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Answering Questions on Student Loan Rates and the Murky Future

By RON LIEBER

Figuring out how to pay for college has quickly turned into one of life's most complicated financial decisions.

This is not because the decision involves the largest number of dollars, although it is getting there for many families. Instead, it is because of a number of confounding factors. There is the uncertainty about a student's future ability to pay back student loan debt or whether spending twice as much for some schools will lead to a future that is twice as lucrative or happy. Then there is the difficulty of having a teenager participating in an enormous financial decision without much experience to draw on.

But perhaps the biggest problem is that people don't always know where to find good information about the choices and their consequences. This was readily apparent this week when, in the wake of our continuing series of stories about student loans, we took questions on the topic on our Bucks blog.

We were able to answer many of the questions fairly quickly, but others were big enough and searching enough that I decided to tackle them here. They fall into two categories: questions about why the rules on interest rates and refinancing are the way they are and how to avoid unpleasant financial surprises after you have taken on all that debt.

Here are answers to four of the most important ones:

High Rates

While one type of federal student loan is (possibly temporarily) available at a 3.4 percent interest rate, others cost 6.8 percent, and loans for parents and graduate students are 7.9 percent. (Private loans from banks are often more costly.) Why are they so high, given the low prevailing rates elsewhere? "I tell Europeans this, and they laugh and shake their heads," said one reader in Copenhagen. As we learned this year when a skirmish broke out in Washington over whether certain rates were going to rise, it is Congress that sets the rates. And doing so is a political act, not one necessarily rooted in economic science or reason.

"Budgeting for the government starts from the status quo, and the status quo is 6.8 percent and 7.9 percent," said Robert Shireman, who worked on student loan issues at the Department of Education for the first few years of President Obama's term. So any change that benefits borrowers means an offsetting cut someplace else, perhaps in Pell Grants for the truly needy.

Jason Delisle, director of the federal education budget project at the New America Foundation, a nonpartisan public policy institute in Washington, begins his analysis by noting how different student loans are from loans like mortgages, which have fixed interest rates that are half of what some student loans offer today. There is no credit check for students, no down payment and no collateral or consideration of where you are studying or whether you are majoring in underwater basket weaving.

Also, the loans come with repayment options and loan forgiveness programs that mortgages do not have.

That's not to say that Mr. Delisle isn't sympathetic to the call for lower rates, given that the student loan program does take in more than it lends out. But how would you set the new rates? The fixed interest rates that exist today seemed to be a good deal when Congress set them years ago.

"Congress could go back to variable interest rates," he said. "But then people want a cap on those rates. What should the cap be? Somebody picks a number, and somebody always loses, either taxpayers or borrowers. And variable looks fair, because everyone has the same rate at the same time. But the problem with that is people can't really plan."

Rafael Pardo, a bankruptcy professor at Emory University's law school, frames the issue differently. He would have no problem with the government making money on the student loan program if it were a bit easier to discharge the loans in bankruptcy for people who get in over their heads. But the process is hard enough that he recently spent nearly 650 hours of pro bono time trying to help just one debtor.

Alternatively, he would be fine with much lower rates while continuing to make it very hard to discharge the debt. "But you can't be hitting them on the front end and on the back end," he said, which is his view of what the status quo does today.

Refinancing

A reader from New York City consolidated a bunch of loans into a single loan more than a decade ago at 8.125 percent and cannot refinance the loan at a lower rate because of rules that prohibit this. The comment summed things up this way: "I have excellent credit but feel like I am unfairly punished and stuck with this extortionate interest rate for the rest of my working life."

This, too, is something only Congress can change, and perhaps it didn't anticipate this problem or worry about it back when it thought it was doing students a favor by letting them consolidate debt at a fixed rate and relieving them of having to keep track of a big pile of individual loans.

Still, Mr. Shireman, who was a champion for the income-based repayment program that now allows people with lower incomes to make more affordable payments and have any remaining debt waived after a certain number of years, doesn't see this particular complaint gaining much traction.

"There aren't the votes to make this kind of change," he said. "And I think one response would be that if these are high-income New York Times subscribers, then their needs are not as great as Pell Grant recipients. And if they're low-income and struggling, they have income-based repayment and they can get a big benefit from that."

There are a few exceptions to the no-refinancing rule, and I have linked to an explanation of them (and the best explanations of many of the loan programs, repayment plans and other exceptions) in the online version of the column.

Forgiveness and Taxes

Another reader posted a question about the income-based repayment plan, noting that she will probably have a large amount of debt forgiven at the end of her term and is worried about the tax bill she will face at that point, when she will be 70 years old.

The amount of any debt forgiveness is often taxable income as far as the federal government is concerned. One big exception, however, is for people enrolled in something called public service loan forgiveness. I have linked to information on how to qualify for that particular program.

If you're not working in a public service job and are enrolled in income-based repayment, you will have to pay taxes on the debt the government forgives. This hasn't happened to anyone yet since the program is still new, and bipartisan efforts are under way to grant waivers for people who find themselves in this situation. "I think the odds are very high that it will be fixed long before anyone qualifies for debt forgiveness," said Lauren Asher, president of the nonprofit Institute for College Access and Success.

Failing that, if your assets (including retirement savings and home equity) are less than your total liabilities right before the remaining student loan balance is supposed to be dismissed, you could declare yourself insolvent and avoid some or all of the big tax bill that way. I.R.S. publication 4681 has the details.

Safe Amount of Loans

And finally, the most difficult reader question of all: “Before starting college, or even choosing which one to attend, how do you suggest families decide on how much borrowing is acceptable?”

There are so many variables here, it’s hard to know where to start. It can depend on the career the teenager seems headed for, the willingness of parents to shoulder some of the debt and the economy.

Mark Kantrowitz, who runs the encyclopedic Finaid.org Web site, has developed one rough guideline: Students should borrow no more, in total, than whatever they think their first-year salary will be once they are finished (though ideally a lot less). That should keep the payments affordable, assuming they don’t change their mind about what they want to study, and manage to get a job in their chosen field.

A slightly more conservative approach may be to limit yourself to $31,000, the maximum amount that the government generally lets undergraduates borrow in federal loans. If you avoid any private student loans from more traditional lenders, every dime of your debt will be eligible for the federal income-based repayment program in case there is little or no income for a while after graduation or later on.

The downside here is that limits like these (and they are caps, not targets, as Mr. Kantrowitz is quick to note) are dream killers for many young people. It may mean no law school at all or community college for two years or the local branch of the state university instead of the flagship.

So how do we get to a point where any college is in reach for every student? It’s a question that no one has a realistic answer for yet.

This article has been revised to reflect the following correction:

Correction: September 14, 2012

An earlier version of this article gave an incorrect title for Lauren Asher of the nonprofit Institute for College Access and Success. She is president, not executive director.