Understanding Mortgage Rate Buydowns

Story by insider@insider.com (Andrew Dehan) • 3mo • 6 min read

- In an interest rate buydown, the seller pays mortgage points on the buyer's mortgage, lowering the interest rate.
- Permanent buydowns are more beneficial than price reductions for the buyer and the seller.
- Also called seller buydowns, they're better for buyers who plan on living in the same house for a long time.

Higher mortgage rates and home prices can prohibit many consumers from getting a mortgage and buying a house.

An interest rate buydown, though, could help. These allow buyers or other involved parties — like the lender or seller — to pay for a lower interest rate. This can reduce the amount of interest the buyer pays, both monthly and over the long haul, considerably.

Types of mortgage rate buydowns

An interest rate buydown is where one party — the buyer, lender, or seller — agrees to pay an upfront fee to lower the buyer's interest rate.

Temporary vs. permanent buydowns

Buydowns can be permanent for the life of the loan or temporary, lasting only the first few years.

The choice between temporary vs. permanent rate buydown options depends on your budget, what the lender or seller is offering, the market, and other factors, but in recent years, buydowns are more often temporary, offering a short reprieve from high interest rates.

Many people opt for a 2-1 buydown. This lowers interest by two points during the first year and one point during the second year. After that, interest returns to the original rate.

"Homebuyers can have a lower payment for two years and ideally be able to refinance right as rates are coming down in the future," says Steve Hill, lead mortgage broker for SBC Lending.

Point-based buydowns

Permanent buydowns are typically done by buyers, agreeing to pay their mortgage lender money upfront in exchange for a lower rate.

This practice is often referred to as buying mortgage points, as you'll pay one "point" and, in return, get an incrementally lower interest rate. The more points you buy, the lower your rate goes. (Though lenders may put a cap on how many points you can purchase).

How mortgage rate buydowns work

How mortgage buydowns work depend on the type you're using. See below for details on buyer-paid buydowns and those paid for by other parties.

The process of buying down a rate

If you're buying down your rate yourself, you'll buy mortgage points. Each point costs 1% of the loan amount and usually lowers the interest rate by about 0.25%. You'll hand these fees over along with your down payment at the closing table.

Other parties can purchase buydowns, too. When a seller or lender does it, the buydown is reflected in the closing costs as "seller credits" or "lender credits." These are usually a tool used to secure a buyer in a competitive market. In lieu of taking a lower offer or making other concessions, a seller can offer a buydown, which will lower the buyer's monthly mortgage payment — either temporarily or permanently — making the purchase more attractive.

Calculating the cost and savings

If a lender or seller offers you a buydown, that's a win-win, even if it's temporary (as long as you can handle the higher payment later on).

If you hope to buy points yourself, though, you'll need to do some math. Specifically, you'll want to calculate the breakeven point — which is the point at which you'll break even on the costs of the buydown. We'll go into this math more later on.

Benefits of mortgage rate buydowns

The benefits of buying down a mortgage rate primarily pertain to affordability.

Lower monthly payments

First, lower rates mean buyers get a lower monthly payment. This could help them afford a home more easily and without stretching their budget.

Considerations before opting for a buydown

If a lender or seller offers you a buydown, that's a win-win, even if it's temporary (as long as you can handle the higher payment later on).

If you hope to buy points yourself, though, you'll need to do some math. Specifically, you'll want to calculate the breakeven point — which is the point at which you'll break even on the costs of the buydown.

buydown.

Analyzing the break-even point and your long-term vs. short-term homeownership plans

Think of this as a cost analysis of mortgage rate buydowns. To calculate yours, take the total cost of the points and divide it by the monthly savings you'd get from it. This will tell you how many months it will take to break even.

From here, you'll need a good idea of how long you plan to be in the home. If you think you'll still be there to reach the breakeven point, then the buydown is probably a good idea. If you're not sure, the move could be risky.

Current and future financial situation

Keep in mind that if you're getting a temporary buydown, you'll need to be confident in your future finances. Once your rate buydown expires, your rate and payment will revert to the original ones quoted by your lender. You'll want to be sure you have the cash to cover this increased payment when the time comes, or you could risk foreclosure.

How to get a mortgage rate buydown

Buying down your rate yourself is pretty simple, but if you want someone else to cover the costs, you'll need to work for it. Use the following strategies for negotiating rate buydowns with lenders and sellers.

Negotiating with lenders and exploring lender credits

Shop around with lenders, and see if any are offering promotions. If rates are high, lenders may offer buydown promos to tempt buyers away from other companies. If you're not finding any, get loan quotes from several lenders and use those estimates to negotiate with others. There's a chance some will offer temporary buydowns to remain competitive.

Seller contributions

To get a home seller to cover your buydown, work with your real estate agent. Sellers are more likely to pay for buydowns in a buyer's market — when there are more properties for sale than buyers. They also may prefer to offer a buydown than lower the price of the home (the math usually works out better in the long run).

And if you do secure a seller buydown, make sure it's clearly outlined in your purchase contract. That's a legally binding document that both buyer and seller must adhere to.

FAQs

What is a mortgage rate buydown?

A mortgage rate buydown allows a borrower or other party, like a lender or seller, to pay an upfront fee to reduce the interest rate on a mortgage. This leads to lower monthly payments, either for a few years or the life of the loan.

What's the difference between temporary and permanent buydowns?

Temporary buydowns reduce the interest rate and monthly payments for a few years at the beginning of the loan. Permanent buydowns lower the rate and payment for the entirety of the loan's term.

How do I know if a mortgage rate buydown is right for me?

If you're paying for the buydown yourself, you'll need to calculate the breakeven point and make sure you'll be in the home long enough the save more than the buydown cost. With temporary buydowns paid for by other parties, you'll need to consider your financial situation and make sure you'll have the funds to cover a higher rate and payment later on.

Can I negotiate a mortgage rate buydown with my lender?

Yes, you can negotiate a rate buydown with your lender. Lenders may also offer buydown options as part of their loan products, which can be discussed during the loan application process. Lenders are more likely to offer this in high-rate environments to entice buyers.

Are there any alternatives to buydowns for reducing mortgage payments?

You may be able to reduce your payment by taking out a smaller loan, making a larger down payment, or exploring low-rate government-backed loan programs. Having a good credit score can also help you get a lower interest rate and payment.

Read the original article on Business Insider
If you enjoyed this story, be sure to follow Business Insider on Microsoft Start.