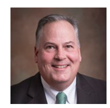
Student Loan Options: Making Smart Decisions

Sticking to federal direct student loans can help limit debt accumulated in college and give you the flexibility of income-driven repayment plans after college.

KEY INSIGHTS

- An important step in college preparation is researching the types of student loans and their repayment terms.
- We recommend limiting debt to federal direct student loans, which have reasonable interest rates and offer flexible repayment options.
- If your loans are significant in relation to your income, choosing one of the four income-driven federal repayment plans can help lower your monthly payments.
- In some situations, you could benefit from forgiveness of a portion of your debt—but you have to pay attention to the details.



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Summer and fall are important seasons for families to research student loans. If your household includes a student preparing to apply to colleges, you'll want to factor cost into the decision and be mindful of the amount of debt that could be accrued. The challenges colleges and students face in the pandemic are a reminder to think carefully about the value of different education options.

If you have a recent college graduate, congratulations! If student loans were part of their funding plan, repayment of those loans will start soon, and the graduate should carefully evaluate the available options.

As a parent, your perspective can help your child make smart decisions around borrowing for college and the realities of taking on debt.

First things first—limit your debt

As a financial planner, I recommend that families limit their education debt to federal direct student loans, if possible, or at the very least take them as the primary source of student debt. These loans are provided by the U.S. Department of Education, and they have several advantages:

- They offer reasonable interest rates and do not require a credit check. Currently, the interest rate for new loans to undergraduates is 2.75% (as of July 2020).
- They limit the amount that you can borrow. Holding yourself to this limit can help you choose a college that is financially reasonable and avoid accumulating too much debt. Over the full course of an undergraduate program, the most that dependent students can borrow is $31,000.

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- If you demonstrate financial need, some of these student loans may be subsidized. This means that the government will cover the interest until you graduate or leave college.
- They provide a variety of repayment options, including income-driven repayment plans.
- If you face economic hardship or unemployment, these student loans may allow for a temporary pause or reduction of loan payments through deferment or forbearance.

After you leave school—consider your federal direct loan repayment options

The standard repayment method for federal direct student loans is a fixed monthly payment for 10 years. Using the standard method (or even paying down your loans faster than that allotted time) limits the interest you'll incur and helps you eliminate student debt in early adulthood. However, you may want to consider income-driven repayment plans if your loans are significant in relation to your post-college income.

There are four structurally similar income-driven federal repayment plans. One option, which has a potentially helpful combination of terms, is the "Pay As You Earn" (PAYE) plan. Here's how it works:

- Your monthly payment is no more than 10% of your discretionary income (in other words, your gross income minus 150% of poverty level income).
- Poverty level is the same throughout the continental U.S. (it's higher for Alaska and Hawaii) and depends on your household size. It is adjusted annually for inflation.
- Payments are recalculated yearly via a recertification process. Under this program, the required payment will never be higher than the original standard payment amount.
- After successfully making 20 years' worth of payments, any remaining balance will be forgiven.

For example, suppose you graduate with $34,000 of federal direct student loans (including accrued interest) with a 2.75% rate. The standard repayment would be around $324 per month for 10 years. Under the PAYE plan, your payment would depend on your income relative to the poverty level. If you're single with no dependents, your applicable poverty level is $12,760 per year, and 150% of that is $19,140. If you earn $40,000 per year, that makes your discretionary income $20,860. Your annualized payments would be 10% of that—$2,086—and dividing that amount by 12 would result in an initial monthly payment of $174.

At first glance, this looks great, since $174 is much lower than $324. But remember that you'll be paying off your loans longer. And, if your income increases—let's assume by two percentage points faster than inflation—your monthly payment will increase gradually, eventually reaching the $324 standard payment. In this scenario, it would take nearly 14 years to pay off your loans, as opposed to 10 years. Additionally, using this method means that you wouldn't have any of your loan forgiven, and your total payments would be about $2,800 higher under the PAYE plan than with the standard plan.

However, there are reasons the income-driven plan may still be preferable:

- If your cash flow is tight, reducing the monthly payment could help you pay essential expenses without high-interest credit card debt.
- Alternatively, you could use the extra cash to increase your retirement plan contributions or other investments. While investment returns aren't guaranteed, you could potentially benefit from returns higher than the loan interest rate.

Adjusted Gross Income (AGI) Level Where Forgiveness at 20 Years Could Outweigh the Longer Repayment Schedule

	AGI threshold, based on number of people in household (indicated at the top of each column)			
Federal direct student loan balance	**1**	**2**	**3**	**4**
$7,000	$18,000	$24,000	$29,000	$35,000
$15,000	$21,000	$27,000	$32,000	$37,000
$23,000 (maximum undergrad subsidized loans)	$24,000	$30,000	$35,000	$40,000
$29,000 (approx. average ending debt for four-year private colleges)	$26,000	$32,000	$37,000	$42,000
$34,000 (approx. undergrad maximum debt, including accrued interest)	$28,000	$34,000	$39,000	$44,000

Source: T. Rowe Price calculations; average debt per studentloans.gov. Assumptions: Poverty levels for continental U.S. as of July 2020 (**https://aspe.hhs.gov/poverty-guidelines**); 2.75% interest rate; 2.4% inflation (for poverty levels and tax brackets); 4.4% income growth (2 points above inflation); federal tax law as of 2020, including brackets, student loan interest deduction, and taxable loan forgiveness; state taxes are not considered. Does not reflect any interest on the cash savings from lower monthly payments—extra cash is assumed to be spent or held in a zero-interest account. Household size refers to the student borrower and his or her spouse and dependents.

- If you work for a government or not-for-profit organization, you could be eligible for Public Service Loan Forgiveness (PSLF). The benefit is that your loan could be forgiven after 10 years instead of 20. This program requires you to use one of the income-driven repayment plans.

- If PSLF doesn't apply, but your loan balance is significant and your household income is modest, you may still benefit from having part of the balance forgiven. The table above shows income levels where potential forgiveness could make total cash outlays lower under the PAYE plan.

Finally, pay attention to the details

- There is helpful information available at studentaid.gov, including a loan simulator to evaluate options for your specific situation.

- Follow the rules. It's critical to complete recertification paperwork to capture any need to make your payments on time. There are numerous reports that PSLF eligibility rules are being tightly enforced.

- If you choose an income-driven plan with investing or reducing high-interest debt in mind, remember that reaping these benefits takes discipline. Setting up automatic investments and budget guardrails can help enforce good habits.

- Remember that things can change over time—your income, marital status, dependents, and other factors. Continue to reevaluate your situation and whether lower payments still help you. You can always pay extra principal on federal loans without penalty.

Understanding the available student loan repayment options is important; the decisions that are made today can greatly affect your child's financial situation in the future.

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