Tax and Insurance Escrow Accounts

Tax and insurance escrow accounts contain funds held by a lender for future payment of property taxes and applicable insurance, such as homeowner/hazard insurance, flood insurance, and/or mortgage insurance Private Mortgage Insurance (PMI). Lenders utilize these types of escrow accounts to ensure that the loan collateral is protected from losses resulting from tax sales for unpaid taxes or lack of insurance coverage due to unpaid premiums.

At closing, taxes for the current year are pro-rated, and the buyer pays up-front for a homeowners insurance policy for one year. The escrow account is established on behalf of the lender to pay future tax bills and insurance renewals.

The lender does not pay interest on the funds held in escrow, and the lender does not charge a fee to manage the account. Lenders analyze the escrow account annually to prevent holding too much money, and the amount a borrower pays into the account each month can change to avoid accumulating overages or shortages.

The lender will generally calculate the tax escrow based on the tax bill used for prorations at closing. Sometimes, however, the tax assessment used for proration purposes is obviously much lower than future tax assessments will be - for example, cases where prorated taxes were based on unimproved property, or prorated taxes were calculated with exemptions no longer applicable for the new buyer. In such cases, the closing agent will calculate an estimated future tax bill based on formulas set forth by the taxing authority. The estimated future tax amount is then used to establish the escrow account.

Insurance escrows are based upon the known guaranteed renewal premium. If a renewal premium is not known or guaranteed, the escrows will be based on the annual premiums for the current year.

At closing, the settlement agent makes an initial deposit into the escrow account to set it up. The borrower then continues to make ongoing monthly deposits into the account with each monthly mortgage payment. When taxes or insurance renewal premiums become due, the account will pay out these items, and a cushion remains in the account going forward.