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The Truth About Balloon Payment Loans

Just the name “Balloon Payment” is enough to alarm anyone, so this article was written to bring to light what that term really means. To better understand the truth about balloon payment mortgages, we first need to comprehend the word “amortization.”

Amortization means that the total sum of the loan is divided into much smaller amounts to be disbursed as monthly payments over the life of the loan. For example, if your mortgage is a $200,000 amortized 30 year loan, the $200,000 will be divided into 360 payments of upwards of a thousand dollars each, paid monthly for 30 years. Initially your payments will consist of about 90% interest and only 10% principal. Not until more than half way through your loan’s term will your principal and interest even out, and by the end of the 30 years you will be paying almost completely principal with only a fraction of the payment going toward interest each month. At the close of the term you will have completely paid off your $200,000 mortgage and you will own your home.

With that understood, we can now return to our original topic. A balloon payment loan is amortized for a long period of time (typically 30 years), but must be paid in full in a short period of time (from 3 to 10 years). For example, a common balloon payment mortgage is one that is amortized for 30 years (so the payments reflect the example above) but the remaining principal is due after only 7 years. Since the first few years of payments are devoted primarily to interest, the remaining principal at the end of the 7 years is almost equal to the original loan. Since the majority of buyers cannot afford the full amount at once, most people either sell or refinance before the balloon payment falls due. But remember, refinancing includes its own fees and many times re-qualification, so it could end up being a bigger hassle than you originally thought.

Balloon payment mortgages often have lower interest rates than conventional loans, so the low payments for the first few years may seem attractive. If you’re absolutely certain that there will be a way for you to pay the balloon payment when it arrives, the low interest rates for the first few years could save you money. Nevertheless, all things considered, if you are interested in low initial payments, there are safer, better options than balloon payment loans. The benefits do not outweigh the risks involved, and you would be wiser to look elsewhere.