

What does capitalization of a loan mean?

Loan capitalization occurs when accrued and unpaid **interest is added to the principal**. The balance of a loan is made up of two major components: the principal, which is the amount borrowed, and the interest, which accrues regularly on the principal.

When unpaid interest is capitalized, it's added to the balance of the loan. Capitalized interest makes your loan balance grow larger. As a result, you're not only borrowing the original loan amount, you're also borrowing to cover the interest costs. Because of that, you also have to pay interest on the interest your lender charged

Example:

As a college student, you take out a college loan that has a non-zero interest rate, but payments need to be made for 5 years. You are deferring payment of both the initial loan and the interest.

Every month for those 5 years, you effectively borrow more money from the lender to pay the interest on the loan and accrued interest.

At the end of the 5 years, you now have a larger loan, which you must now pay as a conventional mortgage.

Note: This is analogous to you putting money in the bank (investing in the bank) and your balance increases as the bank pays you interest. In a capitalized loan, the roles are reversed and the bank is investing in you. The bank expects you to pay back both the initial loan/investment and accrued interest.

In the long term, this is a two part computational problem.

Part 1, the first 5 years: This is treated as a saving account computation, where the initial value is the loan amount. The final value is the initial loan plus accrued interest.

Part 2, the payoff years: This is treated as a conventional mortgage computation, where the loan amount is the initial loan plus the accrued interest.