

# Student Loans 101: Deciphering The Educational Lending Debacle

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As more and more students seek financial assistance to pay for all or part of their college education, many are swayed into poor financial decisions that bury them under a lifetime of educational debt. The following material offers: a) information about the wide variety of loans available, b) the monumental changes in the educational lending business since September of 2007, and c) the importance of fiscally responsible decision-making with respect to choices of lenders as well as deferment and repayment options.

Unlike grants and scholarships, **educational loans** consist of borrowed money that *must* be repaid with interest, just like car loans and mortgages. These loans *cannot* be canceled because of dissatisfaction with the education received or a lack of employment in the desired career or field of study. They constitute legal obligations and will not be eradicated, even by bankruptcy.

Before any amount of money is borrowed, a bare bones budget must be created by students for their time during veterinary school and after they receive their degrees to ensure that they do not borrow any more than is necessary. The only way to do this effectively is to calculate the total cost of repaying this debt at various interest rates and different terms of years and, then, to add to that their expected costs of living and income taxes. The hope is that as this is done, students will have a clearer understanding of the true effect of the money they are borrowing. Lastly, they must then relate all of this financial information to their potential income generation to see what will be required to balance their budgets after graduation.

Any education at the collegiate level must be considered an investment. However, because the veterinary degree adds four more years to the cost of this investment, matching the right educational loans and debt level to the potential career income is crucial to investing this money wisely. For example, if the only way for a student to complete the necessary education and training to become a veterinarian is to acquire loans exceeding \$220,000 and they are unwilling to work 40 plus hours per week for more than 25 years, then a career in veterinary medicine most likely will not provide them with a good enough ROI (return on investment) for their loans to be considered a smart use of the money they are borrowing.

## *Understanding the different types of educational loans, where the money comes from, and what key terms apply to them*

Much of the information that follows is available on web pages at [www.studentaid.ed.gov](http://www.studentaid.ed.gov) and/or [www.finaid.org](http://www.finaid.org).

1. **Direct Stafford Loans.** These are direct loans that come from and are repaid directly by the borrower to the federal government. These loans are available to all undergraduate, graduate, and accelerated or continuing education students.
  - a. **Subsidized Stafford loans** are available only to students who have financial need.

The federal government pays the interest while the student is in school and/or an internship or residency in a post-secondary educational institution and during what is called the grace period. **Grace periods** consist of the time between graduation and a date when repayment of all federally subsidized loans starts. This is usually six months after graduation.

- b. **Unsubsidized Stafford loans** are available to all students, regardless of financial need. However, unless the interest on this loan is paid while students are in school, it cumulates and is added to the loan amount when payments start.

- 2. **Federal Family Education Loans (FFEL).** These are federal student loans made by private lenders (usually banks) that provide funds and for which students make loan repayments directly to the bank. As with Direct Loans, the federal government regulates and guarantees the repayment of these. FFEL loans consist of: a) Stafford loans described above as Direct loans, b) FFEL PLUS Loans, and c) FFEL Consolidation Loans. Prior to 2008, vigorous competition forced banks to offer FFEL loans with various types of incentives. These often included a reduction of 0.25% in the interest rate for direct withdrawals from checking accounts and up to another 1% reduction in the rate for 36 consecutive on time payments. Interest rate reductions for direct deposits still exists in some programs, however if borrowers suffer through a month with insufficient funds to make a payment, this reduction in many cases is lost forever.

As a result of regulatory changes in educational loans by the U.S. Congress in 2007, many FFEL lenders drastically reduced or eliminated these incentives for loans originated after October 2007. This will likely continue unless the federal government makes additional changes to the program. (Again, visit [www.finaid.com](http://www.finaid.com) for the most up-to-date information.)

- 3. **Graduate PLUS Loans (Direct and FFEL).** These loans are only available to graduate students and are in addition to Stafford loans. The interest rates on these loans are a few points higher than Stafford loans (8.5% for FFEL Graduate PLUS loans and 7.9% for Direct Graduate PLUS loans). After borrowing the maximum allowed through the Stafford Loan program, students may borrow up to the cost of attendance in Graduate PLUS. The university determines the amount needed to fulfill the cost of attendance.
- 4. **Health Professions Student Loans (HPSL).** These, too, are need-based, long term, low interest (five percent) loans provided by the U.S. Department of Health and Human Services for health professional schools, including veterinary schools. If these loans are available at the student's school, the financial aid office will determine the eligibility. As with subsidized Stafford loans, the interest is paid by the government while borrowers are enrolled in schools, during internships and residencies and over a one year grace period.
- 5. **Perkins Loans.** These loans are offered by schools to students who have the greatest financial need. Perkins loans come from the schools that students attend and, thus, are repaid to the school itself. Perkins loans are low interest (5%) and have no additional fees or charges unless borrowers default on their payments. As with subsidized Stafford loans, the interest is paid by the government while the borrower is enrolled in school, during internships and residencies and over a nine month grace period.
- 6. **Private Loans.** These are educational loans from banks and/or other financial institutions that lend money to students who are unable to obtain enough money from the above loan sources and, thus, who are at a higher risk of defaulting than those students who do not need this supplemental

money. These loans usually come with loan origination fees, some of which could be as high as 8% of the loan balance. Occasionally, students mistakenly use private loans before exhausting all available federal loans. This can be a costly mistake. Private student loans can be a helpful source of funds when federal loans are not available (e.g. during internships or for relocation expenses). However borrowers must understand the effect of the high interest rates and costs of taking out such loans.

Interest rates for private loans in 2008 varied from the prime rate minus 0.5% to prime plus 4%, depending on one's credit scores and credit worthiness – as determined by the bank. (Personal experience with Wachovia, July 2008). In 2009, the average private loan interest rate is around 10% and this is during a time of extremely low interest rates. Since private loans almost always have variable interest rates, these loans will likely have much higher rates in the future when interest rates begin to trend back upward to the average. The turmoil in the credit markets has caused lenders to increase the margins (prices) on loans as well as the credit standards. The results are higher priced private student loans that are more difficult to obtain.

### ***Ways to Obtain Money for Education that Don't Need to be Repaid by Borrowers***

While almost all students can qualify for loans, some can acquire money that does not need to be repaid. The most common forms for this come from grants and scholarships. Some schools also offer achievement awards, commuter discounts, as well as work study programs to ease the financial burden facing their students.

1. **Pell Grants.** Unlike loans, Pell Grants do not need to be repaid and are usually provided only to undergraduate students who have documented severe economic needs. These grants are available to undergraduate and graduate students but not for accelerated or continuing education students.
2. **Scholarships.** In addition to a multitude of athletic scholarships that provide a full ride for athletes, in exchange for their athletic performances, millions of dollars in scholarship money are awarded for other reasons. This includes everything from academic performance to simply being left handed. If you don't mind writing essay after essay, there likely is a scholarship that is right for you. For more information about potential scholarships log onto [www.scholarship.com](http://www.scholarship.com) or contact your university's financial aid office.
3. **Tuition Reimbursement.** In an effort to improve the value and knowledge of their employees, some employers offer tuition reimbursement benefits to employees interested in continuing or finishing their education. Benefits can range from partial to full reimbursement with limited to no commitment from the employee to stay employed by the company. These are tax deductible for the employer and result in tax-free income for employees. They are called §529 Qualified Tuition Programs (QTPs) or §529 Plans. If you are employed even part-time at a veterinary practice at which you are likely to seek work after graduation, ask your employer about this option.
4. **Federal Relief.** The federal government has recognized the need to relieve the educational debts for employees working in the field of education. Thus, it is creating loan repayment incentives for students entering this arena.
5. **Work Study.** Most universities offer work study programs where students can work for the school or organization in exchange for discounted tuition, paid tuition, class credit, or other benefits. Work study differs from reimbursement because the money goes directly to the

university strictly for tuition. Most jobs are only available through the schools that students attend.

### ***Who's in Charge: Regulating Financial Aid***

In general, the U. S. Government regulates the majority of the educational loan market for college students through federal legislation that sets interest rates and allows for funding directly by the federal government (Direct Loans) or by private banks through the FFEL approach such as by Bank of America, JPMorgan Chase, Sallie Mae, Wachovia (now owned by Wells Fargo) and many more. Loans that are derived through the banking industry are funded via an infusion of money primarily from private investors in the form of notes known as securities. The banks form lending relationships with students and receive loan payments directly from them (FFEL loans).

Up until 2007, banks were able to receive an attractive return on their investments in the student loan business. Though profit margins may not have been as high as in other investment sectors, students generally paid back their loans, and if they defaulted, the government backed the loans.

### ***What pushed some banks out of the market?***

Two key factors contributed to the spring 2008 exit of over 55 lenders who made up 13% of the total student loan market ([www.money.cnn.com](http://www.money.cnn.com), April 2008).

1. As part of the federal legislation signed by President Bush in September of 2007, Banks began receiving lower subsidies from the federal government in the form of a lower interest rate margin with which to work. Historically, the interest rate for the federally-backed FFEL loans was set at the 90-Day Treasury Bill rate plus 2.34%. This gave banks a reasonable margin with which to work and still make money on their educational loan portfolios. However, as part of this 2007 legislation, Congress lowered the subsidy for these loans to the T-bill rate plus 1.79% for loans originating after July 1, 2007. This 0.55% reduction in the subsidy lowered the margins for the banks. Coupled with the second major change in the financial sector, i.e., higher funding costs as a result of the subprime real estate mortgage debacle; it became clear that bank lenders could no longer generate any profits from this line of business ([www.money.cnn.com](http://www.money.cnn.com), April 2008). In fact, many who considered staying in the business found that they would lose money on each educational loan they made.
2. The 2007-2009 credit crunch that has hit Wall Street. Changes in the real estate mortgage market that started in 2007 caused interest rates to go up as a result of the reduced amount of available capital. Millions of borrowers with adjustable rate mortgages (ARMS) have seen their variable rate interest loans rise by as much as several percentage points. This has brought about the default in payments on such loans by up to 2% of homeowners across the USA, much higher than that in some hard hit regions of the U.S.A. As a result of this change in the market, large financial institutions such as Citigroup, Merrill Lynch, Lehman Bros., Countrywide Financial, and Bank of America have lost hundreds of billions of dollars. One of the five biggest, Bear Stearns, was saved from bankruptcy only by action of the Federal Reserve Banking System and a buyout by JP Morgan Chase. Lehman Brothers went bankrupt. To avoid a bank failure, Wachovia was purchased in the fall of 2008 by Wells Fargo, one of the wiser banks that had not been devastated by the subprime mortgage mess.

The result has been private investors demanding higher interest rates for their securities. Historically, this has been the source of the money lenders have used for their educational loans. This resulted in less (or in many cases no) money available for educational loans in 2008 and, when coupled with a slowing economy and higher risks of default by debt burdened recent graduates, the educational loan industry was thrown into a spring 2008 turmoil ([www.bloomberg.com](http://www.bloomberg.com)).

The bottom line: lower subsidies from the government and increased borrowing costs for banks in the educational lending industry have made the federally guaranteed student loan market an unprofitable venture for the banks that previously served as a major source of funds for student loans.

### ***The Future of Student Lending and Educational Debt***

**Government** In May of 2008, the Federal government passed a bill (H.R. 5715) allowing the U.S. Department of Education to buy the remaining 2007-08 federally guaranteed loans that had not been purchased by private banks. Without government intervention, it was expected that demand for loans to fulfill the needs of students headed to school in the fall of 2008 would have vastly exceeded supply. This, in turn would have prevented many students from attending school and many universities from balancing their budgets. A June 11, 2008 report estimated that students will borrow about \$93 billion for the 2008-2009 academic year, \$70 billion of which is expected to come from federally guaranteed loans ([www.bloomberg.com](http://www.bloomberg.com)).

**Banks** Although many banks have temporarily or permanently left the student loan business, some of the larger ones are taking up some of the slack and other smaller lenders, such as Graduate Leverage continue to offer student loan programs. The May 2008 legislation allowed the government to infuse more money into the student loan market, which will allow committed banks to issue new loans for the 2008/2009 academic year. The Ensuring Continued Access to Student Loans Act (ECASLA) was extended for another year to ensure there are no disruptions for federal loans for the 2009/2010 academic year. The steps taken by the government thus far appear to prevent access issues for students. However, without this intervention, the industry would face further difficulties.

### ***Loan CONSOLIDATION – Major changes that have occurred in recent years.***

1. Prior to July 1, 2006, Stafford loans were variable rate loans that changed each July 1<sup>st</sup> as adjusted by the 90-Day Treasury Bill rate. After the stock market crash of March 2000, interest rates in general and educational interest rates specifically dropped from approximately 8% in 2001 to below 2.7% during 2003 and 2004. As interest rates on all loans went up nationally a few years later, the rate on education loans rose to 4.7% in 2005 and was changed to a fixed rate of 6.8% for graduate students for all new Stafford loans disbursed after July 1, 2006. The department of education announced that the rate for 7/1/2008 until 6/30/2009 would continue to be 6.8% for **graduate students**. The interest rate for undergraduate loans will gradually drop to 3.4% by 2011 (on subsidized Stafford only). More information, including updated rates, can be found at [www.studentaid.ed.gov](http://www.studentaid.ed.gov).
2. Prior to the 2006 legislation on this subject, students could consolidate their loans while in school. Even better, as interest rates dropped, they could consolidate (i.e. fixing the interest rate downward) more than once. This was big business for all of the bank lenders from 2003 to 2006. During that time students were consolidating their loans at less than 3% and in some cases with

the aid of various incentives, achieving interest rates as low as 1.2%. **Unfortunately, those days are long gone for most students.**

As it stands in the spring of 2009, students can still consolidate their older federal loans, but it probably only makes sense to consolidate those **variable rate federally guaranteed loans** that were originated in undergraduate or veterinary school prior to July 1, 2006 and even then, only after they graduate. Consolidation of loans while in school is no longer possible. For those few veterinary students who still have such loans, the in-school variable rate is set at 3.61% for the time period from 7/1/2008 until 6/30/2009 for both subsidized and unsubsidized loans.

Over the last year, the Federal Reserve has further lowered interest rates creating a unique opportunity for those lucky students who are graduating with **variable rate loans**. The new rate for variable rate Stafford loans taking effect on July 1<sup>st</sup> will be announced in late May of 2009. Based on the rates in January 2009, it appears students may have the ability to lock-in a rate below 2% for these older loans.

Since no one knows what will happen with interest rates, it will be advisable to consider loan consolidation upon graduation. With that in mind, the new interest rate announcement will dictate the best time to consolidate (before or after July 1<sup>st</sup>). Students who have these unique variable rate loans should also consider consolidating half-way through the six-month grace period that exists immediately following graduation. This way borrowers can use up the majority of the grace period during which payments are not due while still locking in lower interest rates. Various requirements and terms exist depending on each individual's loan portfolio. Because most private lenders no longer offer federal consolidation loans, recent graduates will likely need to use the Direct Loan program for consolidation. For more information on federal loan consolidation, visit [www.loanconsolidation.ed.gov](http://www.loanconsolidation.ed.gov).

Graduate Leverage also provides a service to help students determine if consolidation provides a savings opportunity. If so, this lender can help facilitate the process ([www.GraduateLeverage.com](http://www.GraduateLeverage.com)).

### ***Loan Extensions and Deferments***

**Consolidation.** In many situations, loan consolidation was the only option that allowed students who borrowed vast amounts of money for college to lower their monthly payments to levels that allowed for repayments without living with their parents in a rent free existence. This choice would extend loans from an impossible monthly repayment amount paid over ten years, to a workable level paid over thirty.

Additionally, in those good old days, students could place all of their variable rate loans (from 2.7% to 6.8%) into a group and then ask banks to compete with incentives to consolidate them into one loan. In accordance with federal government guidelines, banks would use a **weighted average** interest rate for this process. This meant calculating the dollar amount of each loan at its interest rate and then arriving at a new interest rate after weighing the amount of money borrowed at each rate. When that was complete, students could extend their loan repayment period from the standard ten years in various increments up to thirty years at the weighted average interest rate. This would drop the monthly payment down to a more reasonable level in the early years after graduation to allow for "a life," even though it would require that borrowers spend remarkably more money for interest over the extended term of the loan.

**Effective with the legislation in 2007, except as mentioned above, loan consolidation became a less attractive or totally unavailable option.** It was replaced only with the option of extending the new fixed rate for graduate level student loans of 6.8% to twenty-five years. These "loan extensions" are now

typical method students can use to bring monthly payments down to an affordable level. However, a new program (Income Based Repayment) provides an alternative low payment. It is discussed below

Upon graduation, loans typically have a six-month **grace period** during which students do not have to make any payments. After this grace period there are two different ways to delay payment, each of which will generate even more interest in most cases! **Graduates who feel they will be unable to make their monthly payments should not waste any time before contacting their loan providers. Fees and penalties are high for missing payments and can adversely affect credit scores.** That, in turn, leads to higher interest rates for credit card and other debts incurred for costs of living or auto loans.

1. **Deferments.** This is a temporary suspension of loan payments where interest does not accrue to the borrower on subsidized loans but does accumulate on unsubsidized ones. Graduates must meet certain qualifications to receive a deferment. The most common for federal loans are listed below but the entire list can be found at [www.dlssonline.com/borrower/DefermentFormList.do?cmd=initializeContext](http://www.dlssonline.com/borrower/DefermentFormList.do?cmd=initializeContext) .
  - a. In-school deferments are for students who are enrolled in school at least half time and fulfill the qualifications for this valuable aid.
  - b. FFEL education related deferments are for students seeking post-graduate training at institutions of higher education or at other named institutions or organizations during their graduate fellowships, internships, and residencies. Interest is deferred on subsidized loans but cumulates on unsubsidized ones, although borrowers have the option of paying the unsubsidized interest as they go – if they can.
  - c. Economic hardship deferments (EHD). Borrowers qualify for this type of deferment for up to three years post-graduation and qualification is based on their debt to income ratio until the qualification requirements change on July 1, 2009. Qualification must be achieved each year. This type of deferment was often used by students who were in private practice internships or residencies. Similar to the above types of deferment, borrowers will not accrue interest on subsidized loans but will accrue interest on all unsubsidized loans, adding to the loan balance to be repaid once payments start again. As mentioned, the qualification requirements for EHD are set to change in July, 2009 at which time it will become extremely difficult to qualify, as debt levels will no longer be part of the equation. ([www.studentaid.ed.gov](http://www.studentaid.ed.gov).)
  - d. Unemployment deferments. Borrowers who are unable to find employment may qualify for deferments for up to three years. Again, interest cumulates on all unsubsidized loans during this period and is added to the principle.
  - e. Military deferments. These have been created for those who pursue military service. For more information on this option visit [www.studentaid.ed.gov](http://www.studentaid.ed.gov).
2. **Forbearance.** This is a temporary suspension of loan payments where interest accrues on both subsidized and unsubsidized loans. Graduates do not need to meet any qualifications to be granted forbearance, and may reapply for up to five years in some cases. Forbearance is granted at the discretion of the lender. As expected, the loan balance will rise substantially but this may give new graduates time to grow into their career, earning a much higher salary than the first year after graduation.

3. **Loan Origination Fees.** These fees are charged to process the origination of educational loans for students. Although these fees were often paid by lenders, now almost all federal loans and many private loans have origination fees. The good news is that the federal government is phasing out origination fees on both FFELP and Direct Stafford loans.
4. **Loan Discounts.** Historically, banks competed for business by offering a variety of incentives to sign with them. For an excellent list of these and the percentages of students who miss deadlines and, thus, lose these discounts, visit [www.finaid.org/loans/studentloandiscounts.phtml](http://www.finaid.org/loans/studentloandiscounts.phtml). As mentioned, as a result of regulatory changes the value of these discounts has been diminished.

### ***Loan Repayment Plans***

When considering loan repayment, there are several plans from which to choose. Of note: if a repayment period or extension is not specified, the plan will automatically be set and billed at the 10-year Standard Repayment Plan. The below list is specific to Direct Consolidation loans, but similar repayment plans exist for Direct Stafford and FFEL Stafford loans. For more detailed information on all of these options, visit [www.studentaid.ed.gov](http://www.studentaid.ed.gov) and [www.loanconsolidation.ed.gov](http://www.loanconsolidation.ed.gov).

1. **Standard Repayment Plans.** This entails monthly payments at a fixed amount for ten or, if extended, up to twenty-five years.
2. **Graduated Repayment Plans.** With this plan, monthly payments begin low and increase every 2 years for up to ten to thirty years until the loan is paid off. The lowest initial payments must equal or exceed the amount of interest accrued monthly.
3. **Extended Repayment Plans.** In this situation, borrowers have up to twenty-five years to pay back their loans that are in either a standard or graduated repayment plan. The only requirement is that loans must cumulate to more than \$30,000 (*not* a problem for most vet students). Payments are a minimum of \$50 per month.
4. **Income Contingent Repayment Plans.** Monthly payments are based on the borrower's annual income, Direct Loan balance, and family size, with repayment periods of up to 25 years.
  - Caution is needed here because if all of the interest is not paid, it will be cumulating each year. If this happens, the debt will grow instead of shrinking, even if payments are being made monthly. As an example, a Penn student went from \$128,000 of debt to \$162,000 over an eight-year period because he selected this option and didn't focus on earning enough money or cutting expenses to make monthly payments sufficient to pay all of the interest. The result – he wasn't even covering the annual interest that was coming due and ended up with much more debt than that with which he started. It did, however, enable him to purchase a home – which appreciated nicely until real estate tanked in 2008.
5. **Income Based Repayment.** Effective July 1, 2009, this is a new type of payment relief and is viewed as a “replacement” for Economic Hardship Deferment by some. It is designed to make repaying education loans easier for students who intend to pursue jobs with lower salaries, such as careers in public service. It does this by capping the monthly payments at 15% of the borrower's discretionary income. This is based on the borrower's income, family size and total amount of money borrowed. The monthly payment amount is adjusted annually, based on changes in annual income and family size. The reduced payments will be used to cover interest

first. Any interest from subsidized loans not covered by the reduced payment will be paid by the federal government, thus providing some subsidy benefits as well as lower monthly payments. The maximum repayment period is 25 years. After 25 years, any remaining debt will be discharged (forgiven). (See [www.finaid.org](http://www.finaid.org) for more information on this and the Public Service Loan Forgiveness program that provides loan forgiveness after ten years of public service. Public service jobs include, among other positions, government and military service plus many others, including work for tax exempt 501c(3) organizations.)

## **Summary**

This is a condensed version of the story on the crisis in the ever and rapidly changing educational loan world. It is truly wreaking havoc on all veterinary students with loans equal to or higher than the 2008 national average of \$120,000. It is not a pretty picture and because of the skyrocketing national debt, no easy solutions are within sight. However, as discussed above, many options exist for students who want to do their homework to reduce their debt and total payback of interest and principal!

*(Many thanks to Ms. Tori Long, VMRVMC class of 2011, VBMA student extern at PVMC and Mike Wilson, Chestnut Hill College class of 2009, who spent many hours locating and creating the early drafts of this information to help students in veterinary schools across America! Equal thanks are in order for the effort and assistance provided by Todd Balsley, MBA, Executive Vice President of Graduate Leverage as well as the reviews completed by Fritz Wood, CPA, CFP)*