

Topic 7: Loans Involving Temporary Interest Buydowns

Change Date: July 27, 2023

- Subsection b. has been updated to clarify when a temporary buydown may be used in conjunction with a VA-guaranteed loan and how escrowed funds are to be held.
- Subsection c. has been updated to clarify buydown payment schedules.
- Subsection d. has been updated to clarify how to underwrite loans involving a temporary buydown.
- Subsection e. has been added to include information on when a temporary buydown is considered a seller concession.

a. Description

VA generally allows two types of temporary interest rate buydowns. One is a marketing tool, where builders, sellers, or lenders establish and fund escrows to temporarily reduce a borrower's loan payments during the initial years of the loan. A second is where a borrower funds an escrow account for herself/himself as a financial management tool. Lenders may not fund or establish a temporary buydown by charging an above market interest rate.

VA can guaranty loans involving temporary interest rate buydowns, provided that the loan meets all other applicable requirements.¹

In VA's home loan programs, temporary interest rate buydowns can only be used in conjunction with fixed rate loans.

b. Escrow Agreement

Funds must be held in a segregated escrow account. The lender is responsible for ensuring that the escrowed funds are legally protected and used only for payments due under the note. The funds may not be used to pay past due monthly loan payments, or for any other purpose. If the loan is foreclosed or prepaid, the funds must be credited against the Veteran's indebtedness. The 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 borrower.

It is the lender's responsibility to review and determine the acceptability of the buydown and ensure that it complies with all applicable federal and state laws. Lenders must provide the Veteran with a clear, written explanation of the buydown agreement. A copy of the buydown and escrow agreements, signed by the Veteran, must be maintained in the lender's loan file.² Lenders must submit such agreements to VA if the loan is selected for review.

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¹ See 38 U.S. Code § 3703(c) (authorizing guaranteed loans with interest rates agreed upon by the Veteran and lender).

² 38 C.F.R. 36.4333.

*Topic 7: Loans Involving Temporary Interest Buydowns, continued***c. Buydown Payment Schedule**

The monthly buydown payments must run for a minimum of 1 year and cannot exceed a maximum of 3 years. Common frameworks for temporary buydowns are 3-2-1 (3 years) and 2-1 (2 years). Reductions in the buydown payments must be scheduled to occur annually, i.e., on the anniversary date of the first loan payment due date. A reduction in the buydown payment means the Veteran's monthly loan payment will increase. To avoid serious financial disruption, VA limits the increase in the Veteran's payment to an amount that corresponds to a one-percent interest rate increase (effective interest rate).

Annual increases can be rate-based or payment-based. If rate-based, the Veteran's payment increase can correspond to equal annual increases in the effective interest rate. If payment-based, the Veteran's monthly loan payments must increase in equal or approximately equal dollar amounts, year over year. Please see the examples below.

Example of equal interest rate increase: A Veteran obtains a \$300,000, 30-year home loan, at an interest rate of 5%, with a two-year, 2-1 temporary buydown. The total monthly amount due under the note is \$1,610. In year one, the Veteran's effective interest rate will be 3%, and in year two the Veteran's effective interest rate will be 4%. In year three, the buydown period is over and the Veteran will start making payments at the full interest rate of 5%. The Veteran's effective interest rate increased by the same amount, i.e., 1 percentage point, for each annual adjustment.

Table 10: Example of an Equal Interest Rate Increase

Year	Effective Interest Rate	Veteran Payment	Monthly Buydown Contribution	Total Payment
1	3%	\$1,265	\$345	\$1,610
2	4%	\$1,432	\$178	\$1,610
3-30	5%	\$1,610	\$0	\$1,610

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Chapter 7: Loans Requiring Special Underwriting, Guaranty, and Other Considerations

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Example of equal monthly payment increase: A Veteran obtains the same loan described in the example above. In year one, the Veteran’s monthly payment is \$1,305 per month with \$305 per month coming from the buydown escrow. In year two, the Veteran’s monthly payment is \$1,457 per month with \$153 per month coming from the buydown escrow. In year three, the buydown period is over and the Veteran’s monthly payment is \$1,610. The Veteran’s monthly payment increased by approximately the same amount, i.e., \$153 per month, for each annual adjustment.

Table 11: Example of an Equal Monthly Payment Increase

Year	Effective Interest Rate	Veteran Payment	Monthly Buydown Contribution	Total Payment
1	3.25%	\$1,305	\$305	\$1,610
2	4.14%	\$1,457	\$153	\$1,610
3-30	5%	\$1,610	\$0	\$1,610

d. Underwriting Considerations

The lender must underwrite the loan and determine that the Veteran can afford the full payment amount under the note, without considering the monthly buydown contributions being applied from escrow.

Nevertheless, the buydown arrangement can be considered a compensating factor for residual income and/or debt-to-income calculations. If these calculations produce marginal results, the buydown plan (which could be used, for example, to offset a short-term debt), along with other compensating factors, may support approval of the loan. See “Compensating Factors” in Chapter 4 of this Handbook.

A statement with the reasons for approval, signed by the underwriter, must be maintained in the lender’s loan file. Lenders must submit the statement to VA if the loan is selected for review.

e. Seller Concessions

Temporary interest rate buydown funds provided by the builder or seller are considered seller concessions. See Chapter 8, Topic 5 of this handbook for more information.