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TEMPORARY MORTGAGE BUYDOWNS

WHAT'S OLD IS NEW AGAIN!!

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Mortgage interest rates have steadily increased from an average of 3.11% at the end of 2021 to currently over 6.50% for a 30-year fixed-rate loan as of October 2022.[1] This rising interest-rate environment has caused lenders to look for ways to reduce the interest rate burden on their borrowers and make housing more affordable. One method is the temporary mortgage buydown or temporary interest rate buydown ("temporary buydown"), which was once fairly common but has not been seen for many years due to historically low interest rates during the last two decades. Mortgage lenders who haven't been in the business for decades are suddenly being introduced to this "new" (read "very old") product, which is quickly gaining popularity once again.

Lenders seeking to learn more about temporary buydowns have many questions. What is a temporary buydown? Who provides buydown funds and how is a buydown agreement memorialized? How does a buydown impact the TILA/RESPA Integrated Disclosures (TRID)? Which temporary buydowns are acceptable to the agencies? FHA? VA? What is the difference between a temporary buydown and a step rate loan? This paper will summarize temporary buydowns and address some of these important questions about the buydown product.

WHAT IS A TEMPORARY BUYDOWN?

A temporary buydown is an agreement whereby money is deposited into an escrow account at loan closing by the borrower, the mortgage lender, a seller, or third-party. The money is then drawn from the escrow account over a set period of time during the loan term and used to "buy down" the interest rate on the loan. In other words, the buydown funds deposited at closing subsidize the interest payments on the loan for a period of time, thereby reducing the interest burden on the borrower.

A temporary buydown is not the same thing as discount points, which are sometimes called a "permanent buydown". A permanent buydown is where the borrower pays one or more discount points at closing in exchange for a decrease in the interest rate for the life of the loan. For example, the borrower pays the lender "1 point" (1% of the loan amount) at closing and the loan's interest rate is decreased by .25% for the life of the loan.

[1] Freddie Mac Primary Mortgage Market Survey®; https://www.freddiemac.com/pmms.

Unlike a permanent buydown/discount point, a temporary buydown only reduces the interest rate for a certain amount of time as set forth in the temporary buydown agreement. Common temporary buydown structures are the "2-1" buydown (where the interest rate is bought down by 2% in the first year of the loan, 1% in the second year, and then reverts to the note rate) and the "3-2-1" buydown (interest rate reduced by 3% in year 1, 2% in year 2, 1% in year 3, and then reverts to the full note rate).

Once the buydown funds are exhausted and/or the buydown period comes to an end, then the interest payments on the loan are no longer subsidized and the borrower pays the full principal and interest payments set forth in the note.

HOW ARE TEMPORARY BUYDOWN AGREEMENTS MEMORIALIZED?

A temporary buydown is documented with a written temporary buydown agreement signed at the time of closing. The agreement identifies the loan whose interest rate is being "bought down", the borrower, the lender, the provider of the buydown funds, and the amount of funds that will be deposited into escrow. It also establishes the length of the buydown period, the amount of interest (as a percentage) that will be bought down during the various stages of the buydown period, and the disposition of remaining buydown funds in the event the loan is refinanced or satisfied during the buydown period. The disposition of funds could be a refund of unused buydown funds to the provider of those funds or to another party, or an application of remaining buydown funds to the principal balance of the loan.

The Official Staff Commentary to Regulation Z, Section 1026.17(c)(3) distinguishes between a seller or other third-party temporary buydown that is reflected in the "credit contract between the consumer and the bank" (i.e., the loan documents such as note and deed of trust) and a third-party temporary buydown that is documented in a separate agreement and is not reflected in the credit contract itself.[2] This distinction is significant because Regulation Z states that if the terms of a separate third-party temporary buydown agreement are not reflected in the credit contract, then they do not affect the Finance Charge, Annual Percentage Rate (APR), or other TRID disclosures. Rather, the disclosures simply reflect the terms of the credit contract.[3] If the terms of the temporary buydown <u>are</u> reflected in the credit contract, however, and are not segregated in a separate buydown agreement, then Regulation Z requires that the terms of the temporary buydown be calculated into the Finance Charge, the APR, and other TRID disclosures.[4]

Because temporary buydowns have not been commonly used since well before TRID took effect in 2015, many systems used to calculate TRID disclosures are not programmed to incorporate the terms of a temporary buydown into the Finance Charge, APR, or other TRID disclosures. Accordingly, if a temporary buydown agreement can be memorialized in a separate agreement that is segregated from the credit contract, it makes disclosing the loan subject to the temporary buydown agreement under Regulation Z much simpler.

HOW IS A TEMPORARY BUYDOWN DISCLOSED UNDER TRID?

As stated above, Regulation Z distinguishes between a seller or other third-party temporary buydown whose terms are reflected in the credit contract between lender and borrower, and a third-party temporary buydown whose terms are set forth in a separate agreement and are not reflected in the credit contract. And, for the reasons stated above, it is desirable to ensure that the terms of a seller or other third-party temporary buydown are <u>not</u> reflected in the credit contract. Assuming that is the case,

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[2] *See* Regulation Z, Section 1026.17(c)(3), Comments 3(i) & (ii).
[3] *See* id. at Comment 3(ii).
[4] *See* id. at Comment 3(i).

Regulation Z requires that the finance charge, APR, and other TRID disclosures be calculated solely based on the terms of the credit contract (ie. the promissory note).

Aside from the official staff commentary to Section 1026.17(c)(3), however, Regulation Z does not address disclosure requirements for loans subject to temporary buydown agreements. Sections 1026.19, 1026.37 and 1026.38 of the Regulation do not include specific instructions for disclosing temporary buydowns in TRID disclosures.[5] When disclosing a loan under TRID that includes a separate seller or other third-party temporary buydown agreement, therefore, the impact of the temporary buydown on the TRID disclosures should be minimal.

One major caveat, however, is that secondary market investor requirements for loans subject to a temporary buydown agreement may vary from investor to investor. Lenders who intend to sell such loans in the secondary market should always ensure they know their investor's specific requirements for TRID disclosures when the loan is subject to a temporary buydown agreement. This paper discusses temporary buydown requirements found in the FNMA Selling Guide below. Other secondary market investors, however, may have additional overlays.

Setting aside secondary market requirements, a third-party temporary buydown pursuant to a separate buydown agreement that is not reflected in the credit contract can be shown on page 3 of the standard format Closing Disclosure (CD) in the Summaries of Transactions section as an amount "Due from Borrower at Closing" in Section K. A corresponding credit from the third-party may then be reflected in Section L as "Paid Already by or on Behalf of Borrower at Closing". Reflecting the buydown in this manner will cause the amounts shown in Section K and Section L to offset one another and the buydown funds will not impact the "Cash to Close" from the borrower. The temporary buydown is not reflected on page 1 of the CD in the "Projected Payments" table, and likewise does not impact the Total of Payments, Finance Charge, Amount Financed, APR, or Total Interest Payment disclosures in the "Loan Calculation" section of page 5. A third-party temporary buydown is not disclosed on the LE.

A seller temporary buydown is likewise not disclosed on the LE. On the CD, a seller temporary buydown that is documented via a separate agreement that is not part of the credit contract can be shown as an "Amount Due From Seller" in Section N of the Summaries of Transactions.

The official staff commentary to Regulation Z provides that a lender temporary buydown (ie. the lender provides the buydown funds) is "analogous" to a seller or third-party temporary buydown for disclosure purposes.[6] As long as a lender temporary buydown is documented in a separate buydown agreement and is not part of the credit contract between lender and borrower, then the temporary buydown can be disclosed in the Summaries of Transactions Section in the same manner as described above for a third-party buydown. If the terms of the temporary buydown are part of the credit contract between lender and borrower, however, then they must be calculated into the finance charge, APR, and other TRID disclosures.[7]

Unlike seller, lender, or third-party buydowns, a consumer buydown (i.e., a temporary buydown where the borrower provides the buydown funds at closing) must be reflected in the Finance Charge, APR, and other TRID disclosures.[8] For a consumer buydown, Regulation Z does not distinguish between a buydown that is reflected in the credit contract and one that is documented in a separate agreement. In

[5] *See* Regulation Z, Sections 1026.19, 1026.37 & 1026.38.
[6] See Regulation Z, Section 1026.17(c)(3), Comment 4(ii).
[7] *See* id.
[8] *See* Regulation Z, Section 1026.17(c)(3), Comment 4.

either case, the amount paid at closing by the borrower is considered a Prepaid Finance Charge.[9] In addition, a composite APR must be calculated that takes into account both interest rates (with and without the buydown) and the effect of the Prepaid Finance Charge.[10] Finally, the Projected Payments Table on Page 1 of both the LE and CD must reflect the multiple rates and payment levels resulting from the buydown, and the Product disclosure in the "Loan Information" Section of page 1 of both the LE and CD must reflect a "Step Rate" product.[11]

Disclosing a consumer buydown under Regulation Z is considerably more complicated than disclosing a seller, lender, or other third-party temporary buydown that is not part of the credit contract. Before attempting to disclose a loan subject to a consumer buydown, lenders should ensure the system they use to generate TRID disclosures is programmed to support such disclosures and the system operator understands the Regulation Z requirements for consumer buydown disclosures.

AGENCY, FHA, AND VA TEMPORARY BUYDOWN REQUIREMENTS

FNMA Selling Guide

Section B2-1.4-04 of the FNMA Selling Guide addresses Fannie Mae's requirements for "Temporary Interest Rate Buydowns".[12] The Guide includes the following general requirements for temporary buydown loans:

a. Temporary buydowns are allowed in connection with fixed-rate mortgages and certain ARM plans for principal residences and second homes (investment properties are ineligible). A temporary buydown may not be used in connection with a loan underwritten as a "cash-out refinance";

b. The rate reduction from the buydown may not exceed 3%, the buydown period may not be greater than 36 months, and the rate increase may not exceed 1% per year;

c. The temporary buydown plan must be a written agreement between the party providing the buydown funds and the borrower. Any buydown agreement must provide that the borrower is not relieved of his or her obligation to make the mortgage payments required by the terms of the promissory note if, for any reason, the buydown funds are not available. The buydown agreement may include an option for funds to be returned to the borrower or lender (if the lender funded the buydown) if the mortgage is paid off before all buydown funds have been applied. And a copy of the buydown agreement must be included in the delivery of documentation to Fannie Mae.

d. All of the terms of the temporary buydown plan must be disclosed to Fannie Mae, the mortgage insurer, and the property appraiser; and

e. The mortgage instruments must reflect the permanent payment terms rather than the terms of the temporary buydown plan. The buydown plan may not change the terms of the mortgage note.

In addition, the Selling Guide imposes other requirements on temporary buydowns. For example, when the source of the buydown funds is an interested party to the property sale or purchase transaction, then Fannie Mae's interested-party contribution limits apply. For a lender temporary buydown, the

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[9] *See* id. at Comment 4(i)(A).
[10] *See* id. at Comment 4(B).
[11] *See* id. at Comment 4(C).
[12] *See* Section B2-1.4-04 at https://selling-guide.fanniemae.com/Selling-Guide/Origination-thru-Closing/.

buydown agreement must require that the buydown funds be transferred to the new servicer if the mortgage is included in a subsequent transfer of servicing.

Section B2-1.4-04 of the FNMA Selling Guide includes other requirements relating to temporary buydowns, and the list above in not exhaustive. Before originating a loan underwritten to FNMA requirements that includes a temporary buydown, lenders should consult the Selling Guide and any other applicable investor overlays to ensure compliance with secondary market requirements.

FHLMC Seller/Servicer Guide

Section 4204.4 of the FHLMC Seller/Servicer Guide addresses Freddie Mac's requirements for "Temporary subsidy buydown plans".[13] The Guide includes the following general requirements for temporary buydown loans that will be sold to FHLMC:

a. Temporary buydowns are permitted for fixed rate loans and certain ARM plans secured by a principal residence or second home (investment properties & manufactured home loans are ineligible), but are not permitted for 3/6 month ARM loans.

b. For any mortgage with a buydown plan, the initial interest rate may not be more than 3% below the note rate. The buydown plan may not extend for more than three years after the first scheduled payment date.

c. For both "limited buydown mortgages" (no more than two years and 2% below the note rate) and "extended buydown mortgages" (no more than three years and 3% below the note rate), the borrower must be qualified at the interest rate reflected in the note.

d. The borrower must agree in writing that the buydown funds will be automatically applied each month to reduce the monthly payment of principal and interest to the extend provided under the buydown agreement. The buydown agreement must provide that the borrower is obligated to make the full payments under the note if, for any reason, the buydown funds are not available or paid.

Section 4204.4 of the FHLMC Seller/Servicer Guide includes other requirements relating to temporary buydowns, and the list above is not exhaustive. Before originating a loan underwritten to FHLMC requirements that includes a temporary buydown, lender should consult the Seller/Servicer Guide and any other applicable investor overlays to ensure compliance with secondary market requirements.

FHA & VA

The Federal Housing Administration (FHA) mortgage insurance program and the Veteran's Administration (VA) mortgage guaranty program both permit temporary buydowns on loans they insure or guaranty, as long as those loans are otherwise eligible under their respective programs.

HUD Handbook 4000.1 provides that temporary buydowns are permitted for FHA fixed-rate purchase mortgages; a temporary buydown is not permitted in connection with ARM loans or

[13] *See* Section 4204.4 at https://guide.freddiemac.com/app/guide/section/4204.4

refinances.[14] Likewise, a temporary buydown is not permitted in connection with property improvement loans or loans secured by manufactured housing.[15]

For eligible mortgage loans, FHA permits Interested Party Contributions to be used to fund temporary buydowns, subject to the general Interested Party Contribution limits.[16] In addition, FHA requires the following regarding temporary buydown escrow agreements:

a. The escrow agreement must not: permit reversion of undistributed escrow funds to the provider if the Property is sold or the Mortgage is prepaid in full; nor allow unexpended escrow funds to be provided to the Borrower in cash, unless the borrower funds were used to establish the escrow account.

b. Payments must be made by the escrow agent to the Mortgagee or servicing agent. If escrow payments are not received for any reason, the Borrower is responsible for making the total payment as described in the mortgage Note.[17]

VA Pamphlet 26-7 provides that a temporary interest buydown may be used in conjunction with any type of VA-guaranteed loan.[18] Chapter 7 of the Lender's Handbook includes the following VA requirements for temporary buydowns:

a. Escrow Agreement Funds must be safely escrowed with an independent third-party escrow agent beyond the reach of prospective creditors of the builder, seller, lender, and the borrower. Exception: If the Federal National Mortgage Association is the holder, it may take custody of the funds.

b. The escrow agent must make payments directly to the lender or servicer. The funds may be used only for payments due on the note. The funds may not be used to pay past due monthly loan payments. If the loan is foreclosed or prepaid, the funds must be credited against the Veteran's indebtedness.

c. Escrowed funds may not revert to the party that established the escrow. If the property is sold subject to, or on an assumption of the loan, the escrow must continue to pay out on behalf of the new owner.

Depending on whether the lender expects the borrower's income to keep pace with payment increases as the interest rate rises during the buydown period, the VA Lender's Handbook includes underwriting requirements for loans subject to temporary buydown agreements, including when decreases in the buydown payment must occur on a specific schedule and the length of the buydown period.

The summary above is not an exhaustive recital of all requirements that FHA and VA may impose on a mortgage loan subject to a temporary buydown agreement. Before originating an FHA-insured or VA-guaranteed loan subject to a temporary buydown agreement, lenders should carefully review the requirements of HUD Handbook 4000.1 or the VA Lender's Handbook, Chapter 7, as applicable, to ensure that the loan is underwritten to FHA or VA requirements.

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[14] *See* HUD Handbook 4000.1, Section II, Chapter A – 8 (Programs and Products – Refinances 9/26/2022); *see also* id. at Chapter A – 8 (Programs and Products – Section 251 Adjustable Rate Mortgages 9/14/2015).

[15] *See* id. at Chapter E – 2 (Property Improvement Loan Program); *see also* id. at Chapter E – 4 (Manufactured Home Loan Program).

[16] *See* id. at Chapter A – 5 (Manual Underwriting of the Borrower).

[17] See id. at Chapter A – 6 (Closing).

[18] *See* VA Lender's Handbook – Pamphlet 26-7, Chapter 7 at https://www.benefits.va.gov/warms/pam26_7.asp.

TEMPORARY BUYDOWN VS. STEP-RATE LOAN

Although a temporary buydown mimics the practical effect of a step-rate loan, the two products have key differences and should not be confused. Both step-rate loans and temporary buydowns feature a lower rate of interest for a set period of time at the beginning of the loan term, which then subsequently increases. A step-rate loan, however, is not subject to a separate written agreement and does not involve the escrowing of funds at closing in order to subsidize the mortgage interest rate. Rather, a step-rate loan simply has a lower rate of interest for a period of time, which then "steps up" to a higher rate of interest.

Significantly, the interest rate increases in a step-rate product are set forth directly in the credit contract between the borrower and lender (i.e., the promissory note). Accordingly, Regulation Z has specific disclosure requirements for step-rate loans that do not apply to a loan subject to a temporary buydown agreement that is separate from the credit contract between borrower and lender. When disclosing a step-rate loan, the LE and CD must reflect the terms of the step-rate feature in the Projected Payments table, the Finance Charge, the APR, and other TRID disclosures. The TRID disclosures for a loan subject to a seller, lender or third-party temporary buydown agreement, however, do not reflect the terms of the temporary buydown as long as the buydown terms are not reflected in the credit contract between the borrower and lender (as a step-rate feature would be).

Since a temporary buydown includes the funding of an escrow account at closing with the buydown funds, which are then applied to mortgage payments pursuant to the buydown agreement, if a loan subject to a temporary buydown is refinanced, assumed, or foreclosed before the buydown funds are exhausted then money will remain in the buydown account which can be applied in the manner set forth in the buydown agreement. A step-rate loan, however, does not include an account that can be transferred or refunded in the same manner as a temporary buydown loan.

For example, if the borrower refinances a loan during the buydown period, the remaining buydown funds can be refunded to the provider of the funds or to the borrower. If the loan is assumed during the buydown period, the funds can be used to benefit the assumptor. In a foreclosure scenario, the buydown funds can be credited towards the debt. Disposition of the buydown funds in any of these scenarios is determined by the terms of the buydown agreement. None of these options exist for a step-rate loan, in which the interest rate simply increases during the term of the loan.

CONCLUSION

For as long as mortgage interest rates continue to increase beyond the record low rates largely prevailing during the past twenty years, temporary interest rate buydowns will remain an option that may benefit certain borrowers. Ironically, the temporary buydown is a very old mortgage product that all but disappeared for many years. In today's challenging environment, however, what's old is new again!

This paper is intended only as a general summary of requirements that apply to mortgage loans subject to a temporary buydown. It should not be construed as legal advice relating to any specific loan transaction. Likewise, this summary is not exhaustive and other legal or secondary market requirements that are not described herein may apply to loans subject to temporary buydown agreements. Lenders should understand the regulatory requirements associated with temporary buydowns, as well as the requirements that secondary market investors and government loan insurance or guaranty programs have for the documentation and disclosure of temporary buydowns.