6

How to Borrow (Wisely)

The most interesting thing I have learned in this financial aid project is definitely the loan forgiveness plan. I definitely think I can afford college much more now than in the past. My mind is more at ease about paying for college... - McKenna B.

Borrowing money often comes with too much stress and too little awareness. Why don't we teach high school students how loans work? Today, we do. First, I'll share quick answers to common student loan questions. Then, we'll look at the reasons debt can sometimes be a useful tool to get your college degree.

When would I need to repay student loans?

Payments on student loans from the federal government[1] don't begin until after your "grace period" expires: 6 months after you graduate, leave school or drop below half-time enrollment.

How would I make repayments?

All at once? Nope. Here are some details about federal student loans: The "standard repayment" length is ten years. Repayment can happen faster or slower than ten years; it's entirely up to you (and

1. For most students, federal student loans are the **only** loans they should ever consider.

depends on your career and income). Each month after your grace period ends, you'll have the option to pay your bill online or by mail. If you borrow $30,000 over four years (nearly the average), your monthly payment will be around $300. If you can't afford $300 per month, you can apply for a different type of repayment plan. You can even have the amount you owe forgiven. Read the rest of the chapter for more info.

Will I be in debt for the rest of my life?

Not as long as you pay back what you owe. And how do you do that? You get a job. And, how do you get a job that provides you with enough income to pay your debt? You graduate with a college degree. If you need to put more thought into these questions, it might be a good time to revisit Loan Default Rates, and Graduation Rates discussed in Chapter 3.

When it comes to student loans, you need to understand what you'll be saying yes or no to, so let's take a more in-depth look.

Why would I ever want to use a student loan?

There are many good reasons why people (even billionaires[2][/footnote]), companies, and governments borrow money.

- You might want to own a home,
- Domino's might want to open up a new store down the street,
- California's government might want to build a bridge.

In each case, the person making the final decision should thoroughly explore *all* costs and benefits involved. You should do the same when deciding how to pay for one of the most significant investments in your life.

2. [footnote]http://www.npr.org/sections/thetwo-way/2012/07/16/156849011/a-perk-of-being-rich-facebooks-zuckerberg-pays-1-percent-interest-on-mortgage

How do I get student loans, and where do they come from?

To receive federal student loans, you must fill out the FAFSA, an application we'll cover in the next chapter. Senior year, you'll submit the FAFSA along with college applications. Then, around the same time you receive college acceptance letters, you'll also receive financial aid award letters. These letters will likely list some combination of grants, scholarships, work-study, and federal loans.[3] These letters differ from school to school, so wait until you receive one from each college before you make a decision.

When you receive a financial aid award letter, you'll be asked to accept what you want, and leave what you don't. You don't have to take any loans if you don't want them, and you can accept less money than the amount offered. **Only borrow what you need.** Here are some general guidelines to follow:[4]

1. The grants and scholarships are free money, so obviously you want those. Make sure you understand any obligations on your end of the deal — many scholarships require you to maintain a certain GPA in college.

2. Take advantage of work-study if it's offered in your financial aid package. It'll be nice to have extra income from an on-campus job where you work flexible hours depending on your class schedule.

3. Loans should be the last form of financial aid you receive because you have to pay this money back, plus interest. Again, don't accept this money unless you *need* it. And if you sign for a student loan, make sure it's the lowest fixed rate you can get.

4. As a general guideline, the Consumer Financial Protection

3. Be aware that you **must** fill out the FAFSA to get federal grants, work-study, and loans.
4. The following have been adapted from a useful page you should reference if you want to read more about accepting aid: https://studentaid.ed.gov/sa/fafsa/next-steps/accept-aid

> Bureau recommends not borrowing more (in total) than your expected annual salary after graduation. So, if you expect to make $50,000 in an entry-level job based on your career interests, don't borrow more than $50,000 while attending college.[5]

If you feel your net price for college is too high and the costs outweigh the benefits, don't feel obligated to take out loans. Look into your other options (hopefully you applied to more than a few schools) and think about what is best for you in the long run.

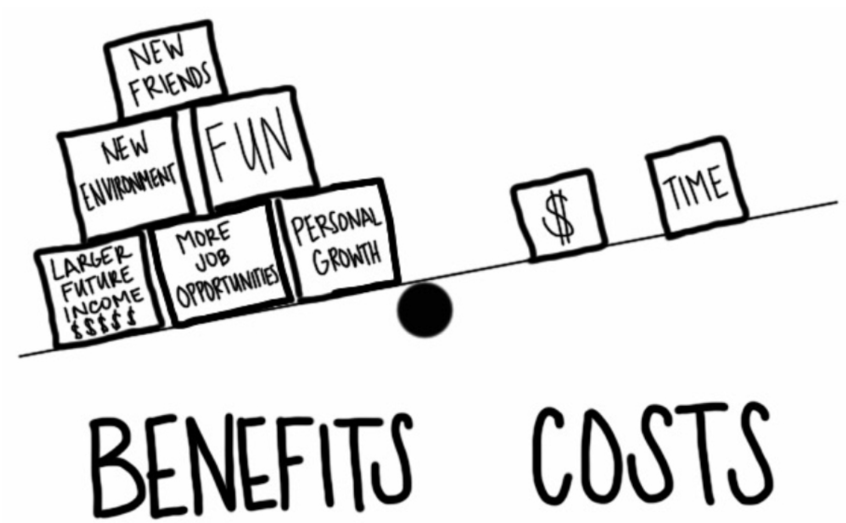
What are the benefits and costs?

Most adults have debt[6] in some form, and just like anything else, some manage it well, and some don't. If it's a particular type of debt (e.g., credit card debt) and you handle it poorly, you could be in severe, long-term financial trouble. But if you carefully consider these five questions and exercise some degree of self-control before making your decision to borrow, it's possible to use debt to your advantage.

1. What type of asset am I purchasing? (e.g., a college education, a car, a home, new clothes, entertainment, etc.)
2. What are the benefits I'll receive from this asset? (e.g., personal achievement or success, higher future income, status, entertainment, etc.)
3. How long will these benefits last? (e.g., one day, one month, one year, entire life, etc.)
4. How much will it cost me to borrow the money I need?
5. When and how will I repay my debt? (e.g., payment of $280 on the 14th of each month, for four years)

5. https://www.consumerfinance.gov/ask-cfpb/how-much-should-i-borrow-in-student-loans-en-579/
6. Money you've borrowed and need to repay.

Simply put, it can be smart to borrow money *when the benefits outweigh the costs*. Benefits include access to goods (like a house) or services (like a college education). You want these benefits — which could be financial, social, physical, etc. — to **last a long time** and **become more valuable** as time goes on. Costs, on the other hand, include an obligation to repay the money on time, with interest.[7]



Think about the difference between taking out a loan for college, and buying some new clothes with your credit card. One will help you find a career and make more money long into the future; the other will become worn out and replaceable within a short time.

You don't want to find yourself in a situation where you're in debt for something you don't even benefit from anymore.

Total student debt in the United States currently sits at more than $1 trillion. News outlets *love* this number because it's scary. After all, $1 trillion is enough money for you to spend $1 million every day for almost 2,800 years! Who doesn't love to be dramatic and get you all

7. Interest is an extra cost you pay to borrow the bank's money.

hot and bothered? So, just chill for a second; let's look at student debt a little closer.

Benefits

Student loans can provide you with access to a college degree and all of the lifelong benefits that come with it. As we discussed in Chapter 1, a college degree gives you a greater variety of job opportunities. A bachelor's degree also comes with an average annual salary that is nearly *$24,000 more than* those who don't go to college at all. Remember, that's tens of thousands of dollars more **per year**.

Your career and salary are long-term benefits, but you'll also enjoy the short-term benefits that college offers. These include opportunities to learn more about subjects you're curious about, to develop friendships with people from around the world, and to have some fun.

Before agreeing to a student loan, you should ask questions to clarify anything that doesn't make complete sense. Compare different loan offers, then thoughtfully consider your consequences in a worst-case scenario. Ask yourself, "Will my benefits be greater than my costs?"[8]

Costs

As I've mentioned, borrowing money comes at a cost. Two costs associated with student loans are interest and loan fees.

<u>Intro to Interest: Brought to You by Brenda</u>

Brenda borrows $20 from her bank for one year, agreeing to pay 10% interest. The agreement she made with her bank is called a **loan.** When it comes time to repay her loan, Brenda will pay back the

8. These are the same questions you should ask whenever you borrow money for anything!

$20, plus 10% of $20 — a total of $22. The most important aspects of a loan are the following:

Principal: The amount of money you borrow. In the story above: $20.

Interest Rate: The interest rate is your cost to borrow the money, as a percentage of your principal. In the story above: 10%.

Interest: The interest is your cost to borrow the money, in dollars. Calculate your interest by multiplying the principal by the interest rate. In the story above: ($20 x 0.10) = $2.

Since the interest rate represents *your cost of borrowing*, you want it to be *as low as possible*. In real life, an interest rate can be **fixed**, which means it doesn't change during the life of the loan.[9] Or the rate can be **variable**, meaning the interest will change over time.

Calculating the cost of student loans is a little more complicated than this. Federal student loan interest is calculated using the "Simple Daily Interest Formula," and payments are made monthly.[10] Don't worry if it sounds like a lot of work to calculate. Later in this chapter, I'll show you an easy-to-use online calculator that does the math for you!

Now, let's look at some real student loans and compare their interest rates.[11]

9. The "life" of a loan refers to the length of time the money is borrowed.
10. To read more about Simple Daily Interest, visit https://studentaid.ed.gov/sa/types/loans/interest-rates
11. As of July 2019

Interest Rate Table

Rank	Name	Lender	Interest Rate
1.	Direct Subsidized Loan	U.S. Gov't.	4.53% (fixed)
2.	Direct Unsubsidized Loan	U.S. Gov't.	4.53% (fixed)
3.	Direct PLUS Loan	U.S. Gov't.	7.08% (fixed)
4.	Private Student Loan	Bank	3% – 13% (fixed or variable)

If you're looking to borrow money for your education, you should be looking for the *lowest fixed rate*. Look at the following two scenarios, which show student options for borrowing in 2018. How much more did the higher interest rate cost them?

Scenario 1: Direct Unsubsidized Loan ($20,000)

Number of Payments	Payment Amount	Fixed Interest Rate
120	$207	4.45%
Total Interest	$4,873	
Interest + Principal	$24,873	

Scenario 2: Private Bank Loan ($20,000)

Number of Payments	Payment Amount	Fixed Interest Rate
140	$232	7.0%
Total Interest	$7,866	
Interest + Principal	$27,866	

Even though a monthly payment of $207 doesn't look much different from $232, the total interest you'll pay on the second loan is nearly $3,000 more!

Fixed vs. Variable

I've introduced loan terms like "fixed rate" and "variable rate," now let's discuss how they appear in reality. Variable rates may seem attractive because they're often lower (initially) when compared to fixed rates, but they can be dangerous because of the unpredictability of the future. Along with other economic factors, interest rates change over time. You might be super excited when the bank offers you an initial variable rate of 3.8%, but within a year you could be paying 5%, and then 8% a few years after that, and so on.

No one knows what future interest rates will look like, but as of August 2019, we're in a period of historically low interest rates. For this reason, it's safe to assume variable rate loans will be adjusted higher in the future.

Choose fixed rate loans if you want to take on less risk, even if their interest is a little higher compared to variable rate loans. Think about the peace of mind you get by locking in a low rate for the entire life of the loan, which could be ten years or longer. If you know your borrowing costs from the beginning, there's a lower risk from the future unknown.

Student Loans Compared to Other Loans

Does borrowing for your education cost more or less than borrowing for other things? To answer this question, let's compare interest rates on student loans to interest rates on other popular loans.

These are average interest rates as of November 2017.

Loan (Asset)	**Annual Percentage Rate (APR)**
Federal Student Loan (Education)	4.53%[12]
Auto Loan (Car)	5.01% (Good Credit)[13]
Mortgage, 30 year fixed (House)	3.78%[14]
Credit Card (Any Purchase)	17.82%[15]
Pay Day Loan (Any Purchase)	650%[16]

12. https://studentaid.ed.gov/sa/types/loans/interest-rates

The cost of borrowing money for your education looks pretty good compared to borrowing for other purchases. Now let's take a quick look at one additional cost of borrowing money.

Loan Fees

Federal loans and many private loans have loan fees, charged as a percentage (1.068% currently, for federal loans) of the principal. Loan fees work like this: if you choose to accept a $5,000 Direct Unsubsidized Loan from the federal government, you will receive $53.30 *less* than $5,000, which is $4,946.70. The $53.30 fee is calculated by taking 1.066% of $5,000. Direct PLUS loans have a much higher fee of 4.264%, so beware.

In a perfect world, you'd rather not pay interest or fees. But, if a few thousand dollars is the only thing between you and your college degree, the benefits of taking out a loan will likely outweigh its costs in the long run.

Federal vs. Private

I'm just going to repeat it, very clearly: **federal student loans are better than private student loans.** Here's why:

1. They cost you less. Federal loans almost always have lower interest rates than private loans.
2. They have a fixed rate. With federal student loans, you don't have to worry about your interest rate changing at any time. Many private loans try to attract students by offering low variable rates in the beginning, but these carry the risk of being more expensive in the long run. Variable

13. http://www.bankrate.com/auto.aspx
14. http://www.bankrate.com/mortgage-rates/
15. http://www.bankrate.com/finance/credit-cards/current-interest-rates.aspx
16. https://www.khanacademy.org/economics-finance-domain/core-finance/interest-tutorial/credit-card-interest/v/payday-loans

rate loans could cost you thousands of dollars you didn't plan on spending.

3. Your credit score is *not* taken into account for federal student loans (except for PLUS loans) — meaning you can borrow if you have no credit history at all, which is the case for many high school students.[17]

4. Some federal loans are **subsidized**, meaning the U.S. government pays the interest on the loan while you're still enrolled in school. These loans are awesome because *you get to borrow this money for free* until you graduate.[18]

5. Direct Subsidized Loans and Federal Perkins Loans are need-based. You'll qualify for them if you demonstrate financial need on the FAFSA, which means you don't have to go through a separate application process.

6. Most federal loans have a grace period, which allows you six months after you graduate to start repaying your loans. The grace period gives you time to transition out of college, get settled with into a new home, new job, and new budget before you start paying the loans back. Some private loans have grace periods, but some don't.

7. Federal loans allow you to choose from a variety of repayment plans. You can choose a plan with lower monthly payments based on your income, or even get your loans forgiven.[19]

8. If you're struggling financially, you'd rather have federal loans compared to private loans. The federal government is pretty flexible with students, allowing you to qualify for a deferment (postponing your payments without defaulting)

17. https://studentaid.ed.gov/sa/types/loans/federal-vs-private
18. Or drop below half-time enrollment.
19. Loan forgiveness means that the government says, "You're off the hook for the money you owe us."

for reasons like:

- you're unemployed or having financial hardship
- you're on active military duty
- you've enrolled in graduate school

A quick example of when I experienced financial hardship: A few years after graduating from college, I went to volunteer in Micronesia, earning a stipend of $300 per month. I couldn't afford my $175 monthly student loan payment during this time, so I contacted my federal loan provider, and they placed my loans in deferment. There was no penalty and the process was easy. I was just asked to update them on my work status the following year.

Read more about deferment here: https://studentaid.ed.gov/sa/repay-loans/deferment-forbearance

Timeline

Before Borrowing

Before leaping into loans, be sure you'll be able to pay them down when they come due. You need to have confidence you'll graduate from college with a job and a lifestyle where you **earn more money than you spend**. Highlight that sentence, cut it out of this book, and put it in your wallet for the rest of your life — it's the cornerstone of good budgeting. An example: you shouldn't borrow $80,000 (total) for college unless you're comfortable paying over $800 per month once you graduate. Use a student loan calculator like the one provided at the end of this chapter to estimate your monthly loan payments and income after graduating.

If you need student loans to help pay for your freshman year, you'll likely need to continue to borrow throughout college. Make thoughtful assumptions about how much money you might owe in total as a college student, and know your limits of borrowing before you get involved. Just because you *can* borrow money doesn't mean you *should*. Remember, if you have students loans, it will be your name on the bill after you graduate.

If you're offered federal student loans, you'll see them in the financial aid package sent by your college. If you want to accept these loans, there will be additional instructions provided. Read the details and ask questions by calling your college's financial aid office. Try to avoid private loans at all costs.

While Borrowing

While you're still enrolled in school at least half-time, you won't need to pay for your student loans.[20] For now, focus on managing your path toward graduation, going to class, and not overspending. In your last two years of college, you should start thinking about possible careers, apply for a summer internship to build your experience, and check out a campus job fair to make connections with employers. If you're planning to do something non-traditional — maybe you decide to volunteer in the Peace Corps or work for Teach for America — plan out the process for deferring your loans or choosing the best repayment plan, and check your options for forgiveness. Go to your school's financial aid office or call your loan provider if you have questions.

After Borrowing

During your six month grace period, you should figure out your budget with your new income and expenses. It's easy to make on-time payments from your checking account if you set up autopay. And currently, if you choose to set up autopay for your federal loans, you'll even get a nice little bonus: a 0.25% interest rate reduction. You can usually set up autopay by following the instructions on your first bill or by calling your lender directly. The alternative is to write a check every month.

20. https://myfedloan.org/help-center/faq/enrollment-status-faq.shtml

If you'd like to read more about loan repayment, visit this link: https://studentaid.ed.gov/sa/repay-loans/understand

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PSLF

Another option to get rid of your student loans is enrolling in something called Public Service Loan Forgiveness (PSLF). If you work in public service (as a teacher, firefighter, police officer, etc.), with a non-profit organization (Greenpeace, UNICEF, etc.), or as a volunteer (with AmeriCorps or the Peace Corps), you can get some or all of your loans forgiven.

Only Federal Direct Loans are eligible for PSLF. Loan forgiveness can be a little tricky, so do some research before committing to PSLF. Be strategic and proactive if you want to benefit from PSLF. Read more about loan forgiveness here: https://studentaid.ed.gov/sa/repay-loans/forgiveness-cancellation.

Tax Benefits?

Yes, please! The U.S. government provides tax benefits for your federal and private student loan expenses because they want you to get your education. When you pay interest on your student loans, you reduce the amount of taxes you have to pay that year (this is called your **tax liability**). The more you reduce your tax liability, the more likely you'll get a refund from the government when you file your taxes!

To check out the tax benefits of student loans in detail, go to:

http://www.irs.gov/uac/Tax-Benefits-for-Education:-Information-Center

Stay Woke

"Lower your rate!!!" I still get emails and letters like this every month, and they go straight to the trash. Be cautious when a company tells you it can lower your rate, manage your debt for you, for-

give your debt, or consolidate your loans. Most likely, they'll hit you up while you're paying off your loans after college. Do your research before getting involved, and don't be quick to give away your login or personal information. Remember, these companies are trying to make money from you and some are outright scams. You may save money in the short-term, but it could cost you more in the long-term. Read more here: https://blog.ed.gov/2016/06/dont-pay-help-student-loans/

CHAPTER RECAP

1. Before borrowing money, carefully weigh the costs and benefits of your investment, confidently understand the terms of the loan, and be prepared to repay the money on time and in full.
2. Choose fixed, low-interest rate loans if you need to borrow to pay for college.
3. The federal government offers the best loans. You can get most of them without any credit history; you just need to fill out the FAFSA.
4. As I've mentioned twice before, if you see loans offered in your financial aid award letter, don't accept them unless you need them.
5. Always plan to have a job and a lifestyle where you earn more money than you spend.

ESSENTIAL QUESTIONS

1. When have you benefited from borrowing money in the past?
2. What concerns you most about borrowing money to pay for college?
3. After grants and scholarships, do you think you'll need

more help paying for college?

DO NOW

6.a. Estimate your future salary[21] and calculate your monthly income, after taxes, using these links:

- Research your potential salary here: http://www.payscale.com/research/US/Country=United_States/Salary
- If you're not sure of a career, research the median salary of graduates from your potential college here: https://collegescorecard.ed.gov/
- Calculate your income after taxes here: http://www.adp.com/tools-and-resources/calculators-and-tools/payroll-calculators/salary-paycheck-calculator.aspx

Career	Potential Salary	Monthly Income after Tax
	$	$
	$	$
	$	$

6.b. Estimate how much money you might borrow to attend four years of college. If you don't think you'll need to borrow any money, that's awesome. But for this exercise, assume you're choosing a school where you will need to borrow. Use a Loan Repayment Calculator[22] to determine the total cost of borrowing (interest) and your monthly payment once you graduate.

21. Use a conservative estimate of your potential salary -- meaning you should guess on the low side of how much money you'll make in the future.
22. https://studentloans.gov/myDirectLoan/mobile/repayment/repaymentEstimator.action

Total Loans (Assumed)	Total Cost of Borrowing	Monthly Student Loan Payment
$	$	$

Math Extension Compare a Direct Subsidized Loan, Direct Unsubsidized Loan, and Private loan of your choice. Assume each loan was originated in your first year of college. **Graph a system of functions** that model the interest and principal of these three loans over ten years. **Write a 100 – 250-word statement** comparing the cost of these loans.

6.c. Choose two repayment plans[23] you think might be best for you, then explain your reasoning. Keep in mind: these repayment plans only apply to Federal Student Loans.

Name of Plan #1:	Reason Why:
Name of Plan #2:	**Reason Why:**

6.d. Fill out the following table using 6.a. and 6.b. to estimate your net income after graduating from college. Then write 100 – 150 words describing your thoughts about living on the income you estimated.

Monthly Income after Tax	$
Monthly Student Loan Payment	– $
Net Income	= $

23. https://studentaid.ed.gov/sa/repay-loans/understand/plans