Amortization explained...

If you know a little French or Latin, and "mort" has you thinking "death", you're on the right track (although "deaden" or "kill" might be a little closer). The amortization of a loan is the process by which the balance is reduced (killed) over time.

Amortization Schedule

The payment schedule for your loan is called its amortization schedule—a table showing how each scheduled payment breaks down between principal and interest and how the loan balance declines over time. My favorite calculator for generating an amortization schedule is at BrettWhissel.net, but hand-figuring an amortization schedule is pretty simple. Depending on how you're wired, this is either an a satisfying, Zen-like experience or the ultimate cure for insomnia:

1) This month's loan balance x note rate / 12 = interest due this month
2) Minimum payment* – interest due this month = principal paid this month
3) Loan balance – principal paid this month = next month's loan balance
4) Repeat.

**Make sure you use the minimum monthly payment for just principal and interest. Exclude taxes, insurance and mortgage insurance.*

Fixed Rate vs. ARM

Fixed rate mortgages have an initial amortization schedule set at closing. The minimum monthly payment is the amount needed to pay all interest plus pay the balance to zero over the term of your loan. If you pay extra amounts toward your principal, you can save lots of interest (seriously... lots) and you will shorten the term of your loan, but you will not alter your minimum monthly payment.

Adjustable rate mortgages re-amortize each time the interest rate adjusts. If you've overpaid on an ARM, upon adjusting, your new monthly payment takes that overpayment into account. Paying extra toward the principal can take some (even all) of the sting out of an increase to your interest rate.

Exceptions

The vast majority of home loans are amortizing loans with relatively level monthly payment schedules, but there are exceptions. A loan with an Interest-Only Payment does not amortize. A loan with Negative Amortization has a payment schedule whereby the loan balance increases due to a minimum payment that does not pay the interest accrued—the unpaid interest gets added to the principal balance.

Recasting

Some fixed rate mortgages have a re-amortization (or "recast") feature, permitting you to request a recalculation of your monthly payment upon paying a lump sum after closing. If you're curious about this, we have a pdf with more information.

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