CALIFORNIA ASSOCIATION OF REALTORS®

QUICK GUIDE

Temporary Interest Rate Buydowns

Rising interest rates have priced some buyers out of the real estate purchase market. Some sellers and lenders have found a way to help buyers afford a home by reducing the buyer's contribution to the monthly mortgage payment by using a "temporary interest rate buydown" program. (Note that permanent buydowns are also available if the seller pays a buyer's points – but that is not the focus of this Quick Guide.)

How does a temporary interest rate buydown work? Initially, a buyer's monthly mortgage payments are calculated just as for any other loan by considering the home's purchase price, buyer's deposit and down payment, and market interest rate. However, for the first one, two or three years of the loan the buyer will pay a reduced amount based on what the buyer's payments would have been if the interest rate was lower than the market rate. The lender, however, still receives the full amount based on the market interest rate. The difference between the market rate payments and the buyer's reduced payments will be paid from a fund that the seller deposits with the lender at closing. The seller's payment is used to "buy down" the buyer's interest rate for the first few years of the loan so the buyer only pays what would have been owed to the lender under a reduced interest rate. The seller's payment is considered a seller credit.

Since the payments increase after the buydown period, how does this help a buyer? Even though a buyer must still qualify for the loan at the market rate, the shock of the high monthly mortgage payments can be lessened by using a temporary interest rate buydown. The buyer would hope that interest rates decrease after the purchase so they could refinance at the then lower rate and avoid the jump in payments to the closing market rate. Or possibly, the buyer could hope for an increase in income by the time of the jump in payments so that the buyer could more easily afford the higher payments.

Since the seller effectively pays for a portion of the buyer's payment during the buydown period, how does this help a seller? A seller may need to incentivize buyers to increase interest in the seller's property. By making the seller's home affordable to a greater number of buyers, the seller may be able to get a higher price than otherwise available in the marketplace. In a sense, the "buydown" is no different than other credits that a seller may offer a buyer as an inducement to buy, such as payment of closing costs or credits in lieu of repairs. The upfront payment of money by the seller can help achieve a successful closing and allow the seller to transfer the property more quickly than would otherwise be possible.

How would a buyer ask the seller for an interest rate buydown? A buyer could write in appropriate language into paragraph 3G(2) in the RPA. It would be best to use language approved by the buyer's lender that is offering the buydown program. A starting point could be something like, "Seller to credit buyer $ ______ , at closing, to be used to buy down buyer's loan payments [for the first (1) (2) (3) years of the loan] [to the following equivalent interest rates: __% for year one, __% for year two, __% for year three] [as per the loan program approved by _____________ (lender)].

What other contract clauses should be considered by buyer and seller before agreeing to an interest rate buydown? Paragraph 5E of the RPA, and 1C of any of the counteroffer forms, limit the amount of any contractual credits to those allowed by the buyer's lender. If other credits are provided for in the transaction, the buyer should take care to make sure that the limit does not exceed that allowed by the lender. Any disallowed contractual credits will not automatically result in a reduction of the purchase price and may impact the buyer's ability to buy or to afford to make necessary repairs.