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ADVISORY RULING #56

The Bureau has had a number of requests for our opinion concerning various "buydown" arrangements in real estate transactions. A "buydown" arrangement is one in which a buyer's monthly payment is subsidized for a certain period (1-5 years) so as to lower the effective contract interest rate in the early years of the mortgage loan. At the expiration of the buydown period, the buyer is responsible for the full monthly payment required by the original contract interest rate.

Buydown programs are being offered by sellers themselves, builder-developers, real estate agents, the secondary market, and private mortgage insurers. In most cases, the effect is to increase the selling price of the home by the amount of the subsidy, thereby increasing the mortgage amount. The subsidy, if provided by the seller, is usually extracted from the proceeds of the mortgage loan and deposited in an escrow account. Payments are made monthly either to the buyer or directly to the lender for the subsidy period. Plans differ on the buyer's right to interest earned by the escrow account and the buyer's right to a rebate of amounts remaining in the subsidy account upon prepayment of the loan (sale of home) during the buydown period.

Code Implications

If the transaction is one within the jurisdiction of the Consumer Credit Code (i.e., first lien mortgage by a licensed lender, any mobile home transaction, any second lien mortgage over 12¼%), nothing in the Code prohibits buydown agreements.

The Bureau views buydown subsidies provided by the buyer to be a prepaid finance charge which must be included in the finance charge for the purpose of determining maximum finance charges allowable in Article II of the Code. This would potentially be the case in the Fannie Mae program in which the buyer (or a relative) may provide the subsidy.

If a builder (or other party to the transaction) seeks to secure repayment of the subsidy amount from the buyer by means of a second mortgage, the Code is applicable if the interest rate exceeds 12¼%, see §1-301(14)(B)(ii). The following provisions may be applicable: Sections 2-307 (restriction on land as security); 2-308 (maximum loan term/equal payments/equal amounts); 2-507 (prohibition on attorney's fees and collection costs); 2-509 (prohibition on prepayment penalties). In

addition, the builder (or other party) may be viewed as a "creditor" (see Section 1-301(17)) subject to licensing (Sec. 2-301) and registration (Sec. 6-201) requirements.

The Bureau distinguishes a buyer's "points" situation from a pledged account program in which the buyer deposits part of his downpayment in a pledged savings account and uses these funds to buydown monthly payments for a set period. This latter program is often known as a Flexible Payment Loan ("FLIP"). The buyer's downpayment is not increased as a condition for the FLIP and the buyer earns interest on the deposit account and receives remaining funds on account

in the event of prepayment. This program is usually offered in conjunction with private mortgage insurance(s) as to allow the lender to keep his exposure within usual limits.

Buydown programs in which the subsidy is derived from the seller or builder-developer are not subject to the limitations on maximum finance charges.

Disclosure Implications

The following advice is based on revised Regulation Z (12 CFR 226, 46 Fed. Reg. 20848, April 7, 1981), issued pursuant to the Truth in Lending Simplification Act and the proposed Commentary to Reg. Z (TIL-1, 46 Fed. Reg. 28560, May 27, 1981).

If the creditor is offering the buydown program and the note reflects (or a separate agreement between the creditor and the consumer reflects) the subsidy agreement, TIL disclosures must reflect the effect of the subsidy (See Section 226.17(c)). If the subsidy is not a part of the legal obligation between the consumer and creditor, the disclosures must not reflect the effect of the subsidy.

If the buyers' points are involved, this prepaid finance charge must be reflected in the Annual Percentage Rate. Sellers' points should be excluded from the APR.

Required deposit accounts that earn more than 5% interest to the buyer are not required to be disclosed pursuant to §226.18(r) of Reg. Z. See TIL-1, §226.18(r).

Only a "creditor" has the obligation to disclose pursuant to TIL. A third party that arranges the subsidy agreement or a builder who provides subsidies is not required to give TIL disclosures. However, TIL advertising rules apply to any "person" whether he is the creditor or not. Advertising of credit terms must comply with Regulation Z, §226.24. The same rules for determining the disclosure of the subsidy apply to advertising the effect of the subsidy.

Other Comments

While not a matter of law or regulation, the Bureau will advise consumers to consider the terms of any buydown agreement carefully. We will recommend that: (1) consumers remember that an increased selling price will result in increased finance charges over the term of the loan; (2) consumers ask whether interest paid on escrow accounts revert to them or another party; and (3) consumers ask whether they will lose their subsidy account prepayment.

/s/ Barbara R. Alexander

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