



Consolidating Student Loans Not Always Best Option

By AnnaMaria Andriotis
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WHEN IT WAS first introduced in the mid-1980s, student loan consolidation was touted as a much-needed solution for those struggling to pay their debts from college. Borrowers could combine their Stafford and Plus loans into one payment and lock in the prevailing interest rate — typically, one lower than the average rates that they were previously paying on their other loans.

Times have changed, however, and consolidation is no longer the cheap and attractive option that it used to be. Thanks to the declining federal funds rate and the phasing out of variable-rate loans, consolidating your student loans now will actually cost you more over the lifetime of the loan. Eventually, consolidation will come back into fashion for variable-rate loans (rates should be much more attractive when they reset in July). But it will probably never again be the least-expensive solution for those with fixed-rate loans.

Here are some ways borrowers can ensure they're getting the best deal. (We've included a glossary of student loan terms¹ to help you along the way.)

Hold Onto Variable-Rate Stafford & Plus Loans for Now

If you're currently making payments on a variable-rate Stafford or Plus loan, don't consolidate for at least a few months, says Mark Kantrowitz, publisher of FinAid.org, an online source for student financial aid information.

Here's why: Federal loan interest rates are tied to the investment rate of the 91-day Treasury bill. To establish the price of the T-bill, auctions are held on a weekly basis. The last auction to occur in May of each year sets the base rate for student loans for the upcoming academic year and goes into effect come July 1. Last year's May 29 auction ended with a T-bill investment rate of 4.9%.

On top of the base rate, an additional interest rate gets tacked on to establish the federal student loan rates. For example, a 1.7% rate was added to the 4.9% to create the current interest rate for Stafford loans in the grace period (a grace period lasts up to six months after graduation). For Stafford loans in the repayment period, which starts once the grace period expires, a 2.3% rate was added to the base rate.

Since July 1 last year, the Federal Reserve has cut the fed-funds rate six times. These cuts have dramatically lowered the T-bill investment rate, which moves in tandem with the fed-funds rate. At the latest auction on March 17, the T-bill investment rate dropped to a mere 1.12%.

On the surface, this appears to be great news for those looking to consolidate. The problem is that any student consolidating now will be stuck paying the higher rate from last year.

Say you have a Stafford loan that's in the repayment period: Your rate is 7.22%. Consolidate now and you'll end up paying a slightly higher 7.25%. Wait until July 1 to consolidate, however, and rates will be near historic lows, says Kantrowitz. The chart below gives you an idea of how much borrowers holding variable rate loans can save if they wait until on or after July 1 to consolidate:

	Stafford Grace Period	Stafford Repayment Period	Plus Loans
Without consolidating	6.62%	7.22%	8.02%
Consolidating now	6.625%	7.25%	8.125%
Consolidating on or after July 1*	2.88%	3.50%	4.25%

Rates for Stafford loans in repayment and Plus loans are for individuals who took out loans no earlier than July 1, 1998.

* Projections made by Kantrowitz based on the recent investment rate of T-bills.

Don't forget that you have a month between the end of May when the base rate is set and July 1 when the new student loan rates go into effect to weigh your options. "If the impossible happened and...the T-bill rate was [rising], you'd...have the month of June to consolidate your loans with the old rates," says Sallie Mae spokesperson Martha Holler.

Don't Consolidate Fixed-Rate Loans

In the past, all student loans came with variable rates. If a borrower had difficulty making their payments, they could consolidate their loans into one low fixed-rate loan.

But as of July 1, 2006, every Stafford and Plus loan now carries a fixed interest rate, making it unnecessary to consolidate in order to lock in a set rate. In fact, borrowers who have fixed-rate loans should never consolidate them. If they do, they'll end up with a higher interest rate than they're already paying. Under consolidation, the interest rate will be the weighted average of the rates of the loans being consolidated, rounded up to the nearest 1/8 of 1%.

Subsidized Stafford loans taken out for the 2007-08 academic year carry an interest rate of 6.8%; the rate for 2008-09 loans is 6%, and for 2009-10, 5.6%. Unsubsidized loans will still carry a 6.8% fixed rate indefinitely. For Plus loans sold through the Direct Loan program, rates are fixed at 7.9%. Plus loans dispersed through the Federal Family Education Loan (FFEL) program carry an 8.5% rate.

Standard Repayment-Period Plans

If you're really struggling to make the payments on your fixed-rate loans, consider temporarily lowering your monthly payments without stopping or postponing your payback period. (Doing so means you'll have to pay more on the back end.) Here are two plans offering a standard 10-year repayment period:

1) Graduated Repayment: With this plan, your interest rate doesn't change. You'll pay a small amount in the beginning — as low as interest-only for the first four years — and your payments will gradually increase over the life of the loan.

2) Income-Sensitive Repayment: This plan is available for loans distributed through the FFEL program. Your monthly payments are between 4% and 25% of your monthly income. At a minimum, your monthly payment must cover the loan's interest.

Extended Repayment Plans

Think you might need more than a decade to pay off those four years of pricey liberal arts education? Then extended repayment plans — while not the most attractive choice by far — may be your best option. Consider a plan that extends your repayment period only if you're unable to pay off your loans in 10 years, says Holler. Any plan with a time horizon of more than 10 years, she says, will cost you a lot more.

"The goal is to find the plan that's suitable to your financial needs," says Holler. You'll need to create a budget to identify the figure that you can pay each month, and speak with your lender about what payment plan works best for you. Should you decide that an extended plan is necessary, here are the 25-year repayment options:

1) Income-Contingent Repayment: This plan is strictly for Stafford and Graduate Plus loans disbursed through the Direct Loan program. Payments are based on the borrower's income and debt. Monthly payments are adjusted annually as your income changes.

2) Income-Based Repayment: This plan goes into effect on July 1, 2009, and is available to both Direct Loan and FFEL program participants with the exception of Parent Plus loans. It pegs your monthly payment to 15% of the amount that your annual discretionary income exceeds 150% of the poverty line, divided by 12 months. The national poverty line for one person is currently \$10,400 in annual income, although that varies based on where you live and the size of your family. So, under this plan, a recent graduate who lands an entry-level job making \$25,600 would have a \$125 monthly payment, says Kantrowitz. This payment will increase in correlation to any increases in salary that the individual receives.

3) Extended Repayment: You'll qualify for this plan if you have \$30,000 in student-loan debt. If you have a variable-rate loan, your interest rate will adjust throughout the life of the loan. If you have a fixed-rate loan, your interest rate and monthly payment will remain the same.

Student Loans Primer

Here's a brief description of the loans and programs discussed in this article.

Consolidation: Allows individuals to combine their federal student loans (whether they're variable- or fixed-rate loans) into one loan with one fixed interest rate and one monthly payment throughout its duration.

Direct Loan Program: Both unsubsidized and subsidized Stafford and Plus loans are available through this program, which is run by the Department of Education. The DOE sends the money to the school, and the school issues the loans to the students.

Federal Family Education Loan (FFEL) Program: Stafford and Plus loans are available through this program where loans are subsidized by the DOE and are provided by private lenders to students and their families.

Plus loans: Graduate students and parents of undergraduate students take out these loans. Parents begin repaying these loans almost immediately (typically, 60 days after full disbursement) while the undergraduate students are in school. Graduate students can defer payments until graduation.

Subsidized Stafford loans: Students who demonstrate financial need on their Free Application for Federal Student Aid (FAFSA) — which shows family size, income and assets — receive these loans. The government pays for the loan's interest while the student attends school. Once they graduate, the student takes over the payments. As of July 1, 2006, these loans carry a fixed rate.

Treasury Bill: This is a short-term security with a maturity of one year or less. The 91-day T-bill is auctioned on a weekly basis. Its investment rate is tied to the federal student loan interest rates. If the T-bill rate drops, then the rate for the variable-student loans drops.

Unsubsidized Stafford loans: These loans are available to students regardless of their financial status. As of July 1, 2006, they carry a fixed rate.

For more information on these loans and loan programs, click [here](#)².

Links in this article:

¹<http://www.smartmoney.com/consumer/index.cfm?story=20080319-student-loans&pgnum=2#primer>

²<http://www.smartmoney.com/college/finaid/index.cfm?story=demyst>

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