THE HAMILTON PROJECT

MAJOR DECISIONS: GRADUATES' EARNINGS GROWTH AND DEBT REPAYMENT

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A Quick Overview of Student Loans

In order to understand The Hamilton Project's analysis of student loan repayment for different college majors, it is helpful to have a basic grasp of how student loans work. For additional information beyond the brief overview presented below, see https://studentaid.ed.gov/types/loans for federal loans and www.finaid.org/loans for more information on private loans.

Loan Types

There are two major types of student loans, federal and private. Federal loans are provided by the federal government and are the most common type of loan. Private loans are provided by private lenders, typically banks and other financial services firms. Other types of loans, including those issued by states and colleges, are relatively rare.

Federal loans (for undergraduate purposes) can be further divided into subsidized and unsubsidized loans. Subsidized loans are available only to students with financial need, generally those from families with lower incomes or attending more-expensive colleges. For these loans, interest effectively does not accrue while the student is enrolled at least half-time. Unsubsidized loans are available to all undergraduates and, unlike subsidized loans, interest begins to accrue while the student is still enrolled in school. All students taking out either loan type in a given year face the same interest rate on their loans. Currently, these interest rates are based on the yield of 10-year Treasury bills. This means that as government interest rates rise or fall, so will the rates that students pay on new loans. The prevailing rate for the 2014–2015 school year is 4.66 percent, which marks an increase from 3.86 percent from the previous school year. For both types of loans, there are annual limits to how much can be borrowed, as well as a lifetime limit. For undergraduates, the lifetime limit for both subsidized and unsubsidized loans combined is $57,500.

Students who borrowed more than this amount likely also took out private loans. In almost all cases, these loans function as unsubsidized loans, with interest beginning to accrue right away. Unlike federal loans, private loans can be denied to students who fail credit checks and have variable interest rates depending on students' (or their families') credit scores. There generally are no annual or lifetime borrowing limits, and loans are made at the discretion of the lender.

Loan Repayment

There are several options for repaying student loans, both federal and private, but the traditional and still most common is the 10-year fixed payment plan [1]. Similar to a mortgage, the borrower makes constant payments over 120 months until the balance of principal and interest is paid off. Other options for repayment allow a longer time horizon (like a 30-year versus 15-year mortgage) or a graduated payment schedule in which monthly payments start low and then increase every two years. For federal loans, there are also payment plans that depend on the borrower's family discretionary income (income above 150 percent of the poverty level). To be eligible for these plans, the monthly payment under the standard 10-year plan must be above a certain fraction (10 percent or 15 percent, depending on the specific option) of discretionary income. Borrowers also have to fill out specific application forms and regularly report their income to participate in these plans. Unlike fixed payment or graduated plans, there is no set horizon of loan repayment; instead, the borrower pays 10 percent or 15 percent of discretionary income each month (but never more than what the standard 10-year monthly payment would be) until the loan is either paid off or 20 to 25 years pass, in which case the remaining balance is forgiven.

For all federal loans, and many private loans, there is a six-month grace period after graduation before the first payment is due (although interest will continue to accrue for unsubsidized loans). For federal loans, there are no prepayment penalties, although this varies with private loans.

[1] According to the Department of Education, as of the third quarter of 2014, 61 percent of borrowers with federal Direct loans were in the 10-year standard repayment plan.