules regarding when servicer may disburse funds to pay property taxes after the tax lien has attached to the property.

This objection seems to raise an issue that was settled in the May 1995 rule, which elevated cash flow over lien priority. The Department has clear legal authority to address the matter of disbursements, as part of the Secretary's rulemaking authority pursuant to section 19(a) of RESPA (12 U.S.C. 2617) to interpret RESPA, including section 10 and section 6(g). Section 10(a) requires that disbursements be made in accordance with prudent lending practice. Section 10(a)(2) prohibits lenders from requiring consumers to deposit in escrow accounts more than one-twelfth of the total amount of the estimated taxes, insurance premiums and other charges which are ''reasonably anticipated'' to be paid on dates during the ensuing twelve months plus a cushion. Section 6(g) requires that disbursements be made as payments become due. By promulgating a rule to address the Annual vs. Installments Disbursement problem, the Department would be acting appropriately under one or more of these statutory provisions.

with an indication, as applicable, if an objection was raised specifically in one context as opposed to another.

The most common objections made by commenters were:

1. It would cause miscellaneous or general increases in costs and/or administrative burdens, such as costs and burdens relating to originating or servicing (64 commenters—60 originators/servicers, 3 trade associations, 1 tax service).

2. They were concerned about the specific costs and burdens of consumer disclosure, including producing and mailing disclosures, soliciting preferences, processing disclosures, tracking selection, and maintaining information on selection (50 commenters—45 originators/servicers, 4 trade associations, 1 financial software company) or opposed the addition of a new disclosure in general (8 commenters—6 originators/servicers, 1 financial software company, 1 person of unknown professional interest).

3. It would require more customer service to explain choices and answer questions for consumers, which would raise costs, workload, and require more staff (46 commenters—41 originators/servicers, 4 trade associations, 1 financial software company).

4. The cost would be passed on to consumers (44 commenters—35 originators/servicers, 6 trade associations, 2 tax services, 1 financial software company).

5. They did not want to make the system and programming changes, acquire the new software, or incur the expense of additional programming that would be needed (38 commenters—32 originators/servicers, 3 trade associations, 2 financial software companies, 1 tax service).

6. It would cause consumer confusion and consumers would not be able to make an educated choice (30 commenters—25 originators/servicers, 3 trade associations, 1 financial software company, 1 person of unknown professional interest).

7. They did not want to have to maintain two, or possibly many more, different disbursement systems for every taxing jurisdiction where they service loans (24 commenters—18 originators/servicers, 5 trade associations, 1 tax service).

8. It would lead to more errors and could result in missed payments and interest and penalties (24 commenters—21 originators/servicers, 1 trade association, 1 tax service, 1 financial software company).

9. It would create hardship for taxing authorities (18 commenters), such as increased administrative costs/burden and workload due to lack of uniformity and similar factors (12 originators/servicers), unexpected shortfalls in tax receipts (8 commenters—7 originators/servicers, 1 trade association), and unspecified or miscellaneous difficulties (2 originators/servicers).

10. It would require additional training of staff (8 commenters—7 originators/servicers, 1 trade association) or require additional staff and/or staff time for processing (13 commenters—12 originators/servicers, 1 trade association).

11. It would result in impossibilities and impracticalities (15 commenters) including that computer and other systems could not handle Consumer Choice (6 commenters—5 originators/servicers, 1 trade association).

12. It would increase the need for manual processing or interfere with technological advances (12 commenters—10 originators/servicers, 1 tax service, 1 financial software company).

13. It would be less efficient (11 commenters—10 originators/servicers, 1 trade association).

14. It would result in a loss of uniformity (10 commenters—9 originators/servicers, 1 trade association).

In addition, several commenters indicated that several aspects of the Consumer Choice alternative in the proposed rule were unclear and required further clarification. For example, eight originators/servicers and a trade association indicated that the proposed rule was not sufficiently clear about what would happen if the customer did not return the format or how a servicer should document that a borrower made no selection. Several commenters recommended that if the Department were to proceed with Consumer Choice, it should make variations of one type or another from the way in which it was proposed.

In its proposed rule, the Department asked Question 4, which was designed to learn more about the potential impact on servicers of requiring them to provide borrowers with a one-time choice at closing as opposed to allowing borrowers to switch disbursement methods during the life of the loan. The answers received to this question substantially overlapped with the comments discussed above regarding the benefits and disadvantages of Consumer Choice.

Twenty-eight commenters (24 originators/servicers, 3 trade associations, 1 tax service) explicitly indicated in their responses to this question that not even a one-time choice should be provided to consumers, but that if the Department chose the Consumer Choice alternative anyway, it should be limited to a one-time choice. This view was implicit in the comments of several others. Among the drawbacks cited for providing more than a one-time choice were the following:

1. It would increase the burden if servicers needed to make constant changes (nine commenters—eight originators/servicers, one trade association).

2. It would result in higher costs (eight commenters—seven originators/servicers, one tax service).

3. It would lead to more errors, confusion, uncertainty and/or noncompliance (seven commenters—five originators/servicers, one trade association).

4. It would be impossible, impractical, or unfair (five originators/servicers).

In its proposed rule, the Department also asked three related questions (Questions 2, 5, and 11) that were designed to elicit responses as to whether, in general, the approach in the final rule should make a distinction between loans that settle before the effective date of a final rule and loans that settle on or after the effective date. While the Department posed the questions so as to be applicable regardless of which alternative was selected, virtually all who answered the questions did so in the context of applying Consumer Choice. The answers received to these questions substantially overlapped each other, as well as overlapping with the comments received on Consumer Choice, and thus are discussed together here.

Fourteen commenters—twelve originators/servicers and two trade associations—emphasized the drawbacks to applying new rules to existing loans, as opposed to only applying it to new loans. The drawbacks to applying consumer choice to all loans included: (1) it would be more costly/burdensome to apply to all (eight commenters); (2) it may result in shortages (two commenters); and (3) it would cause more confusion, disruption, and/or chance for error (two commenters).

In contrast, 13 commenters—11 originators/servicers, 1 trade association, and 1 financial software company—emphasized the drawbacks to trying to apply new rules only to new loans, thereby requiring maintaining separate rules for a portion of their portfolio. These commenters either supported or leaned toward uniform treatment of all loans, some with mixed feelings about the significant burdens it would impose to apply a change to existing loans. The drawbacks cited included: (1) the need for uniformity and consistency (five commenters); (2) it would be costly and burdensome to distinguish (four commenters); (3) it would result in more borrower confusion or dissatisfaction (three commenters); (4) taxing authorities could not gauge the number and amount of tax payments (two commenters); and (5) more errors would result.

Finally, in the proposed rule the Department asked Question 10, which was designed to elicit comments on whether the Department should apply a Consumer Choice approach to other escrow items for which a choice between installments and annual disbursements may be offered. No commenter gave a clear answer that supported applying a consumer's choice to other escrow items. In contrast, 27 commenters (23 originators/servicers and 3 trade associations) opposed extending a consumer's choice to other escrow items. The reasons given for opposing such an approach included the following:

1. Additional costs and burdens would result (e.g., insurance companies impose a service charge for installment payments and this would be passed on to consumer) (19 commenters—17 originators/servicers, 2 trade associations).

2. There would be no benefit to consumers (e.g., taxes are the largest item so the savings from installments will be negligible) (10 commenters—9 originators/servicers and 1 trade association).

3. More errors, customer dissatisfaction, and customer confusion would result (six commenters—five originators/servicers and one trade association).

2. Comments on Servicer Flexibility Alternative

Twenty-five commenters—18 originators/servicers, 5 trade associations, 1 tax service, and 1 financial software company—supported Servicer Flexibility. Eight of these commenters (seven originators/servicers and one financial software company) who otherwise supported Servicer Flexibility, however, did not support the aspect of Servicer Flexibility that would have included restrictions on changing disbursement methods when servicing rights were transferred. Indeed, two of these originators/servicers made a special point of indicating that they would not support Servicer Flexibility if it included that element.

The most common reasons for supporting Servicer Flexibility included:

1. It would be flexible (six commenters—three originators/servicers, three trade associations).

2. It would be easy to administer and cause little disruption (five commenters—two originators/servicers, two trade associations, one financial software company).

3. It would not be costly (four originators/servicers).

4. The lender/servicer is likely to do what is in the consumer's interest anyway; Servicer Flexibility would allow servicers to accommodate borrowers (four commenters—two originators/servicers, two trade associations).

In contrast, 19 commenters—14 originators/servicers, 4 trade associations, and 1 tax service—opposed Servicer Flexibility. The reasons for opposing Servicer Flexibility included:

1. It would not create a system that is uniform, standardized, consistent, or certain; there would still be no clarity (12 commenters—9 originators/servicers, 2 trade associations, 1 tax service).

2. The restriction on changing disbursement methods when there is a transfer of servicing or reasons related thereto was objectionable (five commenters—three originators/servicers, one trade association, one tax service).

3. Increased costs would result (five commenters—four originators/servicers, one trade association).

4. It might not result in the best method for consumers (two originators/servicers, one trade association) and litigation would result (two originators/servicers).

In addition, one federal credit union suggested that the Department adopt a variation on Servicer Flexibility under which the servicer should notify the borrower when the disbursement method is being changed, changing should be limited to when it benefits the borrower (such as taking advantage of a sufficient discount), and the annual statement could be used to inform the borrower of the method used.

3. Comments on Keep, But Clarify, Current Requirements Alternative

Sixty-five commenters—58 originators/servicers, 4 trade associations, 1 tax service, 1 financial software company, and 1 State lending agency—supported the Keep, But Clarify, Current Requirements alternative. Six other commenters (two originators/servicers, three trade associations, and one tax service) indicated it was their second choice. Forty-eight of the commenters who otherwise supported Keep, But Clarify, Current Requirements as either their first or second choice (46 originators/servicers, 1 trade association, and 1 State lending agency), did not support the aspect of this alternative that would include restrictions on changing disbursement methods when servicing rights were transferred. Indeed, 30 of these commenters specifically emphasized their objection to this aspect of this alternative in discussing the support they otherwise would give to it.

The reasons given by those who supported Keep, But Clarify, Current Requirements as their first choice were substantially the same as the reasons given by the three originators/servicers who indicated it was their second choice. The most common reasons of both groups of commenters included:

1. It would be good for consumers for miscellaneous or unspecified reasons (26 commenters—24 originators/servicers, 1 State lending agency, 1 financial software company) or because it would be flexible and allow accommodating customers (8 commenters—5 originators/servicers, 3 trade associations).

2. It would cause little disruption, would not be burdensome, would not require much change, and would be efficient (11 commenters—8 originators/servicers, 2 trade associations, 1 State lending agency).

3. It would not be costly and any costs associated with it would be within an acceptable range (eight commenters—six originators/servicers, two trade associations).

4. It would be a balanced, sensible, practical compromise (six commenters—five originators/servicers, one trade association)

5. It was favored but no specific reason was given (20 commenters—17 originators/servicers, 2 trade associations, 1 tax service).

In contrast, eight originators/servicers and two trade associations opposed Keep, But Clarify, Current Requirements. The most common reasons given for opposing it included the following:

1. It would not standardize the industry (two originators/servicers).

2. It would be unclear, vague, and not specific (two originators/servicers).

3. It would be bad for consumers (e.g., consumer dissatisfaction, confusion, disruption, loss of tax deduction) (two originators/servicers, one trade association).

4. It would be objectionable because of the restriction on switching disbursement methods when there is a transfer of servicing (two commenters—

one originator/servicer, one trade association).

Several commenters recommended variations on Keep, But Clarify, Current Requirements such as requiring installments unless there is a discount for annual disbursements, in which case making annual disbursements mandatory to get the discount instead of optional for servicer. Other commenters encouraged the Department to consider other approaches, such as making no changes at all to address this problem.

4. Comments on Proposed Rule Provision Prohibiting Switching Disbursement Methods Without Borrower's Consent

Only seven commenters supported, in any context, prohibiting a servicer or transferor servicer from changing the disbursement method, as long as a choice exists, without the borrower's prior written consent. Two appeared to support it as a general proposition regardless of the alternative selected. One was Senator D'Amato, who asserted that changes without the borrower's approval ''have been the primary culprit in the unfair treatment which mortgage lenders have imposed on the homeowners of Long Island, chiefly by requiring hundreds of dollars per month from homeowners in escrow payments in order to take advantage of minuscule discounts through the payment of local taxes on an annual basis.'' The other was a federal savings bank, which gave no specific reasons other than suggesting it would be less complicated to do so.

One servicer indicated that if Servicer Flexibility were adopted, it would be logical to prohibit subsequent servicers from changing the disbursement method without the borrower's written consent. This commenter stated that it understands the need to get the borrower's consent before changing the method of tax disbursements when servicing is transferred.

Were the Department to adopt the alternative of Keep, But Clarify, Current Requirements, three commenters supported the restriction. America's Community Bankers (ACB) supported the restriction, so long as the disbursement method continues to be offered by the taxing authority. A large bank with a mortgage lending subsidiary endorsed allowing servicers and subsequent servicers to change the disbursement method only to bring the escrow account into compliance with RESPA under a revised interpretation by the Department. One other servicer commented that requiring the same disbursement date when servicing is transferred is beneficial in that it protects against payment shock for borrowers.

In contrast, 71 commenters opposed the restriction. Fifty-seven of those who opposed it (including 21 originators/servicers submitting the same form letter) discussed their opposition as a general objection applicable to whichever of the three alternatives for addressing the Annual vs. Installment Disbursements problem might be adopted. These 57 included 51 originators/servicers, 4 trade associations, a State lending agency, and a financial software company. Fourteen expressed their opposition in connection with one or more of the specific alternative solutions proposed, but none of these commenters either stated or suggested that the proposal would be acceptable in the context of a different alternative being adopted. Since the objections were consistent regardless of whether expressed in connection with one or all alternatives, all the comments on this issue are discussed in this section. One servicer specifically said that it opposed all the alternatives presented in the proposed rule because of this common feature.

The arguments against including the restriction in the final rule primarily focused on the way in which such a restriction would impair the value of servicing rights and the costs and administrative burdens associated with the restriction. Many of the arguments against the restriction overlapped each other. The most common reasons given included that:

1. It would result in a variety of miscellaneous administrative burdens (35 commenters—34 originators/servicers and 1 trade association).

2. It would increase costs for servicers, such as system and processing changes including computer system changes and the burden on the due diligence process (14 commenters—12 originators/servicers and 2 trade associations) and would increase costs to consumers (6 commenters—4 originators/servicers and 2 trade associations).

3. The restriction would impair the value of servicing rights (13 commenters—10 originators/servicers, 2 trade associations, 1 State lending agency), such as by creating inefficiency and increased cost (3 originators/servicers, 1 trade association).

4. As the restriction applies to the Keep, But Clarify, Current Requirements alternative, it would be a new requirement, rather than a clarification of an existing requirement (seven commenters—six originators/servicers and one trade association).

5. It would result in a variety of practical difficulties or impossibilities (six commenters—five originators/servicers and one trade association).

6. It would reduce the number of sales and transfers of servicing rights (five commenters—four originators/servicers and one trade association).

7. No problem exists that needs to be fixed by such a restriction (five originators/servicers).

In addition, three commenters (two originators/servicers, one trade association) indicated their belief that the Department would lack legal authority to mandate such a restriction. Three originators/servicers requested that the Department clarify certain points pertaining to this restriction.

Six commenters proposed variations on the restriction. Three commenters supported limiting the ability of the acquiring servicer to change the disbursement method to particular types of situations. One federal credit union indicated that it supported restricting a servicer acquiring servicing rights from changing disbursement methods unless the change would benefit the borrower, but gave no details on how to apply such a standard. The Georgia Housing and Finance Administration favored limiting servicers from making changes to the disbursements method to situations involving transfers of servicing, borrower hardships, taxing authority changes, system conversion, and other major organizational changes. GE Capital asked the Department to allow a change in disbursement dates or methods after a transfer of servicing if the dates are incorrect or the methodology is not available to the new servicer. Three mortgage companies suggested that servicers should simply include in the letter notifying the consumer of a transfer of servicing what disbursement method will be used, prior to making the change.

B. Approach Adopted in Today's Final Rule

Having carefully analyzed the comments received, the Department has decided to adopt, with modifications, the Keep, But Clarify, Current Requirements alternative. The Department is revising the rule to provide that servicers must make timely payments, that is, on or before the deadline to avoid a penalty, and advance funds as necessary, so long as the borrower's payment is not more than 30 days overdue. The rule also provides special requirements for property taxes when the taxing jurisdiction offers the servicer a choice between annual disbursements with a discount and installment disbursements. In such cases, if the taxing jurisdiction neither offers a discount for disbursements on a lump sum annual basis nor imposes any additional charge or fee for installment disbursements, the servicer must make disbursements on an installment basis, unless the servicer and borrower agree otherwise. If, however, the taxing jurisdiction offers a discount for disbursements on a lump sum annual basis or imposes any additional charge or fee for installment disbursements, the servicer may, at the servicer's discretion (but is not required by RESPA to), make lump sum annual disbursements, as long as such method of disbursement complies with the requirements of § 3500.17 (k)(1) and (k)(2) of this rule. HUD encourages, but does not require, the servicer to follow the preference of the borrower, if such preference is known to the servicer.

This final rule also incorporates into the regulations a provision that the servicer and borrower may mutually agree, on an individual case basis, to a different disbursement basis (installment or annual) or disbursement dates, than the rule would otherwise require. This provision is consistent with, but more expansive than, the statement contained in the discussion in the preamble to the Department's May 9, 1995 rule (60 FR 24734), which indicated that such agreements were allowed after settlement only. At the time the preamble to the May 1995 rule was written, the Department felt that the concern for borrower coercion was so great as to make it necessary to limit agreements concerning disbursement dates to the period after settlement, when the likelihood of coercion was reduced. The Department understands, however, that allowing such agreements only after settlement discourages them, since it is more burdensome to change the disbursement basis or date after settlement than to set up the account from the start in a way that is mutually agreeable to the borrower and servicer.

This final rule emphasizes that these agreements must be completely voluntary and that neither loan approval nor any term of the loan may be conditioned on the borrower's agreeing to a different disbursement basis or disbursement date for property taxes. The rule does, however, allow such agreements to be made prior to settlement, thereby avoiding the need to make postsettlement changes in the disbursement basis or dates when such an agreement is reached before settlement. This rule also clarifies that whatever the borrower and servicer agree to must avoid a penalty, comply with normal lending practice of the lender and local custom, and constitute prudent lending practice. This new provision provides flexibility. It allows the parties to agree, for example, to annual disbursements of property taxes even if there is no discount where an installment option is offered.

This final rule departs from Keep, But Clarify, Current Requirements as articulated in the proposed rule in that, under this final rule, the only specific requirements for choosing between annual and installment disbursements pertain to property taxes, not other escrow items. The reason the Department distinguishes property taxes from other escrow items is that the concerns that have been raised to the Department on the Annual vs. Installment Disbursement issue have been limited to property taxes. For most consumers, property taxes are much larger than hazard insurance and other escrow items.

This final rule also departs from Keep, But Clarify, Current Requirements as articulated in the proposed rule in that, for the reasons discussed in Part V(D)(3) of this preamble below, it does not adopt the restriction in the proposed rule that a servicer and subsequent servicers would be prohibited from changing the method of disbursement without the borrower's prior written consent, as long as a choice continues to exist in the taxing jurisdiction.

Finally, the final rule adds a definition of ''penalty'' to the definitions in § 3500.17. This definition clarifies that a penalty means a late charge imposed for paying after the disbursement is due. It does not include any additional charge or fee associated with choosing installment disbursements as opposed to annual disbursements or for choosing one installment plan over another. In comments on the proposed rule, four originators/servicers and one tax service commented that the proposed rule had been unclear whether a service fee levied on installment disbursements is regarded as a penalty. These commenters took the position that the servicers may or must use annual disbursements to avoid a penalty (service charge, interest payment, or other fee) for paying in installments, not just to take advantage of a discount available for annual disbursements. One of these commenters questioned whether the existence of a service charge for installment disbursements makes an annual disbursement plan without such a service charge the equivalent of a discount.

Notwithstanding these comments, the Department believes the better approach is not to regard a service charge, interest payment, or other fee associated with choosing installment disbursements as opposed to annual disbursements as a penalty to be avoided. Rather, if a service charge, interest payment, or other fee is imposed for choosing installment disbursements as opposed to annual disbursements, the ability to avoid them by paying annually creates, in essence, a discount for annual disbursements. With respect to disbursements for property taxes, once the choice is viewed as between annual disbursements at a discount and installment disbursements, in accordance with this rule, the servicer may, but is not required by RESPA to,[14] pay annually. Thus, for property taxes, the servicer may choose to disburse the property taxes in installments and incur the service charge, interest payment, or other fee associated with choosing installment disbursements, or may avoid them by disbursing annually. The servicer is encouraged, but not required, to follow the preference of the borrower.[15]

Stated in other terms, for property taxes, the servicer should add up the total payments associated with disbursing annually and compare that amount to the total payments associated with disbursing in installments. In making those calculations, the servicer should take into account any applicable discounts or service charges. If the total amount associated with disbursing property taxes annually is greater than or equal to the total amount associated with disbursing in installments, the servicer must disburse the property taxes in installments, except when the servicer and borrower mutually agree otherwise. If, however, the total amount for disbursing the property taxes in installments is greater than the total amount for disbursing them annually, the servicer may, but is not required by RESPA to, disburse them annually. The servicer is encouraged, but not required, to follow the preference of the borrower.

C. Basis for Approach Adopted

The preamble to the proposed rule indicated that the Department believed the advantage of Keep, But Clarify, Current Requirements would be that, like Servicer Flexibility, it would provide flexibility to servicers. It would also allow servicers to accommodate borrowers with a particular preference.

[14] The caveat, ''by RESPA,'' is designed to allow for the possibility that State law could require annual disbursements.

[15] For other escrow items, the servicer may disburse annually or in installments, so long as the method avoids a penalty and the disbursement basis and disbursement date complies with the normal lending practice of the lender and local custom, and constitutes prudent lending practice.

To the extent that the Department thought Keep, But Clarify, Current Requirements had a potential drawback, it was that it would not guarantee that servicers would accommodate the preferences of individual borrowers, providing less choice for borrowers.

The comments received served to confirm the Department's belief that Keep, But Clarify, Current Requirements, with some modifications, is a workable solution to this problem. Commenters noted many positive reasons for choosing this alternative. The Department is persuaded that, on balance, it is the best approach for meeting consumers' needs and balancing those against the valid concerns of the industry. Such an approach will cause the least disruption and burden and will be the least costly approach, yet it is sufficiently flexible to accommodate the preferences of individual consumers.

By clarifying the regulations in a way that allows more flexibility for servicers and consumers, the Department intends to encourage more servicers to adopt the types of best practices that some servicers are already using that ensure flexibility for consumers. These best practices to address the Annual vs. Installment Disbursements problem include:

- Disbursing property taxes in installments unless a discount is offered for annual disbursements that the servicer, based on its best business judgment, believes is a large enough discount to be in the borrower's interest, in which case the servicer makes disbursements annually.
- Accommodating individual borrowers by switching borrowers who complain to whichever method they prefer for the disbursement of property taxes.

These two practices are examples of the types of best practices that some originators/servicers in the industry are using today, even without a Government requirement. The Department would encourage servicers to adopt these practices so that they will become more widespread.

In contrast, the Department intends to discourage practices that do not provide as much flexibility for the consumer. These include:

- If a choice between annual disbursements with a discount or installment disbursements is offered, always disbursing annually regardless of how insignificant the discount may be and despite the consumer's stated preference for installment disbursements.
- If a choice between annual disbursements or installment disbursements with an additional charge or fee for installment disbursements is offered, always disbursing annually regardless of how insignificant the charge or fee for installment disbursements may be and despite the consumer's stated preference for installment disbursements.

The Department intends that the revisions made in this final rule clarify that these two inflexible practices were not, and are not, compelled by the Department; the Department does not in any way mandate such practices. The Department encourages servicers to use practices that are more consumer friendly.

D. Basis for Rejecting Alternative Approaches

1. Rejection of Consumer Choice Alternative

The preamble to the proposed rule indicated that this approach would provide the greatest flexibility to the borrower. However, the Department also noted that it could impose higher costs on servicers. The Department observed that servicers would likely need two different disbursement systems to reflect the disbursement preferences of borrowers.

While the Department believes that it would have legal authority to impose Consumer Choice as part of the Secretary's rulemaking authority, it has decided not to do so. The Department is persuaded that the types of costs and burdens associated with such an approach are unwarranted at this time. The cost of implementing Consumer Choice with respect to disbursing property taxes on an installment or annual basis would be substantial according to most of the comments received on this issue. New software and operating procedures would have to be developed for originators and all those involved in servicing. Some efficiencies would be lost as multiple processes were employed for making disbursements to taxing authorities, when only one process had been followed before.

Additionally, the Department gathered information from members of the servicing industry on the cost of the Consumer Choice alternative. The Department believes that the cost per account subject to Consumer Choice would be significant, even under a very simple system subject to the following assumptions: (1) a choice would only be permitted at origination with no provisions for the consumer to opt to change the disbursement method later and (2) little in terms of disclosure to the consumer would be provided other than notifying the consumer that a one-time choice at origination was permitted. To the extent that the disclosure required more information or the consumer could opt to change the disbursement method during the life of the loan, the costs would be greater.

The additional costs of consumer choice could be justified if there were commensurate benefits to consumers. But the vast majority of consumer complaints concerning the disbursement method arose out of the transition associated with the 1994–1995 escrow rules. These were one-time, as opposed to ongoing, problems. Complaints about this problem have recently become rare.

Given that the transition associated with the 1994–1995 escrow rules is almost complete and that this transition has been the source of essentially all the complaints concerning the Annual vs. Installment Disbursements problem, the Department believes that only a small percentage of consumers would benefit from the Consumer Choice alternative. It is not anticipated that the benefits to the few who would choose a basis other than what the servicer would choose under the rule would exceed the costs associated with that option. Since it is consumers who would probably bear the additional costs of providing choice, the Department does not believe it is in the consumers' overall best interest to require consumer choice.

The Department was also influenced by the lack of consensus among the commenters on the technical details of the Consumer Choice alternative. The Department asked several specific questions about how to implement such an option in the way least disruptive to the industry. The answers received further reflected the uncertainties and disruptions that would be created by imposing the Consumer Choice alternative and helped convince the Department that such an approach is not feasible. Since the Department is not adopting the Consumer Choice alternative in this final rule, the responses received to a number of the questions raised in the proposed rule do not merit detailed discussion, but a brief summary of the comments in response to these questions is provided below to convey the divergent opinions on this subject.

1. The Department asked Question 7, which was designed to elicit comments on when the appropriate time would be for the originator or servicer to provide the borrower the disclosure, if the Consumer Choice alternative were to be adopted. The commenters were fairly evenly divided on whether the disclosure should be provided and the

selection made before closing but after underwriting or before underwriting. Thirteen commenters simply indicated sometime before closing, whereas 12 commenters indicated it would have to be before underwriting. Seven commenters specifically indicated that the selection would affect underwriting, whereas three commenters specifically indicated that the selection should not affect underwriting.

2. The Department asked Question 8, which was designed to elicit comments about whether the Department should prescribe a disclosure format if an approach were adopted in which the borrower's preference for installments or annual disbursements were controlling. There was general agreement that the Department should prescribe the format (20 commenters supporting prescribing it, with only 4 opposed). However, there was disagreement over what the disclosure should say. Six commenters supported the disclosure the Department had proposed, if one was to be mandated. Seven commenters, however, said it was too confusing and/or unclear. Four criticized it for containing too much information or being overwhelming whereas, two criticized it for not including enough information.

3. The Department asked Question 9, which inquired what period of time would be needed for servicers to be able to implement the Consumer Choice alternative. Four commenters said it could be implemented in less than 12 months, 9 commenters indicated 12 months or more, 2 commenters said 18 to 24 months, and 4 commenters estimated it would take 24 months.

2. Rejection of Servicer Flexibility Alternative

The preamble to the proposed rule explained that the Department perceived this alternative as being the least intrusive regulatory approach for the Department to take and providing the greatest flexibility to servicers, while leaving servicers free to accommodate borrowers with a particular preference, as long as the borrowers' preferences were in accordance with the normal lending practice of the lender and local custom and constituted prudent lending practice. The Department noted that the disadvantage of this alternative is that it would not guarantee that servicers would accommodate the preferences of individual borrowers and, therefore, it provided less choice for borrowers.

The Department has decided not to adopt the Servicer Flexibility alternative. Most commenters did not favor such an approach. The Department decided that there is no reason to adopt this approach and that it would not necessarily be best for the consumer.

3. Rejection of Prohibiting Switching Disbursement Methods Without Borrower's Consent

While the Department would have legal authority to impose a restriction against switching disbursement methods without the borrower's consent as part of the Secretary's rulemaking authority, it has decided not to do so. The types of costs and burdens associated with such a restriction are unwarranted. Therefore, this final rule does not contain this restriction as part of the approach adopted.

E. Clarifications

In issuing this final rule, the Department wishes to address several questions from commenters that will clarify the rule.

1. Selecting From Among Various Installment Plans Offered

Several commenters requested clarification of the servicer's obligations when a taxing authority offers several different installment plans. In such circumstances, the Department encourages the servicer to use the installment plan that results in the lowest closing costs for the consumer. However, the servicer is free to make disbursements according to any installment plan offered by the taxing jurisdiction so long as the selection complies with the normal lending practice of the lender and local custom, and the installment plan selected constitutes prudent lending practice. The servicer may also make disbursements according to any installment plan offered by the taxing jurisdiction to which the servicer and borrower may mutually agree, on an individual case basis.

2. The Size of the Discount Does Not Matter

One mortgage company commented that the Department should make the application of the Keep, But Clarify, Current Requirements approach more consistent by establishing a guideline on when to switch to annual disbursements to take advantage of a discount. One tax service indicated that when the payee offers a choice between installments and annual disbursements at a discount, the Department should either require maximum discounts be taken or set a threshold and require the servicer to disburse to obtain any maximum discount meeting or exceeding that minimum.

In its proposed rule, the Department asked Question 6, which specifically solicited comments on whether the size of an available discount should matter and, if so, how. Fifteen commenters—11 originators/servicers, 1 trade association, 2 tax services, and 1 financial software company—indicated that the size of the discount should make a difference under the rule in some fashion. Eight commenters indicated that the rule should provide that if the discount offered meets a Department-determined threshold, the servicer must disburse annually to obtain the discount. Three commenters indicated that the rule should provide that the servicer is free to decide if the discount is large enough to make it worthwhile to make disbursements in such a way as to collect the discount.

Among those who favored making the size of the discount matter under the rule, there was no agreement on the best approach to setting the discount threshold that would trigger application of one rule or another. Five commenters opposed tying the discount threshold to a market rate, while only one supported this approach. Five commenters favored, but two commenters opposed, a "reasonable servicer" standard. One large tax service commented that not just the size of the discount, but several other factors, affect the value of the discount to the consumer, such as the rate of interest (if any) paid on escrow accounts, market interest rates, and the borrower's income tax rate.

In contrast, 16 commenters—15 originators/servicers and 1 trade association—indicated that the size of the discount should not make a difference under the rule. These commenters indicated that such consideration would present an additional burden and cost to calculate the size of the discount and that discounts are beneficial to the consumer regardless of the size.

The Department has not adopted the approach of making the size of the discount a determinative factor in which disbursement method the servicer should use. There is no apparent way to arrive at a reasonable and acceptable guideline. Rather, the Department's approach in this rule allows latitude to the servicer, while encouraging the servicer to follow the preference of the borrower.

3. Application of Rule to Other Escrow Items

Two originators/servicers commented that this rule should clarify that the Department's policy of favoring installments only applies to taxes, not other escrow items such as hazard insurance. One of these commenters added that this rule should clarify: (1) that servicers should disburse mortgage insurance payments monthly or annually; and (2) that hazard insurance payments should be disbursed annually or as billed by the insurer, and if discounts are available for annual disbursements it should be disbursed annually.

Under this final rule, the only specific requirements for choosing between annual and installment disbursements pertain to property taxes, not other escrow items such as hazard insurance. For escrow items other than property taxes, if a payee offers a servicer a choice between installment or annual disbursements, the servicer is required to make disbursements by a date that avoids a penalty. The servicer, however, is otherwise free to make disbursements on such disbursement basis (annual or installments) and disbursement date as complies with the normal lending practice of the lender and local custom, provided that the selection of each such basis and date constitutes prudent lending practice. The reason for distinguishing property taxes from other escrow items is explained in Part V(B) of this preamble, above.

4. No Preemption of State Law on Installment Option

Two commenters requested clarification of whether RESPA preempts State law in such a way as to require that States offer an installment payments option to servicers, or if they currently only offer that option to individual borrowers. The answer to that question is that RESPA does not so preempt State law. Whether taxing jurisdictions should make an installment option available to servicers is a matter of State law, not RESPA.

5. Disbursing Annually Instead of in Installments When There is no Discount if a Choice is Offered

One commenter, a Wisconsin bank holding company, raised a concern regarding escrow accounts in Wisconsin, stating that servicers should be able to make tax disbursements in an annual disbursement rather than installments, if a choice is offered, even if there is no discount for annual disbursements. The commenter represented that this was partly to protect the servicer's lien, which becomes effective on the first of the year in which the taxes are billed, and partly to give the borrower the benefit of tax deductions for the current year. The commenter explained that in Wisconsin, taxes are billed in November and can be paid in two installments in the following January and July. In addition, State law requires the servicer to issue a joint check to the borrower and the taxing authority by December 20, or give the borrower three options: (1) Pay in full by December 31 if the tax bill is received by December 20, (2) pay the full tax when due (January and July installments), or (3) issue a joint check to the borrower and taxing authority by December 20. If the servicer offers the three options, the servicer is required to follow the borrower's preference.

The commenter asserted that for the Department effectively to prohibit the December payment would conflict with the Department's prior guidance set forth in the preamble to the February 15, 1995 rule (60 FR 8813, second column), which specifically allowed the practice. The commenter further argued that a substantial change in interpretation would undercut servicers who relied on the Department's prior advice, would force servicers to disregard State law, and would negatively impact on borrowers' tax deductions.

In response to this and other comments, this final rule adds a provision to the regulations (§ 3500.17(k)(4)) specifying that a servicer and borrower may mutually agree, on an individual case basis, to a different disbursement basis (installment or annual) or disbursement date than that which would otherwise be prescribed under the regulations. This addition should address the commenter's concern and allow the servicer to comply with Wisconsin law.

VI. Payment Shock—Comments Received, Approach Adopted in This Final Rule, Basis for Approach Adopted, Basis for Rejecting Alternatives

A. Comments Received

Through the comments received on the proposed rule, the Department gained a better understanding of the payment shock problem. A few commenters pointed out that there could be other causes of payment shock aside from those that the Department had described in the preamble to the proposed rule. Citicorp pointed out that payment shock can also be caused by rate adjustments to Adjustable Rate Mortgages (ARMs), special tax assessments, and additional insurance coverage selected by borrowers after closing.

The Department also learned more about how servicers have been addressing the problem of payment shock. Eight originators/servicers indicated that their practice is to notify borrowers ahead of time and provide an opportunity to make voluntary payments ahead of schedule to avoid payment shock. Seven originators/servicers indicated that they offer consumers extended repayment plans, even beyond those required under RESPA, to make up shortages that result from payment shock. Nine originators/servicers indicated that they use short-year statements to minimize payment shock, a practice that also is useful. Two originators/servicers indicated that they simply notify borrowers ahead of time that payment shock may occur but do not explain how to avoid it.

The Department solicited comments to gauge the extent of the payment shock problem. Four originators/servicers and one home builder specifically commented that they agreed with the Department's assessment that payment shock is a very significant problem that needs to be addressed. One commenter estimated that roughly 50 percent of its customers experience payment shock because 30 percent of its loans are for new construction on which taxes are initially assessed on unimproved property and then reassessed for the improvements; an additional 20 percent of its loans have prepaid taxes.

The view that payment shock was a problem was implicit in the comments of several others, such as a servicer who indicated that the current regulations do not work because of difficult situations with borrowers that arise when payment shock occurs. Every commenter who stated a reason for opposing the Make No Change alternative indicated that they opposed the alternative because it would not address the payment shock problem and/or ignored that a problem exists. There were 13 commenters who made such a statement—10 originators/servicers (including 1 of the 4 mentioned above), 1 trade association, 1 tax service, and the home builder mentioned above.

Countrywide commented that payment shock is the most serious problem caused by the existing escrow accounting regulations because it leads to delinquency, hurts borrowers' credit, and may result in people losing their homes. NationsBank commented that it results in an inability to make additional payments in the second year, increases the possibility of delinquent payments, and accelerated collection proceedings, and causes consumers to lose confidence in their lending institutions. Two other originators/servicers agreed with Countrywide's assessment that the situation leads to a significant number of defaults and foreclosures. Two commenters commented that when payment shock occurs, borrowers unfairly blame their lenders and/or their builders and closing agents. Two commenters commented that when it happens, lenders are left having to carry shortages, sometimes for 24 to 48 months, and that this puts the lenders at risk. Countrywide indicated that it is a particularly perilous situation when two or more risk factors are present in a transaction (a condition known as ''layered risk''), such as when payment shock is combined with an upward adjustment in the ARM rate.

In contrast, seven originators/servicers questioned whether payment shock was really a problem in need of fixing. A bank with a mortgage lending subsidiary commented that while many consumers fail to plan for payment shock, they are not really surprised by it and feel that the problem has nothing to do with the servicer. A rural bank commented that it is really a consumer education problem, a problem that will happen regardless of whether there is an escrow account or not. A bank holding company commented that it is not a significant problem, while a federal credit union indicated it was a very infrequent problem. One servicer requested that the Department wait until the transition period expires on the 1994–1995 escrow rules before making any further changes. Citicorp also questioned whether it is a real and on-going problem and suggested waiting until 1998 to consider new requirements.

1. Comments on Consumer Choice

Only one commenter, the California Association of Realtors (CAR), supported Consumer Choice. As with the Annual vs. Installment Disbursements problem, the CAR commented that it favored approaches that provide consumers with as much information as possible and the opportunity, when fully informed, to make choices about the servicing of their loans and the related impound/escrow accounting.

In contrast, 81 commenters opposed the adoption of Consumer Choice—66 originators/servicers, 10 trade associations, 1 tax service, 2 financial software companies, 1 builder, and 1 person of unknown professional interest. The most common reasons given included:

1. It would result in miscellaneous costs and/or administrative burdens (e.g., would increase cost of servicing or be a burden on closing, would create operational problems, would be complicated) (53 commenters—46 originators/servicers, 5 trade associations, 1 financial software company, 1 builder).

2. It would be impractical (36 commenters), for reasons such as servicers will not have or would find it difficult to get or estimate the information needed to calculate the disclosure (30 commenters—28 originators/servicers, 2 financial software companies).

3. It would necessitate more customer service to explain choices and answer questions for consumers (28 commenters—26 originators/servicers, 2 trade associations).

4. Consumer Choice would require system and programming changes and new software or additional programming (23 commenters—19 originators/servicers, 4 trade associations). Two large lenders indicated that if Consumer Choice were selected they would need in excess of 18 to 24 months from the issuance of the final rule to reprogram their computers and develop new forms and procedures.

5. The specific costs and burdens of consumer disclosure, including producing and mailing disclosures, soliciting preferences, processing disclosures, tracking selections, and maintaining information on selection should be avoided (19 commenters—12 originators/servicers, 6 trade associations, 2 financial software companies) or objections to adding a new disclosure in general (5 commenters—4 originators/servicers, 1 builder).

6. The additional cost would be passed on to consumers (21 commenters—16 originators/servicers, 3 trade associations, 1 financial software company, 1 builder).

7. It would create consumer confusion, consumers would not be able to make an educated selection, and it would impose a burden on consumers to have to make such a choice (17 commenters—11 originators/servicers, 4 trade associations, 1 financial software company, 1 builder).

8. There is no need for it (14 commenters) for reasons such that no consumer benefit or no significant consumer benefit would result (10 commenters—6 originators/servicers, 4 trade associations).

9. It would necessitate multiple sets of closing documents to accommodate possible choices or otherwise interfere with the correct preparation of closing documents (eight commenters—five originators/servicers, one trade association, one financial software company, one builder).

10. Additional training of staff would be required (eight commenters—six originators/servicers, two trade associations).

Several commenters commented specifically about the proposed prohibition against servicers switching accounting methods without the borrower's consent, which was one element of the Consumer Choice alternative. Only one commenter, GE Capital, indicated that it supported restricting changes to accounting methods when there is a transfer of servicing. GE Capital's support, however, was conditioned on the selection of the accounting method being limited to a one-time choice at closing, the selection being limited to situations involving new construction, and the regulations being clarified to provide that payments (as opposed to methodology) could be changed in the event of unanticipated changes to escrow items.

In contrast, seven commenters, including six originators/servicers and one trade association, opposed the aspect of Consumer Choice prohibiting servicers from switching escrow accounting methods. The reasons given included the following: (1) It would chill or burden sales of servicing rights (three originators/servicers, one trade association); (2) it would pose an administrative burden (two originators/servicers); and (3) it would impair value of servicing rights (two originators/servicers).

In the proposed rule, the Department asked Question 2, which was designed to elicit commenters' views on how to define a substantial increase in disbursements from an escrow account, and how mortgage servicers could go about determining whether bills paid out of escrow accounts were expected to increase substantially after the first year. Virtually all of the commenters that responded to this question focused on whether a 50 percent increase was an appropriate threshold for defining a substantial increase, as proposed.

Four commenters—three originators/servicers and one trade association—supported using 50 percent as a threshold. One bank holding company indicated that 50 percent was an appropriate threshold but that the payment shock problem should only be addressed in situations involving new construction. Most gave no reason for why they believed 50 percent was an appropriate threshold, other than that it seemed to be a reasonable approach. The National Association of Federal Credit Unions (NAFCU) indicated that the approach would avoid confusion.

In contrast, 21 commenters—17 originators/servicers, 2 trade associations, 1 financial software company, and 1 builder—opposed using 50 percent as a threshold. Many of these commenters indicated that the Department should not set any threshold for when an increase would be considered substantial, yet no commenters favored offering alternatives to borrowers whose escrow payments were not expected to increase substantially after the first year, and 16 commenters (14 originators/servicers, 2 trade associations) specifically opposed such an idea. The reasons for opposing using 50 percent as a threshold and/or opposing any Department-established threshold were similar. They included:

1. Servicers would not be able to estimate if the expected increase was within the threshold (seven comments—six originators/servicers, one trade association).

2. Even less than a 50 percent increase could be a problem for borrowers (five commenters—three originators/servicers, one financial software company, one builder).

3. It would be burdensome and/or costly to calculate if the expected increase would meet the threshold (five commenters—four originators/servicers, one trade association).

4. Servicers should be given more flexibility (two originators/servicers).

The Department also asked Questions 2 and 7, which were designed to elicit responses as to whether, if the Consumer Choice alternative were adopted, the final rule should limit a borrower's opportunity to switch escrow accounting methods. Sixteen commenters (14 originators/servicers, 1 trade association, 1 financial software company) indicated that they opposed allowing even a one-time choice to be provided to consumers, but that if the Department chose the Consumer Choice alternative anyway, it should be limited to a one-time choice, for reasons such as the additional burdens and costs more opportunities to switch would create. Several other commenters that were less clear in their dislike of the Consumer Choice alternative, nonetheless took clear positions against offering more than a one-time choice.

In contrast, only three commenters advised against having different systems for different borrowers. One based its view on the additional confusion it would create over options and management of the options. Another based its opinion on the additional complications. A third stated it would add to the programming, personal, and postage costs and create more confusion.

2. Comments on Make No Change Alternative

A total of 46 commenters supported the Make No Change alternative. Forty-two commenters—35 originators/servicers, 5 trade associations, 1 financial software company, and 1 person of unknown professional interest—supported Make No Change as proposed. The MBA and a bank and trust indicated that Make No Change was their second choice next to Mandate First Year Overpayment; NAFCU also implied it was their second choice.

Four additional commenters indicated they would support Make No Change if Variation (A) were added to it. The proposed rule described Variation (A) as follows:

> (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.

61 FR 46517.

Three of the 42 who supported the Make No Change alternative as proposed also indicated they would support Make No Change with Variation (A). In addition, two originators/servicers that recommended alternatives instead of Make No Change also indicated that as part of those approaches that it should be disclosed to the borrower that a shortage is expected, but not the amount of the expected shortage.

One commenter who otherwise supported the Make No Change alternative indicated that it was opposed to mandating any type of notice, but indicated a notice similar to Variation (A) would be less problematic than the type of disclosure that would be part of the Consumer Choice alternative. The commenter observed that any disclosure should be generic (no calculations) and advise consumers that: (1) The amount of taxes for which escrow funds are being collected is based on information available at time of closing about anticipated property taxes for next year; (2) the amount could change especially for new construction; and (3) the consumer should monitor the situation and consult a tax advisor if the amount increases substantially.

Ten other commenters—eight originators/servicers, one financial software company, one builder—specifically commented that they opposed Variation (A). The primary reasons were that it would not be effective at eliminating payment shock, and giving borrowers advance notice that a payment increase may occur should be left to the originator/servicer. The reasons the commenters gave for supporting the Make No Change alternative as their second choice were similar to the reasons other commenters gave for supporting it as their first choice. The reasons of all the commenters who supported it as their first or second choice are summarized below:

1. This approach would encourage good, voluntary practices to help customers on an individual basis (25 commenters—22 originators/servicers, 3 trade associations).

2. No change is needed because the current rule is adequate (four commenters—three originators/servicers, one financial software company).

3. It would not be disruptive (three commenters—two originators/servicers, one trade association).

4. It would allow servicers to exercise good judgment (two trade associations).

5. It would be flexible (two originators/servicers).

6. Providing consumers with a simple disclosure would give consumers information to act in their own best interest (one trade association).

In contrast, 13 commenters—10 originators/servicers, 1 trade association, 1 tax service, and 1 builder—opposed the Make No Change alternative. Each of these commenters stated that they opposed the alternative because it would not address the problem and/or ignored a problem that exists.

Other commenters supported other variations on the Make No Change alternative. Two originators/servicers supported Variation (B). Variation (B) would have required 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. On the other hand, seven commenters—five originators/servicers and two financial software companies—opposed Variation (B) for reasons such as the burdens and difficulties associated with trying to estimate the amount of a shortage that is expected to result.

In the proposed rule the Department also solicited comments on the following alternative. 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 1 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 of RESPA, it would be necessary for the Secretary to invoke his exemption authority under section 19(a) of RESPA (12 U.S.C. 2617).

Only eight commenters commented on this particular approach. Five commenters supported it while three opposed it. The Department does not believe it is a superior approach to that adopted in this final rule, as discussed below.

The proposed rule also invited commenters to submit other permissible approaches under RESPA that would better serve the interests of the public and the intent of the statute, inviting commenters to submit specific regulatory language to implement their proposals. Fourteen originators/servicers and two trade associations submitted a variety of additional alternatives, none of which appear to the Department to be a superior approach to that adopted in this final rule, as discussed below.

3. Comments on Mandate First Year Overpayment Alternative

Twenty-seven commenters—21 originators/servicers, 2 trade associations, 2 financial software companies, 1 tax service, and 1 State lending agency—supported the Mandate First Year Overpayment alternative. In addition, Citicorp indicated that the Mandate First Year Overpayment alternative was its second choice to the Make No Change alternative. Bank of America indicated it was its second choice next to an alternative of its own creation, but only for new construction and situations involving special tax discounts (e.g., reduced taxes for seniors, disabled, or veterans). GE Capital indicated it was its second choice to the Make No Change alternative, but should only apply if the increase will be due to taxes being based on the land value only for the first year. If the increase will be due to items paid prior to the first payment date, GE Capital favored a different approach.

The reasons given for supporting the Mandate First Year Overpayment alternative included the following:

1. This approach would avoid payment shock best and would result in the fewest shortages (14 commenters—11 originators/servicers, 2 trade associations, 1 financial software company).

2. It would be better for consumers (12 commenters—9 originators/servicers, 2 financial software companies, 1 State lending agency).

3. It would increase consistency, standardization, and uniformity (seven commenters—three originators/servicers, one trade association, two financial software companies, one State lending agency).

4. It would require only minimal changes (four commenters—two originators/servicers, two financial software companies).

5. It would be the least costly alternative to implement (one originator/servicer, one financial software company).

6. It would be the fairest alternative (one originator/servicer, one tax service).

In contrast, 36 commenters—32 originators/servicers, 3 trade associations, and 1 person of unknown professional interest—opposed the Mandate First Year Overpayment alternative. The reasons given for opposing this alternative included the following:

1. It would not be in the consumer's interest to overpay and then money get back; this would be unfair to the borrower (10 commenters—7 originators/servicers, 2 trade associations, 1 person of unknown professional interest).

2. This alternative would be administratively burdensome or costly (e.g., having to make constant refunds and explanations to consumer) (six commenters—four originators/servicers, two trade associations).

3. It would run contrary to the Secretary's stated objectives (21 originators/servicers).

In the proposed rule, the Department proposed that as a variation on Method C, the cushion could be calculated as one-sixth of the estimated annual disbursements for the first year, instead of 2 months of the escrow payments for the first year. Two originators/servicers and a financial software company indicated that they preferred Method C to the variation. One of these commenters, a bank holding company, indicated that the variation would be far less effective at eliminating payment shock, while another, a mortgage company, indicated the variation would be more complicated for borrowers and for the industry. No commenter indicated a preference for the variation.

Commenters also suggested several additional variations on the Mandate First Year Overpayment alternative as their preferred approach, such as limiting it only to situations involving new construction (five commenters—four originators/servicers, one trade association) or offering it even when less than a 50 percent increase in disbursements were expected (four commenters—two originators/servicers, one financial software company, one builder).

B. Approach Adopted in Today's Final Rule

Based on the comments received, the Secretary has determined that there would be little value in rulemaking on the payment shock ''problem.'' The comments, in sum, do not indicate that the ''problem'' is uniformly accepted as such in the industry, there is little support for the Department's prescribing a particular accounting method that will result in overescrowing consumers' money, and there is no agreement on the nature of any form that the Department would prescribe for homebuyers to warn of the possibility of a substantial increase in payments to their accounts.

During the rulemaking, however, the Department identified that individual servicers do provide a written disclosure to borrowers when they anticipate increased payments. The Department favors this approach and believes that such a disclosure should be encouraged as a best practice, without the Department prescribing the particular form.

The Department has decided to adopt, with modifications, the Make No Change alternative. This final rule, therefore, continues the current requirements for escrow analysis, even when the servicer expects that the disbursements from the escrow account will increase substantially after the first year. This alternative will not prevent payment shock in all instances. Under the final rule, however, as in the past, servicers may disclose the problem to borrowers, and borrowers may make voluntary overpayments to escrow accounts. Servicers may also calculate short-year statements. Thus, some methods are available to alleviate the payment shock problem, although they are not required.

This final rule does depart, however, from the Make No Change alternative of the proposed rule in encouraging, on a voluntary basis, the use of a consumer disclosure format concerning payment shock to be given to consumers when the originator or servicer expects that a substantial increase in escrow payments will occur in the second year of the escrow account. The Department has determined not to define a ''substantial increase.'' Instead, this rule leaves this determination to each originator or servicer to apply sound business judgment.

This disclosure format, which is published as an appendix to this final rule, will be available from the Department as a Public Guidance Document at the address indicated in 24 CFR 3500.3. The format is entitled ''Consumer Disclosure for Voluntary Escrow Payments'' to clarify that when the originator or servicer provides the disclosure, the consumer may choose whether to make higher payments during the first year to reduce or eliminate the monthly payment increase in the second year. The disclosure contains the following information:

The bills paid out of your escrow account are expected to increase substantially after the first year[.] [because ______________]. Under normal escrow practices, your monthly escrow payment in the second year could be much higher than in the first.

You may voluntarily choose to make higher payments during the first year to reduce or eliminate the monthly payment increase in the second year. If you are interested in doing this, contact:

The instructions to the preparer explain that the blank provided is to indicate whom to contact for further information on making voluntary overpayments during the first year, including the mailing address, fax number, e-mail address, and/or telephone number of the contact. The terms ''reserve'' or ''impound'' may be substituted for the terms ''escrow account'' or ''escrow'' to reflect local usage.

While use of the disclosure is not mandatory, providing the disclosure to consumers is a best practice that the Department encourages originators and servicers to follow. The Department is publishing this format at the end of this rule as an appendix for the convenience of the reader. It will not be codified in the Code of Federal Regulations.

The recommended format published with this final rule, in addition to providing notice that payment shock may occur, also indicates that payment shock can be avoided by making additional payments to the escrow account, and suggests that the consumer ask the appropriate originator or servicer for more information. While simply informing consumers of the potential of payment shock and providing information on how to avoid it may not lead the consumers to take actions to avoid it, the information will benefit some consumers and may lead them to request voluntary borrower and servicer agreements to make additional payments to avoid shortages.

To provide clarity to servicers, this rule adds a new provision (24 CFR 3500.17(f)(2)(iii)) regarding funds deposited as a result of such voluntary borrower and servicer agreements. The provision states that the voluntary agreement is for a 1-escrow-account-year period, although successive agreements are allowed. By receiving higher escrow payments into the account, the ending balance will be greater, thus lowering or eliminating the anticipated shortage at the time of the next analysis. At the time of the next escrow analysis, § 3500.17(f) regarding shortages, surpluses, and deficiencies will continue to apply, and may not be changed by any voluntary agreement.

C. Basis for Approach Adopted

The comments received served to confirm that the Make No Change alternative, with some modifications, is a workable solution to this problem. Based on its review of the comments, the costs and burdens associated with any other approach are simply too great compared to the benefits. There is no strong evidence that additional regulation is needed at this time to address the problem. Existing procedures are adequate to avoid payment shock. This rule encourages originators and servicers to inform consumers of the potential problem and allow them to use existing procedures to avoid the problem if they so desire.

This final rule is similar to Variation (A) of the Make No Change alternative in the proposed rule, which was recommended by several commenters. As recommended by commenters, use of the format is not mandatory, but the recommended format is similar to that which was suggested by several commenters. Heeding the objections of several commenters, the recommended format does not call for an estimate of the amount of a shortage that is expected to result. Several commenters urged that the final rule leave the decision of whether to give borrowers advance notice that a payment increase may occur to the originator/servicer. In response, this final rule leaves this determination to each originator or servicer to apply sound business judgment in deciding whether to provide the disclosure; it does not make the disclosure mandatory or define a ''substantial increase.''

The Department intends this final rule to encourage more originators and servicers to adopt practices that will ensure that consumers are informed of the payment shock problem and given the opportunity to avoid it. These practices include:

- Notifying borrowers in advance and providing an opportunity to make voluntary payments ahead of schedule to avoid payment shock. The Department encourages servicers to use the recommended format published today to notify borrowers of this potential problem when the originator or servicer, in applying sound business judgment, believes that payment shock is like to occur.
- Offering consumers extended repayment plans, even beyond those required under RESPA, to make up substantial shortages associated with payment shock.

These two practices are examples of the types of best practices that some originators/servicers in the industry are using today, even without a Government requirement. The Department encourages servicers to adopt these practices so that they will become more widespread.

D. Basis for Rejecting Alternative Approaches

1. Rejection of Consumer Choice Alternative

While the Department believes it would have legal authority to impose Consumer Choice, including the prohibition against the servicer changing escrow account methods, as part of the Secretary's rulemaking authority, it has decided not to do so. The types of costs and burdens associated with such an approach are prohibitive at this time.

The Department was also influenced by the obvious lack of consensus among the commenters as to how to work out the technical details associated with the Consumer Choice alternative. The Department asked several specific questions about how to go about implementing such an alternative in the way least disruptive to the industry. The answers reflected the uncertainties and disruptions that would be created by imposing the Consumer Choice alternative, and helped convince the Department that such an approach is not feasible. Since the Department is not adopting the Consumer Choice alternative in this final rule, the responses received to a number of the questions raised in the proposed rule concerning this issue do not merit detailed discussion, but a brief summary of the comments in response to these questions is provided below to give a sense of the divergent opinions received:

1. The Department asked Question 5, which was designed to elicit views on when the appropriate time would be for the originator or servicer to provide the borrower the disclosure, if the Consumer Choice alternative were to be adopted. The commenters were nearly evenly divided on whether the disclosure should be provided and the selection made before closing but after underwriting or before underwriting. Eight commenters simply indicated sometime before closing, whereas six commenters indicated that it would have to be before underwriting. Two originators/servicers and one tax service indicated that no matter what time was selected, problems would arise. Five commenters specifically indicated that the selection would affect underwriting because it could affect the funds needed to close, whereas one mortgage lending subsidiary of a bank stated emphatically that it ''should have absolutely no bearing on the loan underwriting or approval process since the borrower must qualify based on a tax escrow payment calculated on fully assessed value.''

2. The Department asked Question 6, which asked whether the Department should prescribe a disclosure format if an approach were adopted in which the borrower's preference for a particular escrow accounting method were controlling. Although there was general agreement that the Department should prescribe the format (15 commenters supporting prescribing it with only 2 opposed), there was disagreement over what the disclosure should say. One commenter supported the disclosure the Department had proposed, agreeing ''with the simplicity of the proposed format.'' Seven commenters, however, said it was confusing and contained too much information, whereas two commenters criticized it for not including enough information.

2. Rejection of Mandate First Year Overpayment Alternative

While the Mandate First Year Overpayment alternative was extolled by some in the industry as the best solution, there was no consensus even within the industry for this approach. Thirty-two originators/servicers and 3 trade associations opposed it, while only 21 originators/servicers, 2 trade associations, 2 financial software companies, 1 tax service, and 1 State lending agency supported it. The Department is persuaded that it is simply not in the consumer's interest to mandate overpayment into escrow accounts, even if consumers ultimately get the money back. Mandating escrowing beyond the limitations of the statute would be unfair to borrowers. Consumers should not be forced to tie up money unnecessarily in their escrow accounts and may prefer to invest the money elsewhere or use it for other more pressing purposes. There is no compelling case for the Department to exercise its exemption authority for this purpose. Nor would such an approach be consistent with the Secretary's stated objectives for escrow accounting.

VII. Single-Item Analysis With Aggregate Adjustment Problem—Comments Received, Approach Adopted in This Final Rule, and Basis

A. Comments Received on Revision Proposed

The Department sought 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. The Department also invited commenters to submit specific regulatory language to implement their proposals.

A significant number of commenters, including servicers and trade associations, found the proposal to represent a functional or acceptable solution. The MBA, while favoring the proposal, indicated that some of its members were concerned about settlement agent confusion from the change. Those members opposing the change indicated that they make use of the 45-day period within which the initial analysis must be delivered, so they did not share the concern over presenting two different accounting methods. During the Department's development of the proposed rule, Federal Reserve Board staff had indicated that it had no objection to the approach in the proposed rule, inasmuch as the PMI number for APR calculations would otherwise be available.

On the other hand, a number of major lenders and/or servicers opposed the change. For example, Chase Mortgage stated that it was not beneficial for consumers or servicers, since consumers would lose the ease of a single statement from which amounts can be reconciled, and servicers would have no viable audit trail to indicate how the initial deposit was calculated to resolve later differences or discrepancies. Bank of America's comments were similar. A number of other commenters decried a retreat from uniformity (the original premise of the 1994–1995 escrow rules) that allowing options among servicers would produce, and indicated that options affected the ease of servicing transfers. On a tangential point, the American Escrow Association wanted continued clarity that the settlement agent action reflected instructions received, not independent activities of the settlement agent.

B. Approach Adopted in This Final Rule and Basis

The Department carefully reviewed the comments and considered them in view of the mandate issued to the Department and the Federal Reserve Board under legislation enacted September 30, 1996 to re-examine RESPA and TILA disclosure requirements. See sec. 2101 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (Title II of the Omnibus Consolidated Appropriations Act, 1997, Pub. L. 104–208; approved September 30, 1996).

It would be inappropriate to undertake a piecemeal and unilateral revision of the HUD–1 and HUD–1A at this time. In addition, the elimination of the aggregate adjustment from the HUD–1 and HUD–1A would harm those who have already developed systems that rely on it for an audit trail. There simply was no consensus for the change. Therefore, this final rule does not contain any revision to the 1000 series disclosures; servicers should continue to follow existing requirements.

On a related matter, this rule adds information to the footnote instructions to Appendix C, in order to reaffirm a previous clarification that instead of using aggregate accounting with no more than a 2-month cushion, the reserves on the Good Faith Estimate may be estimated by using single item accounting with no more than a 1-month cushion (see 61 FR 46518, column 3, September 3, 1996).

VIII. Lead-Based Paint Disclosure Issue—Comments Received, Approach Adopted in This Final Rule, and Basis

A. Comments Received on Revision Proposed

Commenters were almost evenly divided regarding the desirability of adding the lead-based paint disclosures. Nine commenters—four originators/servicers and five trade associations—indicated that they supported or had no objection to the proposal. Most gave no reason. Among those who did, the National Association of Federal Credit Unions indicated that they supported the proposal because it would help educate borrowers of their rights.

In contrast, eight originators/servicers opposed the proposal. One lender indicated that by imposing the burden of disclosure on the lender, the Department would be blurring the responsibility of sellers to give lead-based paint disclosures required by the EPA/HUD rule (implementing section 1018 of the Housing and Community Development Act of 1992). The commenter noted that lenders have never been required to disclose matters of law between sellers and buyers. Six other originators/servicers presented similar or related arguments.

Four originators/servicers indicated that providing a disclosure on the GFE would be duplicative of other lead disclosures; one commented that the HUD booklet ''Settlement Costs and You'' was a more appropriate forum for this type of disclosure. Two originators/servicers expressed concern that lenders would become involved in lawsuits involving lead-based paint, and that the disclosure could be interpreted as implying a lender duty in some future consumer class action.

B. Approach Adopted in This Final Rule and Basis

Upon careful review of these comments, the Department agrees with the commenters who believe that the lead-based paint disclosure need not specifically be added to the GFE and the HUD–1 and HUD–1A as a separate line at this time. This final rule continues the existing requirement that the lead-based paint inspection fee be included on the HUD–1 or HUD–1A if a lead-based paint inspection is either: (1) required by the lender, whether paid outside of settlement (in which case ''P.O.C.'' should be used) or at settlement; or (2) paid for at settlement. The only change made by this rule is a clarification to the instructions for the HUD–1. The current instructions indicate that Lines 1301 and 1302 of the HUD–1 may be used for ''fees for survey, pest inspection, radon inspection, lead-based paint inspection, or other similar inspections.'' The instructions are being changed to indicate that Lines 1301–1302 or any other available blank line in the 1300 series may be used for these purposes.

In addition, the Department has recently implemented several programs to assist homebuyers in financing the cost of lead-based paint inspections, risk assessments, and repairs. These programs include special requirements for the disclosure of information pertaining to lead-based paint on the HUD–1 and HUD–1A, which were explained in Notice H 96–93 (HUD) issued by the Department's Office of Housing on November 5, 1996.

Most importantly, since the time the September 13, 1996 proposed rule was issued, the Department has replaced its out-of-date settlement costs booklet (see 62 FR 31891, June 11, 1997). This new booklet is also available on the RESPA Website: http://www.hud.gov/fha/res/respa__hm.html. This revised booklet discusses the legal provisions that allow the buyer the option of obtaining a lead-based paint inspection, and gives an earlier and more meaningful description of the lead-based paint inspection process to the consumer. The Department is also currently engaged in a process with the Federal Reserve Board, referred to in Part VII(B) above of this preamble, which involves an overall review of settlement disclosure forms and requirements.

IX. Rule Changes

The changes made in this final rule are summarized below:

1. This rule amends § 3500.17(a) to include a reference to the voluntary disclosure format. This reference clarifies that the Department encourages, but does not require, originators and servicers to provide the format to consumers when they anticipate a substantial increase in disbursements from the escrow account after the first year of the loan.
2. This rule revises the definition of ''disbursement date'' in § 3500.17(b) to eliminate a redundant sentence that had referred to § 3500.17(k).
3. This rule adds a definition of ''penalty'' to § 3500.17(b) to clarify that a penalty does not include any additional charge or fee associated with choosing installment payments as opposed to annual payments or for choosing one installment plan over another. As discussed in Part III(C)(1) of this preamble, this new definition is necessary to clarify, in response to comments on the proposed rule, that a service fee levied by the payee on installment payments is not regarded as a penalty.
4. This rule amends § 3500.17 (c)(1) and (c)(2) to eliminate redundant descriptions of the requirements of § 3500.17(k); the requirements of § 3500.17(k) are clarified by revisions to that paragraph. This rule also makes technical amendments to the citation of § 3500.17 (c)(1) and (c)(2).
5. This rule revises § 3500.17(i)(1) to conform the language more closely to the statutory language in section 10(c)(2)(A) of RESPA. While this clarification pertains to escrow accounting, it does not directly relate to the other matters addressed in this final rule. This is a technical clarification, not a departure from prior requirements. As such, the Department restates its position that because an escrow account statement clearly itemizes all amounts paid out of the escrow account during the period as required, the statement does not also have to provide, as an additional element of the statement, a separate sum of all of those amounts.
6. This rule revises § 3500.17 (k)(1) and (k)(2) to eliminate awkward and unnecessary cross-references to the definition of ''disbursement date.'' The revisions to paragraph (k)(1) eliminate language that had indicated that in calculating the disbursement date, servicers were to 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 language caused much public confusion. Instead, as explained in Part III(C)(1) of this preamble, under this final rule servicers are required to disburse in a timely manner, that is, on or before the deadline to avoid a penalty. For escrow items other than property taxes, the rule leaves it to the servicer to decide whether to disburse on a date early enough to take advantage of discounts, so long as the disbursement basis (annual or installments) and the disbursement date complies with the normal lending practice of the lender and local custom and constitutes prudent lending practice. For property taxes only, this rule contains special requirements in paragraph (k)(3).
7. This rule adds § 3500.17(k)(3) to specify the special additional requirements applicable to property taxes when the taxing jurisdiction offers the servicer a choice of disbursements on an installment or annual basis. Those requirements are explained in Part III(C)(1) of this preamble.
8. This rule adds § 3500.17(k)(4) to specify that a servicer and borrower may mutually agree, on an individual case basis, to a different disbursement basis (installment or annual) or disbursement date for property taxes, so long as their agreement avoids a penalty, complies with the normal lending practice of the lender and local custom, and constitutes prudent lending practice. This provision is discussed in Part III(C)(1) of this preamble.
9. This rule makes one minor clarification to the instructions to the HUD–1 as it relates to disclosure of ''lead-based paint inspection'' fees.
10. This rule includes as an appendix a voluntary disclosure format that is entitled ''Consumer Disclosure for Voluntary Escrow Account Payments.'' This format is discussed in Part IV(C)(1) of this preamble.
11. This rule adds a footnote instruction to Appendix C to part 3500, the Sample Form of Good Faith

Estimate, to clarify that single item analysis with a 1-month cushion can be used in developing the estimates for reserves relating to lines 1000–1005 of the Good Faith Estimate.

Findings and Certifications

Paperwork Reduction Act

The information collection requirements in this final rule have been approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520), and assigned OMB control number 2502–0517. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a valid control number.

Environmental Impact

In accordance with 24 CFR 50.19(c)(1) of the Department's regulations, this rule does not direct, provide for assistance or loan and mortgage insurance for, or otherwise govern or regulate property acquisition, disposition, lease, rehabilitation, alteration, demolition, or new construction, or set out or provide for standards for construction or construction materials, manufactured housing, or occupancy. Therefore, this rule is categorically excluded from the requirements of the National Environmental Policy Act (42 U.S.C. 4321).

Executive Order 12866

The Office of Management and Budget (OMB) reviewed this rule under Executive Order 12866, *Regulatory Planning and Review*, issued by the President on September 30, 1993. OMB determined that this rule is a ''significant regulatory action,'' as defined in section 3(f) of the Order (although not economically significant, as provided in section 3(f)(1) of the Order). Any changes made in this rule subsequent to its submission to OMB are identified in the docket file, which is available for public inspection between 7:30 a.m. and 5:30 p.m. in 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.

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 rule would not have a significant economic impact on a substantial number of small entities. This rule will maintain existing requirements, but clarify them. It also recommends voluntary use of certain practices that would benefit consumers, including voluntary use of a model disclosure format.

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 rule would 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. The rule is directed toward clarifying existing requirements and encouraging voluntary use of certain practices that the Department believes would be beneficial to consumers.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (UMRA) (Pub. L. 104–4; approved March 22, 1995), establishes requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments, and on the private sector. This rule does not impose any Federal mandates on any State, local, or tribal governments, or on the private sector, within the meaning of the UMRA.

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 amended as set forth below.

PART 3500—REAL ESTATE SETTLEMENT PROCEDURES ACT

1. The authority citation is revised to read as follows:

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

2. In § 3500.17:

a. Paragraph (a) is amended by adding a sentence at the end;

b. Paragraph (b) is amended by revising the definition of ''*Disbursement date*'', and by adding a new definition of ''*Penalty*'' in alphabetical order;

c. Paragraphs (c)(2) and (c)(3) are revised;

d. Paragraph (f) is amended by adding a new paragraph (f)(2)(iii);

e. Paragraph (i) is amended by revising the third sentence of the introductory text of paragraph (i)(1) and by revising paragraph (i)(1)(iv); and

f. Paragraph (k) is revised, to read as follows:

§ 3500.17 Escrow accounts.

(a) * * * A HUD Public Guidance Document entitled ''Consumer Disclosure for Voluntary Escrow Account Payments'' provides a model disclosure format that originators and servicers are encouraged, but not required, to provide to consumers when the originator or servicer anticipates a substantial increase in disbursements from the escrow account after the first year of the loan. The disclosures in that model format may be combined with or included in the Initial Escrow Account Statement required in § 3500.17(g).

(b) * * *

* * * * *

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

* * * * *

Penalty means a late charge imposed by the payee for paying after the disbursement is due. It does not include any additional charge or fee imposed by the payee associated with choosing installment payments as opposed to annual payments or for choosing one installment plan over another.

* * * * *

(c) * * *

(2) *Escrow analysis at creation of escrow account.* Before establishing an escrow account, the servicer must conduct an escrow account analysis to determine the amount the borrower must 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 must estimate the disbursement amounts according to paragraph (c)(7) of this section. Pursuant to paragraph (k) of this section, the servicer must use a date on or before the deadline to avoid a penalty as the disbursement date for the escrow item and comply with any other requirements of paragraph (k) of this section. Upon completing the initial escrow account analysis, the servicer must prepare and deliver an initial escrow account statement to the borrower, as set forth in paragraph (g) of this section. The servicer must use the escrow account analysis to determine whether a surplus, shortage, or deficiency exists and must make any

adjustments to the account pursuant to paragraph (f) of this section.

(3) *Subsequent escrow account analyses.* For each escrow account, the servicer must 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 must estimate the disbursement amounts according to paragraph (c)(7) of this section. Pursuant to paragraph (k) of this section, the servicer must use a date on or before the deadline to avoid a penalty as the disbursement date for the escrow item and comply with any other requirements of paragraph (k) of this section. The servicer must use the escrow account analysis to determine whether a surplus, shortage, or deficiency exists, and must make any adjustments to the account pursuant to paragraph (f) of this section. Upon completing an escrow account analysis, the servicer must prepare and submit an annual escrow account statement to the borrower, as set forth in paragraph (i) of this section.

* * * * *

(f) * * *

(2) * * *

(iii) After an initial or annual escrow analysis has been performed, the servicer and the borrower may enter into a voluntary agreement for the forthcoming escrow accounting year for the borrower to deposit funds into the escrow account for that year greater than the limits established under paragraph (c) of this section. Such an agreement shall cover only one escrow accounting year, but a new voluntary agreement may be entered into after the next escrow analysis is performed. The voluntary agreement may not alter how surpluses are to be treated when the next escrow analysis is performed at the end of the escrow accounting year covered by the voluntary agreement.

* * * * *

(i) * * *

(1) * * * The annual escrow account statement must include, at a minimum, the following (the items in paragraphs (i)(1)(i) through (i)(1)(iv) must be clearly itemized):

* * * * *

(iv) The total amount paid out of the escrow account during the same period for taxes, insurance premiums, and other charges (as separately identified);

* * * * *

(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 must 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 must 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 the payment of property taxes from the escrow account, if a taxing jurisdiction offers a servicer a choice between annual and installment disbursements, the servicer must also comply with this paragraph (k)(3). If the taxing jurisdiction neither offers a discount for disbursements on a lump sum annual basis nor imposes any additional charge or fee for installment disbursements, the servicer must make disbursements on an installment basis. If, however, the taxing jurisdiction offers a discount for disbursements on a lump sum annual basis or imposes any additional charge or fee for installment disbursements, 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 or avoid the additional charge or fee for installments, as long as such method of disbursement complies with paragraphs (k)(1) and (k)(2) of this section. HUD encourages, but does not require, the servicer to follow the preference of the borrower, if such preference is known to the servicer.

(4) Notwithstanding paragraph (k)(3) of this section, a servicer and borrower may mutually agree, on an individual case basis, to a different disbursement basis (installment or annual) or disbursement date for property taxes from that required under paragraph (k)(3) of this section, so long as the agreement meets the requirements of paragraphs (k)(1) and (k)(2) of this section. The borrower must voluntarily agree; neither loan approval nor any term of the loan may be conditioned on the borrower's agreeing to a different disbursement basis or disbursement date.

* * * * *

3. In Appendix A to part 3500, under the text heading ''Line Item Instructions'', and under the subheading ''Section L. Settlement Charges'', the paragraph beginning with the phrase ''Lines 1301 and 1302'' is revised 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

* * * * *

Line Item Instructions

* * * * *

Section L. Settlement Charges

* * * * *

Lines 1301 and 1302, or any other available blank line in the 1300 series, are used for fees for survey, pest inspection, radon inspection, lead-based paint inspection, or other similar inspections.

* * * * *

4. Appendix C to part 3500 is amended by adding a new footnote 3 after the word ''Reserves'' in the first column of the table, and by adding the following text under the heading ''FOOTNOTES'' at the end after the text of footnote 2, to read as follows:

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

* * * * *

Footnotes

* * * * *

[3] As an alternative to using aggregate accounting with no more than a two-month cushion, the estimate may be obtained by using single-item accounting with no more than a one-month cushion.

Dated: January 13, 1998.

Nicolas P. Retsinas,

Assistant Secretary for Housing-Federal Housing Commissioner.

The following Appendix, ''Public Guidance Document, Consumer Disclosure for Voluntary Escrow Account Payments'', will not be codified in title 24 of the Code of Federal Regulations.

Appendix

Public Guidance Document

Consumer Disclosure for Voluntary Escrow Account Payments

The bills paid out of your escrow account are expected to increase substantially after the first year[.] [because ________ .] Under normal escrow practices, your monthly escrow payment in the second year could be much higher than in the first.

You may voluntarily choose to make higher payments during the first year to reduce or eliminate the monthly payment increase in the second year. If you are interested in doing this, contact: ____________________.

[INSTRUCTIONS TO PREPARER: You are encouraged to provide this document to borrowers when you anticipate a substantial increase in bills paid out of the escrow account after the first year of the loan. Explanation of the reason for the increase is recommended. The document may be delivered separately or combined with the Initial Escrow Account Statement. In the blank provided, insert the contact for further information, including the mailing address, fax number, e-mail address, and/or telephone number of the contact who will provide further information on making voluntary overpayments during the first year. The terms ‘‘reserve’’ or ‘‘impound’’ may be substituted for the terms ‘‘escrow account’’ or ‘‘escrow’’ to reflect local usage. These INSTRUCTIONS TO PREPARER should not appear on the form.]

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