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Six Common Mistakes People Make With Their Student Loans

By Anne Ter*gesen WSJ print Sept 12, 2016*

As millennials struggle to repay record levels of student-loan debt, many are making costly mistakes that threaten to undermine their long-term financial security.

For instance, roughly one in four is behind on repayments or in default, which can result in a host of negative consequences, from damaged credit to garnished wages. Meanwhile, many others are struggling to find enough money, after making their loan payments, to save for retirement. Among 401(k) participants with student debt in plans administered by Fidelity Investments, two-thirds say they have reduced or stopped their 401(k) contributions or have taken out a 401(k) loan or hardship withdrawal.

With total college-loan debt in the U.S. more than five times what it was just 20 years ago, "the consequences of managing that debt have never been greater," says Heather Jarvis, an attorney who teaches financial professionals about student loans.

What follows are six student-loan mistakes people commonly make and how you can avoid them.

MISTAKE NO. 1: Failing to consider income-driven repayment plans

When it comes to government-backed student loans, many people stick with a "standard" repayment plan. This default option requires the borrower to make fixed monthly payments for up to 10 years—an approach that often minimizes the interest the borrower will pay over the life of the loan, in comparison to other payment plans, but maximizes monthly payments.

Some borrowers—particularly those who are cash-strapped—may benefit from an income-driven repayment plan. These plans, the newest of which became available last year, cap student-loan repayments at 10% to 15% of a borrower's annual discretionary income—an amount that is determined by a formula that includes the borrower's income and family size, among other factors. Using one, a borrower can free up cash for other long-term financial goals, such as saving for retirement.

Payment Plans

The various repayment options and requirements for federal student loans

REVISED PAY AS YOU EARN

ELIGIBILITY: Anyone who took out a federal Direct student loan to pay for their own schooling. Excludes Parent PLUS borrowers.

MONTHLY PAYMENT: 10% of discretionary income.

REPAYMENT TERM: Remaining undergraduate debt is forgiven after 20 years of repayment for those with only undergraduate loans. For those with undergraduate and graduate loans, any remaining debt is forgiven after 25 years.

PAY AS YOU EARN

ELIGIBILITY: All federal student-loan borrowers with a partial financial hardship. Excludes Parent PLUS borrowers.

MONTHLY PAYMENT: 10% of discretionary income, up to the standard 10-year payment amount.

REPAYMENT TERM: Remaining debt is forgiven after 20 years of payments.

NEW INCOME-BASED

ELIGIBILITY: All federal student-loan borrowers with a partial financial hardship. Excludes Parent PLUS borrowers.

MONTHLY PAYMENT: 10% of discretionary income, up to the standard 10-year payment amount.

REPAYMENT TERM: Remaining debt is forgiven after 20 years of payments.

ORIGINAL INCOME-BASED

ELIGIBILITY: All federal student-loan borrowers with a partial financial hardship. Excludes Parent PLUS borrowers.

MONTHLY PAYMENT: 15% of discretionary income, up to the standard 10-year payment amount.

REPAYMENT TERM: Remaining debt is forgiven after 25 years of payments.

INCOME-CONTINGENT

ELIGIBILITY: All federal Direct Loan borrowers, including borrowers who consolidate their Parent PLUS loans.

MONTHLY PAYMENT: Up to 20% of discretionary income. (The government uses a different definition of discretionary income for this plan).

REPAYMENT TERM: Remaining debt is forgiven after 25 years of payments.

—Jillian Berman

Source: The Department of Education and The Institute for College Access and Success

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They also offer the possibility of loan forgiveness after a set number of years of on-time repayments—from 10 to 25 years, depending on the plan and the borrower's profession. More on that in Mistake No. 3.

For those looking to reduce their monthly payments, these options generally are more attractive than older alternatives, including "graduated" and "extended" plans, says Ms. Jarvis. Graduated plans start with lower payments that increase every two years—and eventually surpass the standard fixed payment. Extended plans lower monthly payments by allowing up to 25 years for repayment.

Borrowers whose debt is two-thirds of their income or more are likely to qualify for at least some of the various income-driven repayment plans, says Mark Kantrowitz, a financial-aid expert and the publisher of Cappex.com, a college scholarship and search site.

But those who can benefit the most from these plans generally have debt in excess of their income—a threshold at which borrowers are likely to eventually see some of their loan balances forgiven, says Ms. Jarvis.

MISTAKE NO. 2: Failing to understand the loans

There are two basic types of student loans: federal and private. Interest rates on federal loans are set annually by a formula based on the yield of the 10-year Treasury note. With private loans, banks set interest rates using a borrower's credit history.

To understand their repayment options, it's important for borrowers to compile a list of their loans, including the loan type, principal amount and interest rate. Lenders should have the details or, for federal loans, borrowers can go to the National Student Loan Data System at nslds.ed.gov.

Why bother? For one thing, borrowers need to know the interest rates on their loans to figure out whether it makes sense to refinance or consolidate what they owe. (With refinancing, a borrower takes out a new private loan to pay off some or all of his or her existing loans, typically at a lower interest rate. With consolidation, the borrower combines some or all existing federal loans at the weighted average interest rate on the old loans. See more on these options in Mistake No. 5.)

In addition, to understand which income-driven repayment options borrowers are eligible for, they'll need to know the dates when they borrowed. For example, to use the popular Pay As You Earn (PAYE) method—an income-driven plan that frequently generates the lowest monthly payments and the highest projected loan

forgiveness—a borrower can't have borrowed before Oct. 1, 2007 and must have taken out at least one federal loan on or after Oct. 1, 2011.

To see what monthly and total payments would be under the various repayment options, borrowers can plug their loan information into the U.S. Education Department's online Repayment Estimator. Among other things, this tool assumes income will rise 5% a year. If borrowers want to control that and other inputs—such as the number of children they plan to have and information about their spouse—they can use the Student Loan Repayment Simulator sponsored by the nonprofit VIN Foundation for veterinarians.

For advice, a borrower might consider hiring a financial planner. The XY Planning Network consists of some 290 financial advisers who cater to younger clients. Some have expertise in student loans and charge hourly or project-based fees.

Beware of companies that charge an upfront fee to help student-loan borrowers obtain debt relief, says Ms. Jarvis, adding that some are scams.

MISTAKE NO. 3: Failing to research student-loan forgiveness programs

Some employers—including the U.S. military, PricewaterhouseCoopers and Fidelity Investments—contribute to employees' student-loan payments.

Borrowers with federal loans who use income-driven repayment plans may also receive partial loan forgiveness.

Under the Federal government's Public Service Loan Forgiveness program, teachers, law-enforcement employees, doctors, lawyers and others who work full-time for 10 years for certain types of nonprofits or government are eligible to have their remaining balances forgiven tax-free after 10 years of payments. To ensure they will receive loan forgiveness, they should use an income-driven repayment plan.

For those not in public-service jobs, loan forgiveness is less generous. To qualify, these borrowers must repay their loans for 20 to 25 years—the exact term depends on which income-driven repayment plan they select. In addition, they must pay income tax on any debt that is canceled—a payment that can amount to as much as one-third or more of the forgiven amount.

MISTAKE NO. 4: Prioritizing student loans at the expense of retirement savings

In a push to become debt-free, many borrowers prioritize paying off their student loans over saving for retirement.

That's a mistake. A recent report from Morningstar Inc. subsidiary HelloWallet found that someone with a starting salary of $50,000 who pays off a $20,000 student loan ahead of schedule but skimps on retirement savings—by contributing only enough to an employer-sponsored 401(k) plan to receive half the employer's 3% matching contribution—will wind up with a net worth at age 65 that's $150,000 below where it would have been had he or she contributed enough to receive the full match and repaid the loan over a longer period, by making the minimum required payment.

"The match is free money," says Marcio Silveira, a financial adviser in Arlington, Va. If a company offers a 50-cent match for every dollar an employee contributes to a 401(k) plan up to 6% of pay, "it's a 50% return on your money," he says. That's far higher than the return on paying off a student loan, which is equivalent to the loan's interest rate.

If payments under a 10-year standard repayment plan leave a borrower too cash-strapped to get an employer's full matching contribution and the employee doesn't have room to cut spending, he or she might consider an income-driven repayment plan, says Jake Spiegel, a senior research analyst at HelloWallet.

His advice: Borrowers should use the cash they free up to set aside at least three months of expenses in an emergency fund. Then, they can save enough in their 401(k) plan to receive their employer's full matching contribution. Their next priority should be to pay down any high-interest credit-card debt they owe. And if choosing an income-driven plan means they're likely to incur a tax on debt forgiveness, they should save a little each month to cover the projected tab.

Anything left over should go into a retirement plan, says Mr. Spiegel.

Why? People are likely to earn a higher return in stocks and bonds—that will compound for decades—than they would by extinguishing student-loan debt at today's low interest rates, he says. In addition, the more a person contributes to a traditional 401(k) plan, the lower his or her adjusted gross income will be. This will help reduce income-driven student-loan payments the next year, says Daniel Wrenne, a financial adviser in Lexington, Ky.

MISTAKE NO. 5: Automatically refinancing or consolidating

If people with student loans have private loans with high interest rates, they should look into refinancing. Online lenders including Social Finance Inc., CommonBond Inc., and First Republic Bank frequently offer attractive deals to those with healthy credit scores and good prospects for future earnings, among other factors, says Mr. Wrenne.

Borrowers can refinance their federal loans, too, but they should be careful, weighing any interest-rate reduction they receive against the benefits they'll lose by swapping their federal loans for private loans. These include the flexibility to suspend their payments if they become unemployed or to use an income-driven repayment plan.

The decision to consolidate also requires analysis. Consolidation makes it easier to keep track of and repay student debt. It also allows borrowers to swap loans issued under the discontinued Federal Family Education Loan program for a new Federal Direct loan—a prerequisite to using certain income-driven repayment plans.

But borrowers who consolidate all their loans lose the flexibility to pay off the ones with the highest interest rates first. Borrowers who want to maintain that flexibility don't have to consolidate all of their loans, says Ms. Jarvis.

MISTAKE NO. 6: Failing to automate payments

To ensure they won't be late with their loan payments—a misstep that can wreak havoc with credit scores and push back the date at which one becomes eligible for debt forgiveness—borrowers should automate all of their loan payments. Many lenders offer those who do so a reduction of a quarter to half a percentage point in their interest rates, says Mr. Kantrowitz.

Advisers suggest that people automate their savings, too, including contributions to 401(k) plans and emergency savings. If they are in an income-driven repayment plan that will generate a tax bill on forgiven debt, they should start saving for that, as well.

To keep tax savings on track, Alan Moore, a financial planner in Nashville, Tenn., suggests segregating this money in a separate investment account.

"If you don't save enough money for the tax bill, all you are accomplishing is swapping your student-loan debt for a debt to the IRS," he says, adding that savings earmarked for the tax payment shouldn't be invested too heavily in stocks due to the risk of a bear market.

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