“Student Loan ABCs”

As trusted financial advisers, CPAs are in a position where clients, friends and family ask about college financing or, more specifically, about student loans. But which one do you recommend? Or what combination of loans is best? Options are increasing as demand rises. In California alone, annual federal student loan volume increased 59 percent to $4.5 billion between 1994 and 2004, and continues to grow.

Following is some information to help CPAs understand the financial aid process so they can guide their clients toward the most affordable financing options.

THE FINANCIAL AID PROCESS

To start the process of applying for federal, as well as most state and school financial aid, students need to complete the free Application for Federal Student AID (FAFSA) as soon as possible after Jan, 1 to maximize eligibility for certain types of grant aid. The FAFSA determines the student’s Expected Family Contribution (EFC) by collecting both the student and parent/legal guardian financial data.

The Financial Aid Package (FAP) incorporates information from the FAFSA and is the key piece in the financial aid puzzle. Once a student is accepted to a school, the school will provide an FAP composed of grants, scholarships, work-study and loans. Students need to compare the packages offered by school when choosing which school to attend.

FAPs are assembled annually and must be re-applied for each year that financial aid is sought. Primarily determined by need, financial aid packages are calculated by subtracting the EFC and other non-federal aid from the school’s Cost of Attendance (Figure 1), which, according to the U.S. Department of Education (DOE), “includes tuition and fees; room and board (or an allowance for housing and food); an allowance for books, supplies, transportation, loan fees, and dependent care (if applicable); disability related expenses, and some miscellaneous expenses as well as the cost of a computer and a one time cost of the first professional license or credential," among other expenses.

Figure 1

Cost of Attendance

- Expected Family Contribution
- <u>Other non-federal aid</u>
= Student's Financial Need

If the student's EFC is less than their COA, they may be eligible for need-based financial aid. If the EFC is more than the COA and the student does not qualify for need-based aid, they still qualify for federal student loans. Their school will list the types and amounts of aid for which they are eligible in the FAP.

The types and amounts of aid offered will vary from school to school, depending on each school's cost of attendance, available funds and the number of aid applicants. Students must accept or decline each part of the aid package, depending on their individual preferences.

The FAFSA comes in two formats: paper and electronic. The paper FAFSA is available in numerous places, including high schools, postsecondary institutions, public libraries and by calling 1-800-4EDAID. The electronic version is the recommended method of submission and is available at www.fafsa.ed.gov.

To help students and families financially prepare and plan for college before a student's senior year of high school, the DOE offers FAFSA4caster, an online tool that instantly calculates a student's EFC.

While this calculation in not the "official" EFC, it provides an indication of financial aid eligibility, allowing students to create scenarios based o future earnings and establish college savings strategies. The FAFSA4caster is available at www.fafsa4caster.ed.gov.

In addition to the FAFSA, students who are California residents and are applying to a college or university in California should also submit a Cal Grant GPA Verification from by March 2 in their senior year of high school. Students who submit this form will be considered for grants offered by the state of California to undergraduate students who meet the financial, academic and eligibility requirements. More information on Cal Grants can be found at www.csac.ca.gov.

STUDENT LOANS 101

Of course, students should be counseled to take advantage of all grants and scholarships before turning to loans. Increasingly, though, loans are a necessary part of students' aid packages. And depending on their eligibility, students have many loan options:

- Perkins Loans: These are low-interest loans for undergraduate and graduate students who have financial need. The student's school is the lender and determines eligibility. Schools often allocate Perkins Loans on a first-come, first-served basis, another reason why completing the FAFSA early is important.
- Stafford Loans: These are available for both undergraduates and graduates enrolled at least as half-time students. Students with financial need qualify for subsidized Stafford Loans, in which the federal government pays their interest while they are in school. If they do not qualify for a subsidized Stafford Loan, they will automatically be offered an unsubsidized Stafford Loan and will be responsible for interest that accrues while they are in School.

For Stafford Loans first disbursed after July 1, 2007, the interest rate is 6.80 percent before any lender rate reductions are applied.

- PLUS Loans: These are provided to students' parent(s). Because there are limits on the amount of Stafford Loan debt students can incur, PLUS Loans are useful option for many families. The borrower must pass a credit check and generally begin repayment within 60 days after the loan is disbursed.

Additionally, graduate students may borrow directly through the Grad PLUS Loan program, which operates similarly to the PLUS Loan program.

For PLUS Loans and Grad PLUS Loans first disbursed after July 1, 2007, the interest rate is 7.9 percent or 8.5 percent before any lender rate reductions are applied, depending on whether the student borrows from a private sector lender or from the U.S. Department of Education.

- Consolidation Loans: These are a means for borrowers to combine multiple loans into a single loan, often with lower monthly payments. For recent graduates, consolidation may be a great option as the lower payments help them avoid default. However, there are cases when consolidation may not be best.

For example, if a borrower enjoys a reduced interest rate for making on-time payments, they will lose that benefit if the loan is consolidated. Also, consolidation loans extend the repayment period, meaning borrowers will pay more in interest over the life of the loan; however, there is no penalty for early repayment.

The interest rate on consolidation loans is the weighted average of the underlying loans, rounded up to the nearest one-eighth of a percent, and is capped at 8.25 percent.

All of the interest rates discussed above are the maximum rates set by Congress. Lenders often offer lower rates and/or payment of fees as a way to attract more borrowers. While many of these "borrower benefits" look great on paper, borrowers need to pay close attention to the details and choose the benefit most likely to be realized. For example, many lenders offer an interest rate reduction after 48 on-time payments, but few borrowers make it four years without at least one late payment and thus do not qualify.

- Private Loans. These are nothing more than consumer loans targeted to education expenses. Sometimes referred to as alternative or supplemental loans, they are credit-based and carry higher interest rates than federal loans. Across the board, the best strategy for borrowers is to exhaust their federal loan opportunities before turning to private loans, credit cards, or other financing vehicles.
- Nonprofit lenders: This is an often overlooked resource for student loans. Focused on mission instead of increasing return for shareholders, nonprofit lenders often offer the best rate on federal student loans. Moreover, many nonprofits offer loan forgiveness for borrowers in certain fields (such as nursing) and unbiased financial aid literacy materials that can be easily adapted for use with clients.

CHANGING TIMES

In the past, school financial aid offices were students' primary source of information on financial aid and student loans. Today, as competition increases, lenders are marketing directly to students and families. The resulting mound of information can be confusing, leaving CPAs in a position to provide guidance. The aforementioned information can provide a starting point for CPAs to gain knowledge and step and fill that gap.