How to Pick the Right Student Loan

By

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Updated Feb. 1, 2015 11:00 p.m. ET

College financial-aid season is in full swing, which means millions of families will soon decide whether they need student loans to help cover tuition bills for the 2015-16 year.

Students generally choose between federal student loans, provided by the U.S. government, or private loans, available at some banks and other financial institutions.

Students and their parents have been advised for years to sign up for federal loans before considering private options. But recent changes are making private loans attractive for more students—in particular those with creditworthy parents who can qualify for lower rates than are available with federal loans.

These changes come as private lenders are looking to court young, lifelong customers who later will need mortgages and other banking and loan products. This is also largely why some lenders have rolled out refinancing options that can lower the interest rate on student loans, and loan modifications for some borrowers who are unable to make their payments.

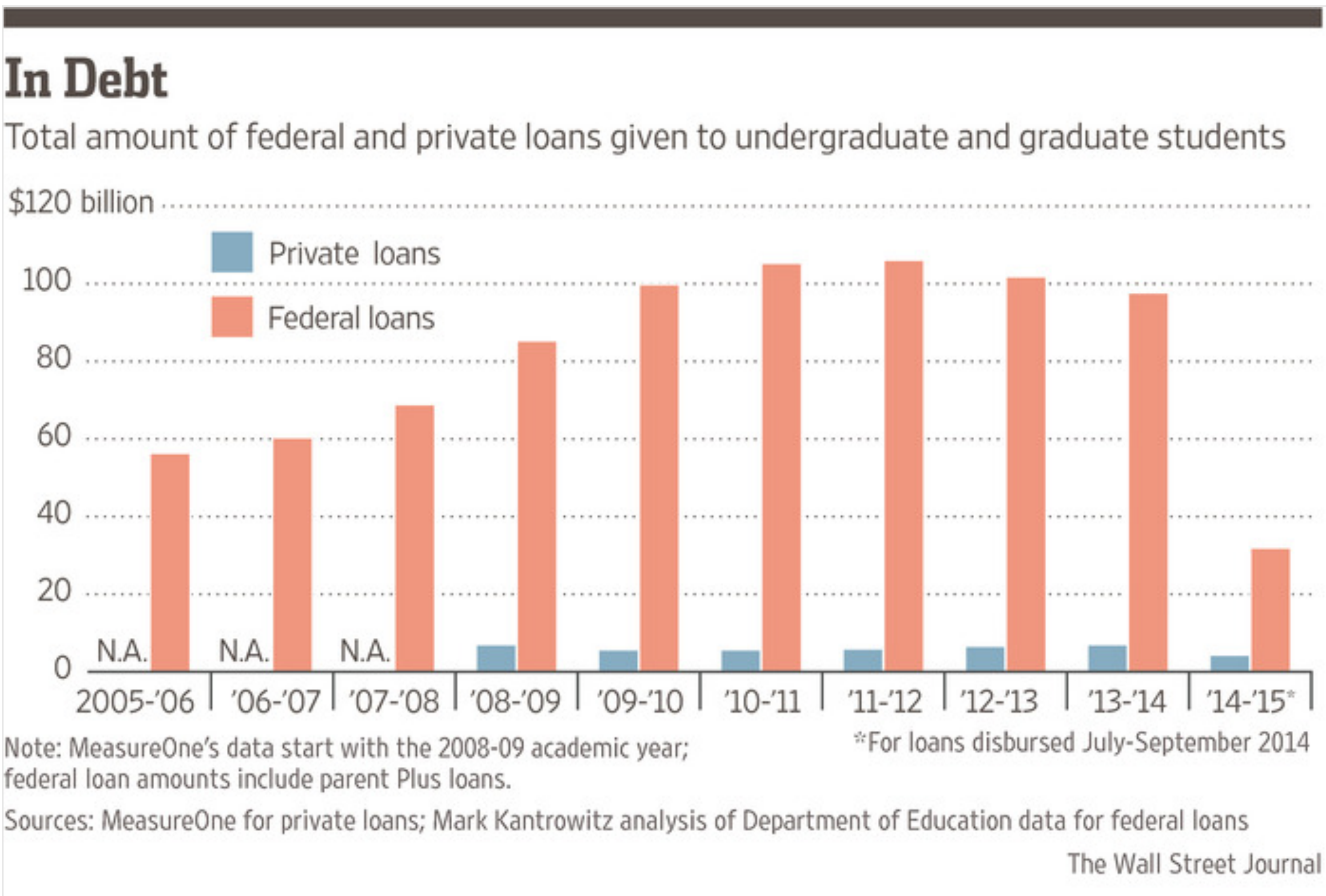
The Wall Street Journal spoke with two college-loan experts about the key differences between the two types of loans and what parents and students should be aware of before they apply: Mark Kantrowitz, senior vice president at Edvisors.com, which tracks financial aid trends, and Dan Feshbach, chief executive at MeasureOne, which tracks student loans.

Here are edited excerpts:

WSJ: Who should consider federal loans?

MR. KANTROWITZ: Undergraduates who are borrowing on their own, without help from their parents, should always choose federal loans. They are cheaper—since everyone who gets approved gets the same fixed rate—and have better repayment terms. If borrowers are unable to repay the loans because of a low salary or unemployment, they can qualify for repayment options that will keep them out of default, which can ruin their credit. Federal loans have more of these options than private loans.

MR. FESHBACH: Pick a federal loan if you are concerned about your employment when you get out of school or if you see some reason in your financial future that might lead to needing to modify your payments. If, for example, you're going to school to be a social worker or a teacher, federal loans offer a lot of benefits, such as loan forgiveness in public-service jobs, which means you may not have to pay back the full amount.



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Cheapest Federal Options

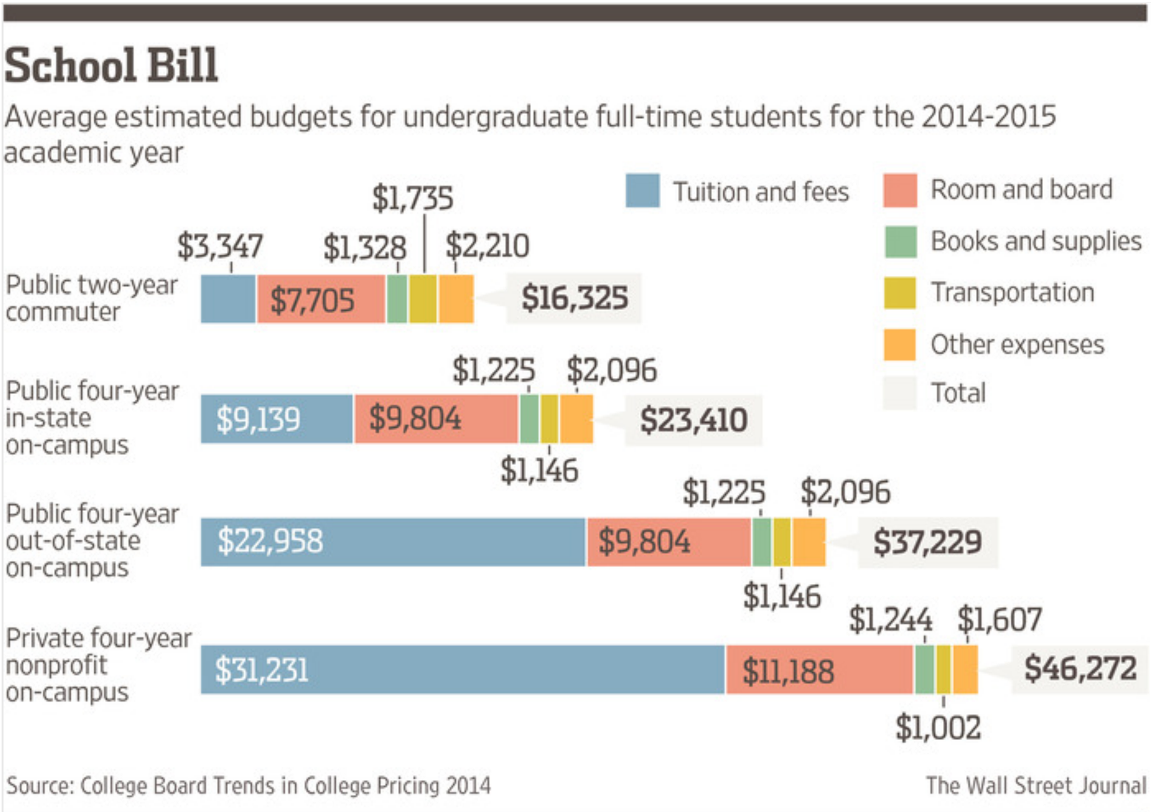
WSJ: What are the cheapest federal loans and who can qualify for them?

MR. KANTROWITZ: The federal government pays the interest on subsidized federal loans—which include the subsidized Stafford loan and the Perkins loan—while undergrads are in college and for the six and nine months, respectively, after graduation or after the student drops below halftime enrollment. The government also pays the interest during certain periods of deferment.

Loan amounts are determined by the college financial-aid office, based on financial need. For borrowers who received the subsidized Stafford loan for the 2014-15 school year, the interest rate is 4.66%, plus an origination fee. The interest rate on the Stafford loan is likely to increase in 2015-16, at which point the Perkins loan is likely to once again be the lowest-cost federal education loan.

WSJ: Who are private loans a good deal for?

MR. FESHBACH: People with high credit scores, often at least around 740 on the FICO scale, which tops out at 850. Private loans are largely viewed as a family loan because cosigners are required in most cases. The federal government charges interest rates that aren't correlated with the likelihood of a creditworthy borrower defaulting. The federal Plus loan [which can be used by parents of undergraduate students or by grad students] for the current academic year has a 7.21% interest rate plus an origination fee. Many borrowers can qualify for a better rate and terms with private lenders.



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WSJ: How should borrowers compare the costs of these two types of loans?

MR. KANTROWITZ: The first thing to compare is whether the loan has a fixed or variable rate. All new federal loans currently have fixed rates. Private lenders offer fixed and variable rates. The variable rates are the lowest, but could increase significantly over the next four to six years. Loan applicants should add four percentage points to the variable interest rate they're being offered to get a ballpark estimate of the average interest rate they're going to pay over the life of the loan, assuming a 10-year repayment term.

If you're planning on paying off that private loan in just a few years, then a variable rate may save you money compared with a fixed rate.

Also compare loan fees. There is a 1.073% origination fee for federal Stafford loans and a 4.292% fee for the federal Plus loan. These fees may rise for the coming school year by a small amount depending on Congress. Most private loans don't charge fees these days. Amortized over a 10-year term, 4% in fees is about the same as a one-percentage-pointhigher interest rate.

WSJ: What should borrowers keep in mind about repayment options?

MR. KANTROWITZ: Federal loans allow borrowers to postpone payments for three years or longer through deferment or forbearance if they are facing a financial difficulty, like unemployment or medical expenses. Borrowers whose income is too low to pay their monthly bills in full can apply for income-based repayment or the pay-as-you-earn program, which lower the monthly payments.

With private loans, you're usually limited to no more than a year in total forbearance, typically in two-month increments. Some lenders extend repayment terms, which lowers the monthly payment [but increases a loan's total cost], and some allow for periods with interest-only payments followed by regular amortization. Lenders have been demonstrating increased flexibility in modifying terms of their loans for borrowers experiencing financial difficulty.

Lower the Rate?

WSJ: Can you ever lower the rate?

MR. FESHBACH: Borrowers can consolidate federal student loans at StudentLoans.gov. The interest rate won't be lower, it will simply be the dollar-weighted average of the rates on the underlying loans [rounded up to the nearest one-eighth of a percentage point.]

Borrowers retain the ability to use federal loan assistance programs, such as forbearance and income-based repayment. They may be able to lengthen the term of their loan, but the total amount they will pay over the life of the loan will increase.

A number of private lenders will refinance private student loans. The pricing and terms are based [in part] on the applicant's credit history. Many with good credit histories and strong income may get a materially better rate than the rates on underlying loans. They may be able to extend the term of the loan as well.

A small number of lenders, nonbanks and a few banks, are offering to refinance any combination of federal and private loans. Individuals who are refinancing federal loans into private loans will be giving up the borrower benefits offered by federal loans, such as the amount of eligible forbearance, debt forgiveness for public-service jobs, and some income-based programs. Private lenders target highly qualified borrowers who are unlikely to need or use such benefits. Borrowers wanting to refinance often need a cosigner to stay with them on the loan.

WSJ: Does one loan leave parents more on the hook than another?

MR. FESHBACH: If you [a parent] decide to cosign a private loan, you're signing on the dotted line to make a commitment to step in if your child can't make the payments.

MR. KANTROWITZ: Parents who sign up for the federal Plus loan aren't eligible for income-based repayment or loan forgiveness—so the difference between federal and private loans is much narrower for parents than students. Parents are on the hook either way, as the borrower of a federal Plus loan or as the cosigner of a private student loan.

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