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Consolidating Student Loans, with a Review of Student Loans in General

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Consolidating Student Loans, with a Review of Student Loans in General

By: Richard Serlin[1]

As I've written before, Federal Government Student loans are safe due to income based repayment programs. These programs (which undergo moderate changes over time) make it so your payment is capped at a modest and manageable percentage of your income. If things go wrong and your income plummets, or you lose your job, then your student loan payment also plummets, and it can easily go to zero.

Below is a table from IBRInfo.org. This is a very good, reliable, and accurate source. From my research it is one of the two best sources, the other being the U.S. federal government itself, which makes the loans. For example, see this page:

http://studentaid.ed.gov/repay-loans/understand/plans/income-based.

And note the .gov in the email address.

If you see a .com, the organization is a for-profit business. This can still be a good organization, but keep in the back of your mind that they may have a profit incentive to mislead you, or cut corners in their research. There are reputational incentives to be accurate and not mislead, but these aren't always enough (Just think of Standard and Poor's and the late 2000's finance crisis). Often the misleading goes undetected by consumers, and/or the organization doesn't have much of an established reputation or heritage to lose. So, in general, when dealing with a for profit company, or salespeople, keep in mind their profit incentives and their reputation.

If you see a .org, there's a good chance it's a non-profit, but this isn't for sure. You might want to check the "about us", or google them.

Ok, now on to the table:

Number of persons in household	$20,000	$40,000	$60,000	$100,000
6	No payment required	No payment required	3.4%	8.0%
4	No payment required	2.0%	6.4%	9.8%
2	No payment required	6.5%	9.3%	11.6%
1	2.4%	8.7%	10.8%	12.5%

2012 family income

Source: http://www.ibrinfo.org/what.vp.html

On the horizontal axis you have adjusted gross income (AGI). This is your initial before-tax income, minus some deductions, like your 401k contributions, and your IRA contributions. For most people it's still pretty close to your actual pure before tax income, and if anything before-tax income is higher than (AGI). So, when you see in the table $100,000 for a family of 4, that's a very nice income with just two kids – It may easily be $120,000 before the AGI deductions. And yet, what is the student loan payment? Just 9.8% – no matter how much you owe in student loans. No matter how big your debt is, you only pay 9.8%.

With an AGI of $60,000, which is maybe $75,000 before-tax, it's just 6.4%, again, no matter how much you owe. So your payment can never get crushing, even if you got a PhD, a J.D., and two master's degrees.

And, if times get bad, then your required payment can drop to 2% – or even zero! Yet, even if your payment is zero, that *still* counts as time towards the 25 year limit for payments! With the IBR program (Income Based Repayment), there's a 25 year limit for your payments on the program. After 25 years of payments, if there's still any debt owed, it's 100% forgiven.

Now, this is true no matter how small your required IBR payments are – again, even if they're zero! You could, in fact, pay zero for 25 years as your required payment with IBR, and your balance would still be 100% forgiven at the end!

And payments that you made when you weren't on the IBR program also count towards that 25 years. Here are the various types of payments that count towards your 25 years worth of payments (copied from ibrinfo.org):

What are qualifying payments? The Department of Education has indicated that the following types of payments will count towards IBR's 25-year forgiveness period, as long as you are in IBR at some point during those 25 years.

- Payments made in the Income Contingent Repayment plan (ICR) *before* July 1, 2009.
- All payments made on or after July 1, 2009 in the IBR, Income Contingent Repayment (ICR), and Standard (10-year) Repayment plans.
- Periods when the borrower has a calculated payment of zero in IBR or ICR (this occurs when your income is at or below 150% of the poverty level for your family size).
- Periods on or after July 1, 2009, when the borrower has been granted an economic hardship deferment.

At: http://www.ibrinfo.org/what.vp.html

And it actually gets even better. Periodically, there are attempts to improve income based repayment. Now, whether it gets better or worse, depends on who's elected. The Republicans are the party of smaller government, and that often means less student financial aid, as well as less of a safety net, than if Democrats are elected (although sometimes it can take strong control to get action, for example many bills require a 60% super-majority to pass in the Senate, with the current filibuster rules). Of course, you may favor smaller government. Your political views are completely your own. But in your personal finance strategy, you should keep in mind how changes in government – who wins the elections, and by how much – affect you and your personal financial security.

This election, 2012, made a big difference in personal finance in many ways. Obama winning means that Obamacare (The Patient Protection and Affordable Care Act, PPACA) will survive to be (more or less) fully implemented in 2014. This means important and large benefits and subsidies to help people to afford health insurance if things go badly and they don't have a job that provides it. And many of you will now have health insurance who wouldn't. Obamacare requires all insurers to insure the policyholder's children until age 26, allowing time for you to complete a bachelor's and master's degree and get your own job with insurance.

The point is, of course your political views are your own, but in managing our personal finances we should keep an eye on changes in politics and who wins elections, as that can have a substantial effect on our personal financial security, and it may entitle us to new benefits and insurance – if we follow the major events going on, and know about it.

The case in point here is that Obama winning means a strengthening, rather than a promised weakening, of income based repayment. We will now be getting a new, even better, program, called "Pay-as-you-Earn".

Now, here let's note that there is no danger of having a program taken away that you have already been entitled to in the contract for the student loans you signed up for. If a future President and congress vote to end income based repayment, it will only be for new loans, loans that come after that vote. You've already signed a contract entitling you to your income based repayment option.

Now, it turns out that with Obama winning we will be getting an even better income based repayment program, "Pay-as-you-Earn". This is a real improvement. The maximum payment you would be required to make under any circumstances is just 10% of your family's *discretionary* income. This is down from 15% with the older income based repayment programs. And, the maximum number of years' worth of payments you have to make has been cut from 25 to 20. So, after 20 years of payments on the Pay-as-you-Earn program, any remaining balance, no matter how big, is forgiven.

Now note that the cap on your payments is 10% of the family's *discretionary* income. Discretionary income can be far less than total income. Discretionary income is defined as the difference between your adjusted gross income (AGI) and 150 percent of the poverty guideline amount for your state of residence and family size. As a result, your family income could be $100,000, but your AGI is $85,000, and your discretionary income is just $55,000. So, the maximum you would pay is 10% of *that $55,000*, not 10% of the $100,000 you earned. And maybe a lot less than 10%.

Let's take an example, and an extreme one that really makes clear how powerfully protective this program is: Suppose you and your spouse went all the way up to PhD, and you took out huge loans all along the way, as big as you could imagine, and you each owed $200,000, for a $400,000 total! Gargantuan! How are you ever going to pay that down? or afford the payments? Well, let's see the power of the Pay-as-you-Earn program.

Suppose you and your spouse jointly earn an adjusted gross income of $75,000 (You got liberal arts PhDs, or one spouse works part time and takes care of your young children), and suppose you have two children. Now, there's a calculator provided by the federal government that will calculate your payment under the Pay-as-you-Earn program. It's at:

http://studentaid.ed.gov/repay-loans/understand/plans/pay-as-you-earn/calculator

According to this calculator, our family's monthly payment would be just $169 for each spouse, only $338 total! Now, with an adjusted gross income (AGI) of $75,000, the family's actual pre-tax income without the AGI tax deductions (things like 401k contributions) would be something like $90,000. Their student loan payments sum to $338/month x 12 months = $4,056. So, as a percentage of their income that's just 4.5%. It's very manageable, even in this super-extreme case where they owe an amazing $400,000 (most students will owe one-tenth of this, or much less). That $338/month can easily be taken care of just by maintaining well a used car, rather than having the purchase and insurance payments of a new one (*and all of you should be thinking very seriously about used cars, and keeping then for a long time in today's world*).

Now, $338/month isn't going to even come close to covering the interest on $400,000, but after 20 years in the program, no matter how little you've paid relative to what you owe, any remaining balance is 100% canceled.

Next, what if things go well for our family, and their adjusted gross income rises to a very nice $125,000/year. Before the AGI deductions, pre-tax, that's about $150,000/year! Even at that very high income the family's joint payment is just $674/month, very easy to handle when you're making $150,000/year.

Now what if things go badly for our family, lost jobs, unable to find good full-time work, and their income plummets to $40,000/year. You know what their payment drops to? $45/month! That's right, just forty-five dollars per month – on $400,000 owed! And even that tiny payment counts towards their 20 year limit.

So, lessons:

1) When you finish your education and have to start making payments, you immediately want to look into an income based repayment program. You can start by googling (and look for reliable, credible sites, like the federal government's Direct Loans site and IBRInfo.org), but eventually you'll want to call the Direct Loans toll-free customer service number (at their website) to sort out the specifics for your case.

2) Getting a college degree, and the best possible education, and the highest GPA, and the best possible learning, competence, and skills, is absolutely crucial in today's world. And this will only become more and more true in 10, 20, 30 years. You do not want to be low skilled and without a college degree in today's world, let alone the world of the future that you will likely have a family in. So, if taking out a safe federal government student loan (and of course never under any circumstances a ***private*** student loan, which has no protections) makes it so you study a lot more, and flip burgers a lot less, this is a great investment, a profoundly important one.

If you're working 40 hours per week while going to school full-time, you're really increasing your odds of never graduating. You're really hurting your GPA, and your learning – learning and skills and competence you will need to succeed in an increasingly challenging world. To really do well in college, and really learn, takes a lot of study time. It's a serious full-time job. You have to hit the books in a quiet place, like the library, many hours per day.

If a large federal government student loan means you can work 20 or 40 hours less per week, this can be enormously beneficial for you future, and ridiculously well worth it – *if* you use that freed up time to study seriously, not to party, or – and this is just a crime – to buy a new car.

So if you're working more than 15 hours per week, you should seriously consider taking out federal student loans so that you can study more and work less. And even if you're working less than 15 hours per week you should consider it. Any extra studying really helps your future. But if you take out the loans and work less, make sure you use the freed up time to study more, not to fool around, or study lying on the bed, with the stereo on, looking at Facebook. Real, focused studying, in a quiet place in an upright chair, like in the library, or a study room.

Ok, now without further ado, let's move on to consolidation.

Consolidation, in general, means to take several loans and pool them together – or consolidate them – into just one single big loan. So, if you had four student loans, one for $5,000, one for $5,500, one for $6,000, and one for $7,000, then with consolidation, your loan consolidator (The Federal Government's Direct Student Loans Program) would pay off all of your four old loans for you, and you would now owe the consolidator the total – one big loan of $23,500. This makes things simpler for you. Now you only have to keep track of one loan. It can be a nice benefit.

In the old days of student loans, not that long ago, the system was more fragmented, time consuming, and inefficient. The government essentially contracted out to hundreds of banks and finance companies to service student loans, instead of handling it directly themselves in one central simple location. So, those four loans, although government backed and regulated, might have been with four different banks, with four different payments, and unique programs, and systems to learn and deal with. Consolidating into just one big loan certainly made things easier, and it made it easier to see what special programs you could qualify for – you only had to learn one system.

But, there are other potentially large benefits to consolidation.

Today when you consolidate you should do it directly with the Federal Government, through their Direct Loans Program. ***If you consolidate with a private company, you will be making one***

of the worst mistakes someone could make – You will actually be turning all of your government student loans into one big private student loan, with all of the devastating, virtually inescapable, risk!! Loans that you can never get rid of in bankruptcy (with extremely rare exception), and no safety of an income based repayment plan and loan forgiveness.

So you only consolidate with the federal government.

And a Federal Direct Loans consolidation has two potential benefits:

1) You may sometimes get a lower interest rate, or much lower.

2) You may sometimes qualify for new payment options which can be very valuable, or other perks.

Let's start with (1), how do you sometimes get a lower interest rate?

The rates on federal government student loans have changed pretty frequently over the years, as new administrations and congresses change them, and it can depend on the type of federal government student loan, like "subsidized", or "unsubsidized", or Perkins.

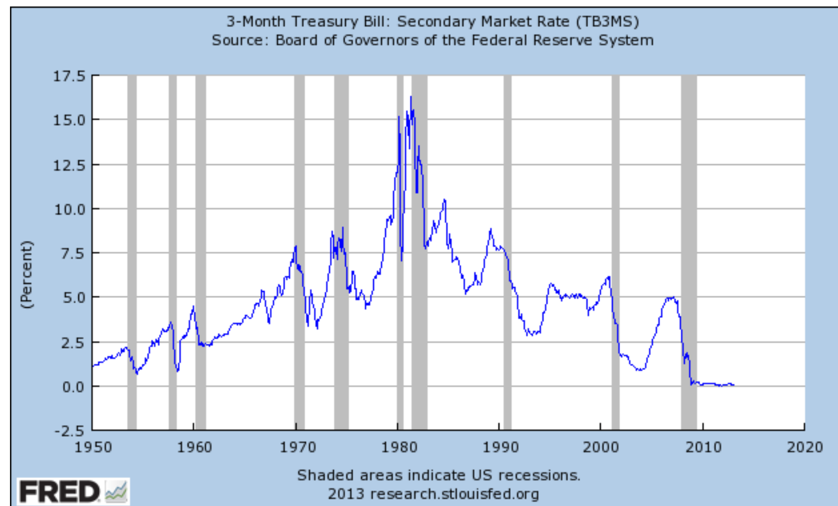
But when you consolidate your old student loans into one new big loan, the new big loan will not necessarily have the same interest rate as the old ones (or even the average of the old ones). In some cases, they will change it, sometimes to one which is much more favorable.

Let's take an example. Suppose you took out your student loans between 2002 and 2005. At that time, standard federal government student loans had variable interest rates[2] Your rate was the 91-day U.S. T-Bill rate, plus 2.3%. And there was a cap of 8.25%.

What does this mean? Your interest rate was variable. It varied over the life of the loan. Specifically, in this case, once a year the government reset your interest rate to a new one. How? With what formula? First, they looked at the 91-day T-Bill rate on the day of resetting.

T-Bill is short for Treasury-Bill. These are U.S. federal government bonds, but of short duration. With the 91-day T-Bill, the government borrows money from people and parties for 91 days at a certain interest rate. Right now, the interest rate on T-Bills is almost zero! This is because in order to fight the Great Recession, the Federal Reserve has forced short-term government interest rates about as low as they can go (and, as well, recessions themselves depress interest rates, due to decreased investment demand).

But sometimes the Federal Reserve is more concerned about inflation, and so it forces short-term T-Bill rates up, which helps lower inflation. And in the early 1980's, they were as high as 16%! Here is a graph showing how the 91-day T-Bill rate has moved over time:



The student loan interest rate in this example is that 91-day T-bill rate plus 2.3%. For example, on the day the government checked in 2005, the T-Bill rate was 3.0%. So add the 2.3%, and you get your rate, 5.3%.

And the cap of 8.25% means that no matter how high the T-Bill rate goes, the most you will pay is 8.25%.

Now, fast forward to 2012. The T-Bill rate on the day the government checked was a mere 0.09%! Virtually zero! So, your interest rate was 0.09% + 2.3% = 2.39%, less than half as much.

Now, here's where consolidation can be great for this person. With consolidation, the variable rate becomes a fixed one, a permanent one. Their current formula is to do the same 91-day T-bill rate plus 2.3%, but to fix that permanently. And this is the perfect time to fix it permanently because the T-Bill rate is about as low as it can ever go, as it's virtually zero. It can only go up in the future, and probably a lot if you stick to variable and have annual resets.

In general, all other things equal, a fixed interest rate loan is better than a variable rate one, because with a variable rate loan you take a risk that the interest rate could go up. Fixed is more safe and sure, lower risk. With consolidation, you can wait until a great time when interest rates are low, and then lock that in permanently as a fixed rate. And right now is the perfect time, as interest rates can't go any lower than virtually zero.

So, this is an example of where consolidating can get you a much better interest rate.

Unfortunately, for more current loans, there is no interest rate advantage. Loans after 2005 were all fixed rate to start with, and consolidation gives the same fixed rate..., sorry.

Still, the policy on consolidation may change in the future, and they may offer an advantage even for loans taken out after 2005, so it's good idea to periodically check the federal government Direct consolidation website (If the link goes bad, it's easy to find with a google search, as is true of most things). And, you should keep an ear open for promises of Presidential candidates and their parties regarding student loans. If they win, these promises may be enacted.

Keep in mind, though, something too many people forget, or never learned. In our system, the President is not a king. He can't pass legislation if the other party holds a house of congress and won't pass it. And even if the President's party holds both houses of congress, in recent years the filibuster went from a historically great rarity to a regularity. That means that commonly, even if the President's party holds 59% of the Senate, 41% can prevent him from passing his legislation.

So, winning the election is no guarantee that a president will be able to enact his promises on student loans, or anything else. However, another avenue is executive orders; and agency appointments, rules, and powers. For many things, this does not give you authority – you just still need to pass a law that's approved by the House and the Senate and signed by the President. But particularly for student loans, a lot of big things can, in fact, be done by executive order and agency ruling. So here, the President does have more power than usual. And, indeed, that's how Obama was able to enact the new Pay-as-you-Earn program.

In any case, keep your ears open, consolidation may change in the future in a way that helps the interest rates of people with student loans taken out after 2005.

Now, to potential benefit number two: You may qualify for new payment options, or other perks:

Let's do an example here: Suppose you took out your student loans between 2007 and 2010. During that time there were two major types of federal student loans, Direct and FFEL (Federal Family Education Loan). With the Direct loans, you borrowed directly through the federal government, and the federal government administered the loans. With FFEL you borrowed from a bank, but the government guaranteed the loan and regulated its terms. By guaranteed, I mean the federal government guaranteed that the funds would be paid back, so these were (more or less) zero risk loans to the bank.

As a result, we had government student loans being made through thousands of banks, acting as middlemen who administered the loans. This resulted in a great deal of unnecessary fragmentation, complication, and lowered economies of scale, as well as some monopoly power

for the banks. As a result, the Congressional Budget Office found in 2009 that eliminating the FFEL loans and doing all student loans directly through the federal government would save $94 billion over ten years[3], a substantial amount even by US government standards.

Studies had shown for decades that it was cheaper and more efficient for the government to do the student loans directly, rather than going through private banks, but due to ideological and political reasons, a move to only direct loans was not able to pass. Finally, however, in 2010 President Obama was able to pass a move to only direct federal government student loans by attaching it to one of the bills which created Obamacare (PPACA), which just squeaked through congress.

So, a little history. So since 2010 there are now only Direct government student loans, at least the new ones. No more new FFEL student loans are issued. In our example, however, the student took out his loans between 2007 and 2010, and he has three FFEL loans, and one Direct loan. A problem is that FFEL loans don't have as good an income based repayment program as Direct loans. As well, they fall short in other areas, like no public service loan forgiveness program.

The new Pay-as-you-Earn program is awesome. It's much better than the income-based repayment program offered with FFEL loans, and you can't get it with a FFEL loan[4], but our example student can turn all of his FFEL loans into Direct loans by consolidating with the federal government's Direct program. The resulting consolidated loan will be considered a Direct loan and will qualify for Pay-as-you-Earn. (But, one stipulation to get Pay-as-you-Earn is that it's only for newer borrowers, that is borrowers who never took out student loans before 2006. Our example student qualifies since his first student loan wasn't until 2007).

I'll give you one more example of where a borrower can qualify for an extremely valuable payment program by consolidating, that he didn't have access to before: Suppose our borrower took out five federal government student loans between 2004 and 2008, and all of those loans were FFEL loans. Unfortunately, FFEL loans don't have the Public Service Loan Forgiveness Program, but Direct Loans do. So, what can you do? Consolidate all of those FFEL loans into one big Direct Consolidation Loan, which is a Direct Loan, so it does allow you to choose to go on the Public Service Loan Forgiveness Program.[5] And this can be extremely valuable.

The Public Service Loan Forgiveness Program is an amazing income-based repayment program. It's the Pay-as-you-Earn program we talked about, with the payments only as a very low percentage of your income, but instead of any remaining loan balance forgiven after 20 years on the program, you're forgiven after just 10 years! So, even if you've accumulated massive student loans to get a Ph.D., after just 10 years of very reasonable payments, you're done. Anything left owed is forgiven. So, it's an amazing program, but you must have a job in "public service". That

means working for the government – any level, city, state, or federal, or for a non-profit organization. And the criteria for a qualifying non-profit are not very stringent.[6]

So, take our example student loan borrower. Suppose she works as a school teacher. With her FFEL loans, the best she can do is their income based repayment program where payments can be as high as 15% of your income, and you have to make payments for 25 years before any remaining balance is forgiven. But, by consolidating with the Federal Direct Program, she can now qualify for the Public Service Loan Forgiveness Program and have payments of 10%, at most, of *discretionary* income (and probably much lower for a school teacher), and any remaining balance is forgiven after just 10 years. So, for this example student, there's an enormous benefit to consolidating.

But what about me? What about my situation? Is there a big benefit for me to consolidating? The thing is that there are so many ins-and-outs, and different kinds of student loans over different years, that I can't cover every situation in this article. I've covered some of the major ones, and I'll give some major rules. But generally, once you finish your education, you'll have to look into this yourself. And by that time there could be new rules and programs passed which could benefit you.

You really have to, at that time, look into it for your particular loans, with a little bit of reading of the Direct Loans Consolidation website, and googling around, and a phone call to the Direct Loans Consolidation Counselors to talk it out. The toll-free phone number's easy to find on their website. If the benefits aren't that good at that time, keep an ear open for changes, and if you still are carrying a substantial amount of student debt a few years later, check into it again to see if there were any favorable changes relevant to you.

In the meantime, here are some major points to keep in mind:

1) Perkins loans – These are federal government loans that are only for students with greater financial need. They have a lower interest rate than standard federal government student loans, but interestingly, there is no income based repayment (because of the funny way they are structured, with your school administering them, not the federal government). But, you can get income based repayment, the Pay-as-you-Earn program, by consolidating them with the federal Direct Loans consolidation program. So, if your income is so high that income based repayment won't lower your payments anyway, then it's best to stick with the Perkins loans, and keep getting the lower interest rate. But if your income is not so high – or you really get into trouble, then you may want to consolidate those Perkins loans with the federal Direct program to get access to Pay-as-you-Earn.

Another complication is that Perkins loans have some very good loan forgiveness programs for certain professions, like military, firefighter, and teacher in a disadvantaged district. These can mean that you make payments for only as little as five years, and then any remaining balance is forgiven (or the term canceled is sometimes used)! For details see here and here.

2) As I've said, there aren't currently great benefits to consolidation for federal student loans taken out 2006 and later. But student loan laws and rules change a lot, so keep an ear open; perhaps in the future consolidation will provide a big benefit again. For students with older, variable rate loans, there's huge potential savings to be had by locking in rock-bottom variable rates permanently. And for students with older FFEL loans there are potentially huge benefits, as I've noted.

3) Keep in mind the Public Service Loan Forgiveness Program if you work for the government at any level, including school teacher or administrator, or a non-profit. This can save you a fortune, but you may need to consolidate your loans with the federal Direct Loans consolidation program to get it.

4) ***Never consolidate with a private company, you will be making one of the worst mistakes someone could make – You will actually be turning all of you government student loans into one big private student loan, with all of the devastating, virtually inescapable, risk!! Loans that you can never get rid of in bankruptcy (with extremely rare exception), and no safety of an income based repayment plan and loan forgiveness. You only consolidate with the federal government.***

So, once you complete your education – and I expect all of you to do so! – and settle in to your great new job, spend a little time looking into consolidation.

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[1] I'm thankful for valuable review and suggestions from top student loans expert and attorney, Heather Jarvis. Her website is a valuable resource for borrowers and experts alike. Any errors or ommissions are, of course, mine alone.

[2] For a nice history of federal student loan rates and terms, see, "Federal Student Loan Interest Rates: History, Subsidies, and Cost", February 2012, from the respected non-partisan think tank "New America Foundation", at: http://newamerica.net/publications/policy/student_loan_interest_rates .

[3] See: "Government vs. the Private Sector: Health Care and Student Loans", New York Times, Economix, March 1st, 2009, at: http://economix.blogs.nytimes.com/2009/05/01/should-government-compete-with-the-private-sector/

[4] See: http://studentaid.ed.gov/repay-loans/understand/plans/pay-as-you-earn

[5] Quoting from the federal government's student financial aid website, "If you have FFEL and/or Perkins loans, you may consolidate them into a Direct Consolidation Loan to take advantage of PSLF. However, only payments you make on the new Direct Consolidation Loan will count toward the 120-month payment requirement for PSLF. Payments made on your FFEL or Perkins loans, even if they were made under a qualifying repayment plan, do not count as qualifying PSLF payments.", at: http://www.studentaid.ed.gov/repay-loans/forgiveness-cancellation/charts/public-service

[6] Quoting from the federal government's student financial aid website: "Qualifying employment is any employment with a federal, state, or local government agency, entity, or organization or a non-profit organization that has been designated as tax-exempt by the Internal Revenue Service (IRS) under Section 501(c)(3) of the Internal Revenue Code (IRC). The type or nature of employment with the organization does not matter for PSLF purposes. Additionally, the type of services that these public service organizations provide does not matter for PSLF purposes.

A private non-profit employer that is not a tax-exempt organization under Section 501(c)(3) of the IRC may be a qualifying public service organization if it provides certain specified public services. These services include emergency management, military service, public safety, or law enforcement services; public health services; public education or public library services; school library and other school-based services; public interest law services; early childhood education; public service for individuals with disabilities and the elderly. The organization must not be a labor union or a partisan political organization."

At: http://www.studentaid.ed.gov/repay-loans/forgiveness-cancellation/charts/public-service