Amortization and balloon mortgages

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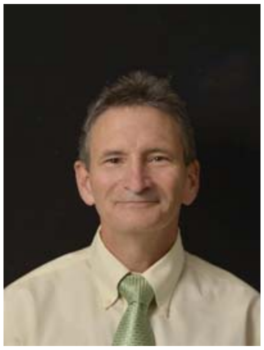

(Photo: Provided)

When we borrow money for our home (a mortgage), we usually have to pay back the principal borrowed along with an interest rate. These loans are "amortized" which means that a series of payments are scheduled with a decreasing percentage of interest cost and an increasing amount of principal payment over time.

If we did not amortize a loan, it would look more like a credit card charge-being the principal owed plus the interest on that entire amount for the month. Payments would progressively drop as the principal owed decreased presumably on a time based proportional schedule.

To explain, imagine that we borrow 120,000 dollars at 10 percent for a home for 10 years. We might structure the loan to pay off the 120,000 dollars equally over the 120 months of the loan at $1,000 dollars a month principal payoff. So, payment one would be $1,000 plus interest for one month on the full $120,000 for one month (another $1,000). Each month, the principal payment would be the same, but the interest would drop. For example, after one full year, the principal owed is down by $12,000 to $108,000 and the next payment would be the $1,000 principal reduction plus interest on $108,000 for one month (about $900). The last mortgage payment would be $1,000 in principal plus interest on $1,000 for one month, or about $1,010 total.

To level out the payments to be the same over the term of the loan, the mortgage is "amortized", such that mostly interest is credited in the early years and principal in later years. So, in the same loan as above amortized over ten years, the first payment would be $1,585, with only $585 applied towards principal reduction. The last payment would also be $,1585, with all but $13 applied to principal.

A balloon mortgage implies that the loan is over before the principal is paid off. If the loan above is amortized over ten years (meaning that if the loan will last the full 10 years till all paid off), but "balloons" at five years, the principal owed at five years must be paid to the lender at that time. With a standard, 10-year amortized loan as above, at the end of five years, the borrower would owe the lender a little over $61,000. A balloon mortgage allows a lender to avoid the interest rate risk associated with a long term loan, but while charging a fixed rate of interest. It is an alternative to charging an adjustable rate on the loan and usually allows a lower initial fixed rate of borrowing.

The risk of a balloon mortgage is that interest rates when the loan is due may be much higher than they would be when compared to a "capped" ARM. Or, your credit status may have worsened such that refinancing would be troublesome. In most cases, an ARM is a better choice to use for financing if an initially lower interest rate is desired.