Financing The College Education
The Enigma Inside the Conundrum
Or - College Loans 101

I thought I was pretty astute from a financial standpoint. After all I am a college graduate with some master's studies thrown in. I passed all four parts of the CPA exam in one sitting and I relentlessly take continuing education on all things financial. So how hard could pulling the financial application process together for my daughter's first year at college be? After all there is so much help these days – financial assistance centers at the colleges abound (manned by summer interns who are not that well informed), web sites (virtually un-navigable and unable to answer questions that veer from the script) and telephone operators (scary that they control the biggest expenditure of my life outside of my house). So how did this begin? Haven't I advised clients for over 25 years about education planning? Saving early, using home equity loans, scholarships, 529 plans – aren't these tried and true action plans to avoid college-funding destitution? Yes they are but there is much more, as I was about to find out…in spades.

My interest was piqued when I read the article in the Boston Globe about Student Loan Marketing Corp (SLM Corp. a.k.a. Sallie Mae) – the government organization that lends money for college. An alternative to a home equity loan or draining a savings account ravaged by the dot.com crash, I thought I should give them a try. This turned out to be very easy. I made the call to the 800 number [1](once I found it) and a very helpful and knowledgeable person took my information over the phone and approved me in 10 minutes.

[1] The number is 888-272-5543

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This was easy. I boasted to my brother who has 2 kids in college – "Why didn't you tell me about it?" I said to him. The "parent plus" loan (a federal program offered by many lenders) I qualified for was straightforward. I borrowed money to pay the tuition and the interest rate was fixed for one year starting July 1, 2003 at 4.22%[2]. Home run I thought – no brainer. I was so excited I told all the fathers on my son's AAU basketball team about it. I was amazed that all of them who already had kids in college had never heard of the program. I gave one father the 800 number and smugly stated "I won't even charge you for this advice". After his inquiry, the questions began at the next game. "Mike" he said, "why didn't you tell me about the points that must be paid on the loan?" "Points?" I said. "What points?" He said he called 3 different people and got two different answers. One weekend and about five phone calls later I determined he is right - the parent plus loan carries a 3% fee that gets paid to the Department of Education. I knew more questions were coming and I began to fear I would have few answers. Why shouldn't I just use my home equity line, he peppered me with now that he knew I was on the defensive. And how is the rate determined? And when do I start paying? And how much can I take? And when do I get the money? Did I say earlier this was easy? I needed a crash course in Sallie Mae and parent plus loans I thought but really how hard could it be? As it turned out, it got worse before it got better. Once you get pre approved by Sallie Mae for the parent plus loan – the mail onslaught begins. The informative person on the phone said a package will come in the mail so review it and send it back. A few days later the paper

[2] Based on the rate in effect on July 1, 2003, the parent plus loan interest rate is capped at 9%. This cap will change every July 1 as the base rate changes.

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deluge began. We received an official looking postcard that had all the relevant information – my daughter's name, codes, so I called the number to reconfirm the process. Again, they were very helpful and said to send it back and we will be all set. By the way, if you pay the loan back on time for 48 months, the interest rate is lowered by 2%. Great I thought – why didn't they tell me this earlier? Well, Next Student[3], the outfit that sent the postcard is not part of Sallie Mae. In fact, they are competitors. The Parent Plus Loan Program is a federal program that any lender can participate in. Boy, was I feeling dumb especially since I had now signed two promissory notes – one to Sallie Mae and one to Next Student.

The Parent Plus Menu #1 – 10 year plan

Parent Plus is the code word for a loan given to parents of a college student. It is not need based, it is open to everyone based on credit history. When qualified, the parent plus lender coordinates with the Financial Aid Office of the school to determine the exact amount of the loan. Once the final payment to the college for the year is made (usually December or January) the repayment cycle of the program begins (generally 60 days after final payment). The basic repayment period is over 10 years. So here is an example assuming the student has a $5,000 scholarship and the financial aid office estimates costs of $30,000 and the interest rate is 4.22% as mentioned previously.

Example 1 -	College cost	$30,000
	Scholarship	<5,000>
	Amount borrowed	25,000
	+ 3% fee	750
	Total Financing	$25,750

Monthly payment due Feb 1 @ 4.22% estimated over 10 years is $263.41 per month.

[3] Their number is 800-658-6801

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Over the first 4 years while the student is in college it would look like this:

Principal & Interest Payments	Year 1	Year 2	Year 3	Year 4
Amount financed	$25,750.00	$25,750.00	$25,750.00	$25,750.00
Monthly Payment (Principal & Interest)	263.41	263.41	263.41	263.41
Prior year payment		263.41	526.82	790.23
Total Payments		526.82	790.23	1,053.64
Interest Only Payments				
Interest only monthly payment	90.55	90.55	90.55	90.55
Prior year payment		90.55	181.11	271.66
Total payments		$181.11	$271.66	$362.21

As shown above, if you don't like the option of paying immediately – you can elect to pay interest only. In the above example, therefore, your interest only monthly payments would be $90.55 compared to $263.41 for a 10 year principal and interest loan. The interest only election can be made for the years the student is in college. Since no principal would have been paid, your monthly payments will be higher in years 5 through 10 as you pay the loan off (assuming the rate stays the same @ 4.22% - monthly payments beginning in year 5 would be $1,621.80 - $25,750x4 @4.22 for 72 months).

A third way to repay the loan is to request *forbearance*. That is the term Parent Plus uses to describe your request to pay nothing while your child is in school. The interest gets added to principal the result of which creates a bigger loan to repay and higher monthly

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payments once repayment begins.[4] Using data from example 1 and assuming the same 4.22% interest rate, let's show the affect after 4 years.

	Year 1	Year 2	Year 3	Year 4
Original amount borrowed	$25,750	$25,750	$25,750	$25,750
Yearly interest not paid	1,087	1,087	1,087	1,087
	26,837	26,837	26,837	26,837
Prior year loan		26,837	54,807	83,957
Interest on prior year loan		1,133	2,313	3,543
Total Owed		$54,807	$83,957	$114,337

Thus, with 72 months remaining on the 10-year schedule (120 months – 48 months deferred) you will begin repaying $114,337. The monthly payment for this (again assuming 4.22%) rate is $1,800.30. However, with the forbearance option you do not lose your ability to pay the loan over 10 years. If the full 10-year term is chosen, payments will be $1,169.60 for the $114,337 loan.

Thus, in summary, you have 3 options.

1) Begin principal and interest payments in the year the loan is made (the $263.41 month illustration).

2) Pay only interest and begin paying principal and interest after 48 months (the $90.55 illustration)

3) Make no payments and begin paying principal and interest after 48 months for ten years (the $1,169.60 illustration).

[4] Note: For persons with financial difficulties, the repayment options can vary. For example, for two additional years repayment can be interest only.

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Parent Plus Menu #2 – 30 year plan

If you are not exhausted going through the Parent Plus 10 year option scenario, you will certainly need respirators after this. Just when you thought it was safe to sign the 10 year promissory notes – don't do it. The 30 year option might appeal to you. This feature is called the Federal Consolidation Loan Program[5] and provides the same three methods of payment described above but over a longer term. The rate is fixed based on an average of the rates on the loans you have received plus 1/8 of a percent. Using our same $25,750 loan amount – let's illustrate the concept over 4 years. You borrow $25,750 each year at rates of 2,4,6, & 8 % totaling 20%. The average rate therefore is 5% (20% divided by 4 years = 5%). If you choose to consolidate the loans the interest rate will be 5.125%[6] (5 + 1/8%), fixed for the term of the loan. The term of the loan is based on the total amount owed based on the following table:

Amount Consolidated	Term
7,500 – 12,000	12 years
10,000 – 20,000	15 years
20,000 – 40,000	20 years
40,000 – 60,000	25 years
60,000 +	30 years

Thus, in the above example, if at the end of 4 years the amount owed is $103,000 ($25,750 x 4), amortized over 30 years @5.125% the monthly payments would be $560.82. This illustration assumes that the borrower used option #2, which pays the interest during the 4 years of college and financing the 103,000 after the 4-year college

[5] Their number is 800-448-3533
[6] Financial aid.com 1-888-868-1391 offers incentives if the consolidation loan is paid on time. After 36 months of timely payments the rate will be reduced by 1%. Thus, 5.125% would be 4.125%. If the lender can withdraw repayment directly from your account, an additional .25% can be taken off reducing the rate to 3.875%.

experience. The other two options are also available, just like in the 10 year plan, interest plus principal can be paid (option #1) or forbearance can be elected (no payments). Option #3 for example using the forbearance numbers from the 10 year plan would produce $114,337 @5.125 for 30 years. The payments would be $622.55 monthly. To further confuse the situation – election of the consolidation feature can be at anytime – year 1, 2, 3, or 4.

In summary, Parent Plus allows loans to be paid off over 10 years or up to 30 years. Both programs allow for (1) principal plus interest payments (2) interest only payments (3) forbearance – no payments with interest calculated daily and compounded yearly.

Stafford Loans

Stafford loans is another option where loans given directly to students at more favorable rates then parent plus loans but the same favorable term length. That is, a student can also elect to consolidate the loans according to the table previously mentioned. A Parent Plus and a Stafford loan can be consolidated together. The trade-off is, of course, the amount that a student can borrow is lower. The Stafford loan rate while the student is in school is based on the 91 Day T-Bill + 1.70%. As of July 1, 2003, the 91 T Bill rate is 1.12% thus, the rate for the year is 2.82%. This is significantly better than the Parent Plus Loan rate of 4.22% (91-T Bill 1.12% + 3.1% = 4.22%). Based on the rate in effect at July 1, 2003, the Stafford loan interest rate is capped at 8.25%. This cap will change every July 1 as the base rate changes.

The amounts a student can borrow are as follows[7].

Year 1	$ 2,625
Year 2	3,500
Year 3	5,500
Year 4	5,500
Total	$17,125

The same payment options, while in school, are available to the student as to the parent in parent plus; that is:

1) payments of interest and principal can be paid from inception over 10 years
2) payments of interest only (interest paid quarterly not monthly)
3) no payments until 6 months after school ends

(Note: the Stafford Loan, in fact, does not allow for payments unless the student elects to make payments). When the student begins payments interest is charged using a repayment index. It is the 91-day T-Bill rate +2.30% based on July 1, 2003 or 3.42%. If the student decides to consolidate the loans, the rate can be much more favorable than the parent plus loan. Assuming the average rate is 2.82% as shown above, a 15 year loan of $17,125 @ 2.82% would require a monthly payment of $116.79, however, during repayment the repayment index must be used. Since that rate is 3.42%, the monthly payment is $121.75.

Stafford loan subsidized

The above loan where interest is paid or added to principal if not paid is called an unsubsidized loan and is not based on need. A Stafford subsidized loan is based on need

[7] A fifth year is allowed for $5,500. The maximum amount a dependent student can borrow under the program is $23,000. For an independent student it is $46,000 (see page 9 for details).

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and no interest is charged during school nor needs to be repaid during school. Six months after school ends, payments will commence in both the unsubsidized and subsidized programs.

Stafford loan – Supersized

Stafford loans are enhanced when parents do not qualify for the parent plus loans.

Amounts that students can borrow is as follows:

	Stafford Loan Light	Stafford Loan Supersized	Total Loan Available
Year 1	$ 2,625	$ 4,000	$ 6,625
Year 2	3,500	4,000	7,500
Year 3	5,500	5,000	10,500
Year 4	5,500	5,000	10,500
Year 5	5,500	5,000	10,500
	$22,625	$23,000	$ 45,625

Note: The numbers change to $18,500 per year for graduate school, comprised of an $8,500 subsidized loan, and a $10,000 unsubsidized loan. The maximum an undergraduate and graduate student can borrow is $138,500.

Alternative Loans

Did I tell you it was safe to put your financial calculator down now? Not so fast, let's explain even more possibilities for you to go deeper in debt (and another day older).

Just as I was patting myself on the back for doing a good job of analyzing the Parent Plus and Stafford Loan opportunities, my wife and daughter bring home from college a whole new pack of information. I received a list of what was called preferred lenders[8] with 800 members for loans other than Parent Plus & Stafford. (These preferred lenders also do

[8] They are: Citibank-800-967-2400, Educaid-800-338-2243, Wells Fargo-800-658-3567, EdSouth-800-337-6884, Bank One-800-961-4327, Bank of America-800-666-4352, National Education-800-345-4325, IDAPP-800-961-4327

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parent plus loans). There were eight lenders listed – so I started dialing for dollars (I stopped at four, I was so fatigued). As an example, Wells Fargo offered a program of a $20,000 per year loan at the prime rate of interest with the term of 12 years.

Other Programs

Other specialized programs exist such as a Federal Perkins Loans and scholarships such as Target, Coca-Cola, Wal-Mart Foundation.

Conclusion

Can't write anymore. Just heard about a new loan program with the rate tied to the S & P index and hedged by cattle futures on the Chicago Board of Options Exchange (CBOE)……I'll get back to you.

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