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Buydowns: Benefits, Types, Rules, and Frequently Asked Questions

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I. What is a Buydown?

A buydown is a financing method offered by lenders in which the interest rate of a given loan is lowered in exchange for an upfront payment. Buydowns can be either permanent or temporary. Permanent buydowns, typically called purchasing "discount points," permanently reduce the borrower's interest rate over the entire life of the loan, whereas temporary buydowns only reduce the borrower's interest rate over the Buydown Period, which usually lasts only a few years. *This article focuses only on temporary buydowns.*

In a temporary buydown, a lump sum payment is collected at closing (the Buydown Deposit) that goes into a Buydown Escrow Account. During the Buydown Period, the borrower will pay a reduced principal and interest (P&I) payment each month at the Buydown Rate. Meanwhile, every month, the servicing lender will draw down a Buydown Subsidy payment from the Buydown Escrow Account.

The Buydown Subsidy payment is calculated by subtracting the borrower's P&I payment at the Buydown Rate from the P&I payment at the Note Rate. The borrower's P&I payment at the Buydown Rate combined with the Buydown Subsidy payment are then applied together towards the outstanding balance and accrued interest on the loan each month as usual. As such, the total monthly payment made to the lender remains the same throughout the term of the loan; however, during the Buydown Period, the payments are made via the borrower and the Buydown Subsidy payment, while after the Buydown Period, the payments are made solely by the borrower.

There is no legally-fixed limit on how long the Buydown Period can last; however, it is typically from one to three years. The most common buydown arrangements are 2/1 buydowns, 3/2/1 buydowns, and 1/1 buydowns. See examples and explanations of these common buydown scenarios below in Section IV of this article.

II. Why Buydowns?

When interest rates increase and the demand for homes decreases, lenders and sellers are motivated to incentivize a sale or loan by offering a buydown. Due to the Federal Reserve consistently raising the Federal Funds Rate (the average interest rate that lenders pay for overnight borrowing in the federal funds market) since early 2022, home loan interest rates have risen accordingly, chilling the home-buying and lending market. In effect, temporary buydowns have become an increasingly popular method for sellers and lenders to encourage buyers to purchase houses and obtain mortgages.

For borrowers, buydowns provide the benefit of lowering their interest rate, resulting in a lower P&I payment throughout the Buydown Period. Having a lower monthly payment for the first few years of a loan may allow a borrower to put more money towards the initial deposit. Additionally, because the buydown is only spread over part of the loan term, rather than over the entire life of the loan, there is a larger *short-term* benefit to the borrower than if the total loan amount were reduced by the same amount.

For sellers, buydowns can appeal to buyers who are otherwise hesitant to purchase due to rising interest rates, thus allowing the sale to proceed, while also preventing the seller from reducing the posted sales price.

For lenders, buydowns provide assurance that the P&I will be paid and consistent throughout the loan term, while also ensuring that the loan can close without borrower hesitations regarding interest rates.

III. Types of Buydowns and How to Disclose Them

Buydown funds may come from the seller, lender, borrower, or any interested third party. Where the buydown funds come from determine how and where the buydown should be disclosed. Investors may have their own guidelines on how to disclose buydowns; therefore, *lenders should always ensure the buydown is disclosed pursuant to their specific investor's guidelines*.

1. *Borrower-Paid Buydowns*

   Borrower-paid buydowns are those in which the <u>borrower</u> pays the Buydown Deposit.

   According to the Consumer Financial Protection Bureau's official interpretation of 12 CFR § 1026.17(c)(1), "Consumer buydowns must be reflected as an amendment to the contract's interest rate provision in the disclosure of the finance charge and other disclosures affected by it given for that transaction . . . Depending upon the buydown plan, the consumer's prepayment of the obligation may or may not result in a portion of the amount being credited or refunded to the consumer. In the disclosure of the finance charge and other disclosures affected by it given for the mortgage, the creditor must reflect the terms of the buydown agreement."

   For a borrower-paid buydown, the Buydown Deposit should be reflected on Page 2, Section A, of the Closing Disclosure (CD). The Buydown Deposit must be included in the Truth-in-Lending (TILA) figures and reflected in the Proposed Payment Schedule on Page 1 of the CD.

2. *Seller-Paid Buydowns*

   Seller-paid buydowns are those in which the <u>seller</u> pays the Buydown Deposit.

   Regardless of whether the seller-paid buydown is reflected in the credit contract between the buyer and the lender, the seller-paid buydown should be disclosed as a seller's credit. Specifically, seller-paid buydowns should be reflected on Page 3, Sections L and N, of the CD.

3. *Third Party-Paid Buydowns*

Third party-paid buydowns are those in which a <u>third party</u>, such as a realtor or builder, pays the Buydown Deposit.

Whether the buydown is reflected in the credit contract between the Borrower and the Lender can impact how the buydown is disclosed. According to the Consumer Financial Protection Bureau's official interpretation of 12 CFR § 1026.17(c)(1), "If the third-party buydown is reflected in the credit contract between the consumer and the bank, the finance charge and all other disclosures affected by it must take the buydown into account as an amendment to the contract's interest rate provision." Otherwise, "[i]f the third-party buydown is not reflected in the credit contract between the consumer and the bank and the consumer is legally bound to the [same interest] rate from the outset, the disclosure of the finance charge and other disclosures affected by it given by the bank must not reflect any seller buydown in any way."

If the third party-paid buydown is part of the credit contract, the Buydown Deposit should be reflected on Page 2, Section A, of the CD. If the third party-paid buydown is not part of the credit contract, it should be reflected on Page 3, Section L, of the CD.

4. *Lender-Paid Buydowns*

Lender-paid buydowns are those in which the <u>lender</u> pays the Buydown Deposit.

According to the Consumer Financial Protection Bureau's official interpretation of 12 CFR § 1026.17(c)(1), "Typically, these transactions are structured as a buydown of the interest rate during an initial period of the transaction with a higher than usual rate for the remainder of the term. The disclosure of the finance charge and other disclosures affected by it for lender buydowns should be based on the terms of the legal obligation between the consumer and the creditor."

For disclosure purposes, a lender-paid buydown is treated similarly to a third-party buydown. If the lender-paid buydown is part of the credit contract, the Buydown Deposit should be reflected on Page 2, Section A, of the CD. If the lender-paid buydown is not part of the credit contract, it should be reflected on Page 3, Section L, of the CD.

5. *Split Buydowns*

In a split buydown, multiple parties are paying the Buydown Deposit. For example, if the seller pays half of the Buydown Deposit while the borrower pays the other half, that is a split buydown. Each portion of the split buydown is disclosed separately, as though they were individual buydowns.

The Consumer Financial Protection Bureau gives an example of a split buydown in its official interpretation of 12 CFR § 1026.17(c)(1): “a [seller] and a consumer both pay an amount to the creditor to reduce the interest rate. The creditor must include the portion paid by the consumer in the finance charge and disclose the corresponding multiple payment levels, except as otherwise provided in §§ 1026.18(s), 1026.37(c), and 1026.38(c), and composite annual percentage rate. The portion paid by the [seller] and the corresponding reduction in interest rate, however, should not be reflected in the disclosure of the finance charge and other disclosures affected by it unless the lower rate is reflected in the credit contract.”

IV. Examples

1. 2/1 Buydown: In a 2/1 buydown, the Buydown Period is 2 years. The Note Rate is “bought down” by 2% for the first year and 1% for the second year.

   Loan Parameters:
   - 30 year Conventional Fixed Rate
   - $100,000.00 Loan Amount
   - 5.500% Note Rate

Buydown Period	Borrower’s Interest Rate	Borrower P&I Payment	Buydown Subsidy Payment	Actual P&I Payment	Total Buydown Amount
Year 1 (12 mos.)	3.500%	$449.04	$118.75	= $567.79	$1,425.00
Year 2 (12 mos.)	4.500%	$506.69	$61.10	= $567.79	$733.20
Years 3-30	5.500% (back to Note Rate)	$567.79		$567.79	
				Total Buydown Deposit	**$2,158.20**

2. 3/2/1 Buydown: In a 3/2/1 buydown, the Buydown Period is 3 years. The Note Rate is “bought down” by 3% for the first year, by 2% for the second year, and by 1% for the third year.

   Loan Parameters:
   - 30 year Conventional Fixed Rate
   - $100,000.00 Loan Amount
   - 5.500% Note Rate

Buydown Period	Borrower’s Interest Rate	Borrower P&I Payment	Buydown Subsidy Payment	Actual P&I Payment	Total Buydown Amount
Year 1 (12 mos.)	2.500%	$395.12	$172.67	= $567.79	$2,072.04

Year 2 (12 mos.)	3.500%	$449.04	$118.75	= $567.79	$1,425.00
Year 3 (12 mos.)	4.500%	$506.69	$61.10	= $567.79	$733.20
Years 4-30	5.500% (back to Note Rate)	$567.79		$567.79	
				Total Buydown Deposit	**$4,230.24**

3. 1/1 Buydown: In a 1/1 buydown, the Buydown Period is 2 years. The Note Rate is "bought down" by 1% for the first year and 1% again for the second year.

   Loan Parameters:
   - 30 year Conventional Fixed Rate
   - $100,000.00 Loan Amount
   - 5.500% Note Rate

Buydown Period	Borrower's Interest Rate	Borrower P&I Payment	Buydown Subsidy Payment	Actual P&I Payment	Total Buydown Amount
Year 1 (12 mos.)	4.500%	$506.69	$61.10	= $567.79	$733.20
Year 2 (12 mos.)	4.500%	$506.69	$61.10	= $567.79	$733.20
Years 3-30	5.500% (back to Note Rate)	$567.79		$567.79	
				Total Buydown Deposit	**$1,466.40**

V. Frequently Asked Questions

1. *What is a "credit contract"?*

   For federal Regulation Z (12 CFR Part 1026) disclosure purposes, a "credit contract" refers to the legal obligation between consumer and creditor, i.e., the promissory note signed by the borrower.

2. *For split buydowns, are separate buydown agreements necessary for each contributing party?*

   No – separate buydown agreements are generally not necessary if the Buydown Deposit is being paid by more than one party. There can be one buydown agreement signed by the borrower and the contributing parties of the Buydown Deposit.

3. *Are there any special requirements for Veterans Affairs (VA) Loans regarding temporary buydowns?*

   No – the Department of Veterans Affairs will guaranty loans involving temporary interest rate buydowns, and will allow temporary buydowns for any type of VA-guaranteed loan.

4. *Are there any special requirements for Federal Housing Administration (FHA) Loans regarding temporary buydowns?*

   Yes - the Department of Housing and Urban Development (HUD), which governs the FHA, limits sellers and third parties in their contributions for buydowns corresponding with FHA-guaranteed loans. Specifically, HUD Rule 4155.1 2.A.3.b states that the "seller and/or third party may contribute up to six percent [(6%)] of the *lesser of* the property's sales price or the appraised value" toward the buyer's loan interest "for fixed rate mortgages."

   If the buydown exceeds 6% of the sales price, then the buydown is considered an "inducement to purchase" and will "result in a dollar-for-dollar reduction to the *lesser of* the sales price or appraised value of the property before applying the appropriate loan-to-value (LTV) factor," per HUD Rule 4155.1 2.A.4a. In other words, if the buydown given by a seller or third party exceeds 6% of the sales price, then the sales price must be reduced by the amount of excess buydown given by the seller or third party.

5. *Does the Federal National Mortgage Association (FNMA or "Fannie Mae") have special requirements for temporary buydowns?*

   Yes – FNMA's requirements regarding buydowns for secondary market loan sale eligibility purposes can be found in Section B2-1.4-04 of FNMA's Selling Guide.

   In particular, these requirements include:

   i. Temporary buydowns must not reduce the interest rate by more than 3%;
   ii. When the lender funds the buydown, the buydown agreement must require that the funds in the buydown account be transferred to the new servicer if the mortgage is included as part of a subsequent transfer of servicing;
   iii. Loans for investor properties cannot have buydowns;
   iv. Cash-out refinance loans cannot have buydowns;
   v. In no event may the buydown plan change the terms of the mortgage note;
   vi. The buydown period must not be more than 36 months (3 years);
   vii. There can be increases of no more than 1% in the portion of the interest rate paid by the borrower in each 12-month interval; and
   viii. When the source of buydown funds is a party other than the lender or buyer, those contributions are subject to FNMA's Interest-Party Contribution Limits in Sections B3-4.1-02 and B3-4.1-03 of their Selling Guide.

6. *Does the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac") have special requirements for temporary buydowns?*

   Yes – FHLMC's requirements regarding buydowns for secondary market loan sale eligibility purposes can be found in Section 4204.4 of FHLMC's Selling Guide, which are similar to FNMA's requirements.

In particular, these requirements include:

i. Loans for manufactured homes cannot have buydowns; and
ii. "No cash-out" refinance loans with buydowns funded from lender credit derived from an interest rate increase are ineligible.

7. *Does the Government National Mortgage Association (GNMA or "Ginnie Mae") have special requirements for temporary buydowns?*

   Yes – GNMA's requirements for loan guarantee, which can impact FHA and VA Loans in particular, can be found in Chapter 24 and Chapter 25 of their Mortgage-Backed Securities (MBS) Program Guide.

8. *For lender-paid buydowns, can the lender recoup remaining funds from the buydown subsidy balance if the loan amount has been paid off, as opposed to the remaining funds going to the borrower's loan balance?*

   Yes – if the Buydown Agreement includes an option for the lender to recoup any remaining funds when the loan is paid off before all the buydown funds are used, then the lender may do so. If the Buydown Agreement does not include this option, the buydown funds should be applied to the principal balance. This is based on FNMA's guidance in Section B2-1.4-04 of their Selling Guide.

9. *If a lender contributes to a buydown (in which the borrower did not contribute to the buydown amount) and also provides a separate, general Lender Credit for the borrower, can the Lender Credit be reduced by the amount of the lender's buydown contribution?*

   No – if no portion of the given buydown agreement was paid by the borrower, then the Lender Credit cannot be reduced by the amount of the lender's contribution. Rather, the Lender Credit would need to go toward borrower-responsible fees/costs (e.g., closing costs). Applying the Lender Credit to the buydown amount would be considered a Lender Credit reduction; an investor (if the loan is to be sold on the secondary market) would most likely require a cure in the amount of Lender Credit utilized towards the buydown.

   If the borrower *did* contribute to the buydown amount, then a Lender Credit could be applied to the borrower's contribution to the buydown, if agreed upon by the borrower and lender.

VI. Conclusion – Prepare for Buydowns when Interest Rates are High

Buydowns can bring a number of advantages for borrowers, lenders, sellers, and other interested parties in a loan transaction. So long as interest rates continue to have a chilling effect on the home-buying and lending market, buydown agreements will continue to be a topic often referred to in purchase and lending negotiations. Accordingly, all interested parties in these transactions should be prepared for, and informed of, buydowns as a financing option.

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