Student Loan Debt: What Every Borrower Should Know

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It's mid-May. You open your social media app of choice, and your newsfeed is flooded with pictures of smiling people in caps, gowns, and cords preparing to shake hands with the dean and receive their diplomas. This time of year is full of graduation parties, celebrations of new jobs and hopeful aspirations for the future.

But if you look under the surface, you will find that many graduates are in distress about one thing that could get in the way of all that: student loan debt. Here are some points you can share with graduates to help put them at ease. (For related reading, see: *How to Get Out of Paying Your Student Loans.*)

Know Your Debt

It is important for graduates to know and understand the types of student loans they have. There are two broad categories of student loans: federal loans and private loans. Recent or near-graduates can start by obtaining an inventory of their loans to learn what they have outstanding. Federal loan inventories with details on balances and interest rates are available at the National Student Loan Data System. A credit report—available for free once per year at annualcreditreport.com—may have details about private loans. If you know what company is servicing the loans, you may be able to request the actual promissory notes from them.

Federal loans may have some favorable characteristics compared with private loans. Federal student loans have had fixed interest rates since 2006, and they may have lower interest rates than private student loans. Additionally, some federal loans may be eligible for income-driven repayment plans, which can provide flexibility and reduce some of the stress associated with traditional payment plans. Graduates with federal student loans should be wary when presented with refinancing offers from private student loan providers, even ones that would initially reduce their monthly payments or interest rates. Bottom line: graduates who find themselves with only federal loans may be able to begin breathing a little easier. (For related reading, see: *6 Life Events That Call for Professional Financial Advice.*)

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Consolidation Is Key

Some federal student loans can offer flexibility through income-driven repayment plans, but the only loans that are definitively eligible for those plans are known as direct loans. Other loans that are not eligible for income-driven repayment include Federal Family Education Loans (including Stafford Loans and PLUS Loans),Federal Perkins Loans and certain health profession and nursing loans. Fortunately these other types of federal student loans may become eligible for income-driven repayment plans by consolidation through the Federal Direct Consolidation Loan Program. Once consolidated, the new loan will be categorized as a Direct Consolidation Loan and become eligible for one of the income-driven repayment plans. Consolidation can also simplify loan repayments by centralizing all of an individual's federal loans with one bill. Direct Consolidation Loans have a fixed interest rate calculated as the weighted average of the consolidated loans' interest rates.

Federal loan consolidation is free and can be completed with an online application at studentloans.gov. A complete list of the graduate's specific federal loans that are eligible for consolidation is available within the application. Unfortunately, private loans are not eligible for the Federal Direct Consolidation Loan Program. One important item to consider is that consolidation cannot be reversed. Once consolidated, the original loans are effectively paid off and no longer exist, and the new consolidated loan takes their place.

After the graduate has consolidated his or her federal loans, he or she can begin to examine repayment options and choose the one that best suits his or her situation. (For related reading, see: *5 Financial Strategies to Last a Lifetime.*)

Income-Driven Repayment Plans

There are four income-driven repayment plans that are available for Direct Loans and Direct Consolidation Loans: Income-Contingent Repayment (ICR), Income-Based Repayment (IBR), Pay As You Earn (PAYE), and Revised Pay As You Earn (REPAYE).

Each plan allows for flexible payments based on income and establishes a fixed repayment period. The payments are calculated based on a formula that includes adjusted gross income and household size. An income-driven monthly payment can be calculated as low as $0. This can provide relief for those experiencing difficulty landing their first job or earning entry-level salaries and who still want to achieve other financial goals that come along with independence in their 20s and 30s.

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The repayment periods range from 20 to 25 years after which no further payments are due, even if a loan balance remains. That's right: direct loans have the potential to be partially forgiven under income-driven repayment plans. This is a key benefit of holding federal over private student loans. A glimmer of light can be seen at the end of the long, dark tunnel. Graduates may still face at least 20 years of payments before they can become debt-free, but they will not have to worry about making payments beyond their own retirement.

Wait, There's a Catch …

There is one catch to federal loan forgiveness. Any loan balance that is forgiven at the end of the repayment period will be treated as taxable income to the borrower in the year of forgiveness. In 20 to 25 years, when the borrower is most likely established in his/her career and in a higher tax bracket, the taxable loan forgiveness may seem like more of a curse than a blessing. However, there is yet another federal program that can provide a final form of relief. Under the Public Service Loan Forgiveness Program (PSLF), final direct loan forgiveness is non-taxable. The PSLF program can be layered on top of any of the direct loan income-driven repayment plans. However, PSLF is only available to those working full-time for a government organization, 501(c)(3) charity, or other qualifying non-profit that provides a public service.

Those who qualify for PSLF may also be eligible for loan forgiveness after only 10 years (120 separate monthly payments). This could be a fantastic solution for those that fit the program's criteria.

Don't Wait Until Graduation

These topics represent the basic steps toward contending with federal student loans. Of course many nuances and complexities exist and as is the case with most complex situations, knowledge is key. For those who must take on student debt, I urge them to educate themselves while they are still students on the different types of student loans and federal programs available. Having an early understanding of this information can leave a graduate with a much less imposing student loan inventory. (For related reading, see: *Financial Advice for Women of Any Age.*)