2008 Guide to Alternative Loans

Important: Only look for alternative loans after you have exhausted all potential scholarships, federal grants, work study funds, and federal loan programs (Perkins, Stafford, PLUS and Grad PLUS). Alternative loans (also called private loans) have been the fastest growing source for funding a college education. This guide is intended to provide students and their parents with the tools they need to make the best decision in evaluating alternative loan options.

Here are the key steps in the process:

1. **Collect all the information that you need prior to starting the application process**. Most lender applications require information on the borrower (the student), a co-borrower (also referred to as a co-signer) and several references. To speed the application process along, SLA has provided a list of common data fields that lenders request in the application process.

2. **Identify a co-borrower (also called a co-signer) who will strengthen your application**. A co-borrower guarantees the loan taken out by the student borrower. A co-borrower can be a parent, a grandparent, a relative or any individual willing to take on that responsibility. Co-borrowers are liable for repayment of the loan in the event the borrower defaults. You will want to ensure that they have good credit, as their credit status will play a significant role in the pricing of your loan. Given the current "credit crunch", having a creditworthy co-borrower can be critical to getting your loan approved.

3. **Ask your college's financial aid office if they have a Preferred Lender List for Alternative Loans**. This can provide you with a good starting point for your research. If your school does not have a lender list, then be sure to choose a lender that offers **a school-certified loan**, as their rates and fee structures tend to be better than direct-to-consumer loans.

4. **Plan on applying for up to 3-4 loans.** Research indicates that applying for too many loans can have a negative impact on your credit score. The tradeoff is that by not applying for more than one loan you may be missing an opportunity to save on your loan. **Recent SLA research on just three lenders found interest rates ranged from 9.0% to 12.4% while fees ranged from 0-9% for a good credit borrower. It pays to compare!**

Evaluating Your Alternative Loan Options

Great news! You have received a notification from one or more lenders indicating that you have been conditionally approved for an alternative student loan. Be sure to evaluate the information that they provide. The Q&A section that follows provides answers to questions you may have about your alternative loan options.

1. **Once I have received approval on the lender's website, what additional steps do I need to take to get final approval?**

   Answer: While the application process for all lenders will vary somewhat, be aware that there are additional steps that you need to complete in order to receive the loan. The lenders will often provide you this information with their conditional approval.

   These steps may include the following:

   - Send in a signed application and promissory note. Many lenders offer e-signature capabilities which allow you to sign the application and promissory note on-line.
   - Send documents to verify elements of your application for the applicant and co-borrower including:
     - Income levels
     - Citizenship
     - Employment

   Be aware that a lender may provide you with a timeframe (e.g., 20-30 days from conditional approval) in which it must receive this documentation in order for the loan to receive final approval. **Once you have selected among your alternative loan options, do not delay in completing the process.**

2. **What is the interest rate index tied to my loan (i.e., what is LIBOR)?**

   Answer: Interest rates on alternative loans are typically priced off of an index, such as the Prime Rate or LIBOR index (one or three month LIBOR are common). The loan is then priced as a margin over that index (e.g., LIBOR + 6%). The rates on these indices for the week of July 30, 2008 are indicated below (click on the links below for updated information):

   - 3 month LIBOR: 2.80%
   - 1 month LIBOR: 2.46%
   - Prime Rate: 5.0%

   Please note that lenders update their indices on a regular basis (typically monthly or quarterly) so the rates listed above may not match the actual rates charged by lenders. Ask the lender what its Current Index is which will answer this question.

3. My family is also considering taking out a Parent PLUS loan, in addition to, or instead of, an alternative loan. Which is a better deal?

Answer: There is no simple answer to this question given the differences in the loans. First, note that the borrower is different for each of these loans: the parent would be the borrower for a Parent PLUS loan while a student would be responsible for the payments on an alternative loan (although a parent may choose to co-sign (guarantee) their child's alternative loan).

While a borrower with great credit could receive an alternative loan as low as 4.5%-5.0%, **only a very small percentage of borrowers (usually less than 10%)** actually receive this teaser rate. Remember that this is a variable rate loan that is tied to a specific index, such as LIBOR or the Prime Rate. Variable rates can go up over time. U.S. interest rates are at historically low levels today (e.g., Prime Rate was 8.25% or 325 basis points higher just 12 months ago). Average interest rates over the last 15 years have been 1.5% - 2.0% higher than their current levels, so that 5% loan today could average closer to 7% if rates revert to their average levels. Of course, past performance is no guarantee of future performance for interest rate levels.

Here is a table comparing Parent PLUS to Alternative Loans:

	PLUS Loan	Alternative Loan
Borrower	Parent	Student (Parent can co-sign)
Fixed/Variable Rate	Fixed over life of loan	Variable over life of loan, Changes with index (LIBOR, Prime Rate)
Interest Rate	7.9% – 8.5%	Wide range based on credit (e.g., 5.0% - 12.5%)
Credit Requirement	No Adverse Credit	Determined by Lender (Up to the Cost of Attendance)
Borrowing Limits	Up to Cost of Attendance	Determined by Lender (Up to the Cost of Attendance)
Fees	3% origination fee, 1% default fee	Determined by Lender (Up to the Cost of Attendance)

Helpful Hint: Generally, only borrowers who can qualify for alternative loans with an A.P.R. (annual percentage rate which includes the interest rate and fees tied to the loan) at least 2.0% - 2.5% below PLUS Loans **AND** who will have the capability to pay off the loan when interest rates move significantly higher should consider an alternative loan over a PLUS loan.

4. **Will the loan rate change over the term of the loan?**

   Answer: Most alternative loans are variable-rate loans which adjust as the interest rate on the index changes (either Prime Rate or LIBOR indices). Lenders will disclose the frequency by which they change these indices in the promissory note, with quarterly changes being most prevalent.

5. **How do I convert the interest rate description that the lender provided into an actual interest rate?**

   Answer: As described above, the interest rate on your alternative loan will typically be variable and change over time. The interest rate quote you received had two elements: an index (e.g., LIBOR or Prime Rate) and an interest rate margin (e.g., +4%, -.5%, +2%). The index will be adjusted (e.g., quarterly) while the margin will usually remain fixed throughout the loan term. This means that the overall variable interest rate can go up over time. Please note that some loans may have different margins for in-school and repayment periods.

   Below are some examples based on the interest rates of the indices described above. Actual rates charged by lenders will vary as they may adjust rates for the quarter based on the index's interest rate on the first day of that quarter.

   - 3 month LIBOR + 4.0% = 6.80%
   - 1 month LIBOR + 9.0% = 11.46%
   - Prime + 4.5% = 9.5%

6. **The lender has informed me that I have been approved for the loan but has not provided me with information about interest rates and fees. What should I do?**

   Answer: While rare, **there are lenders who will notify you that your loan has been conditionally approved WITHOUT providing information on interest rates and fees**. In effect, the lender is asking you to accept this loan prior to having this critical information. **DO NOT sign your promissory note until you have this information from the lender in writing**. If they are not willing to provide you with this information, shop elsewhere.

7. **What fees are common with alternative loans?**

   Answer: Fees typically fall into several categories:

   - **Origination fees** are fees charged by lenders to process your loan and are paid at the beginning of the loan period. Fees are either subtracted from the amount you are borrowing or added to your principal. These fees can range from 0% up to 9%. **Look for no-fee lenders to minimize these costs.**
   - **Late charges** are fees paid when a payment is not made within a period after which it is due (e.g., A late charge of $25 or 5% of the past due payment will be

assessed within 15 days after such payment becomes due). These charges typically range from $5 to $25.

- **An Insufficient Funds Fee** is charged any time that a payment is returned unpaid for any reason (e.g., bounced check). These fees typically range from $15-$20.

8. Where are the fees disclosed?

Answer: Fees are disclosed in the **Student Loan Promissory Note** and **a Disclosure Statement**, which should be reviewed carefully prior to accepting the loan. Once you have received conditional approval for your loan, the lender should provide you with the Promissory Note. In addition, a lender will provide a Disclosure Statement, usually after the Application and Promissory Note have been signed, which also describes interest rate and fee information.

9. How can I compare a loan with no fees and a high interest rate to a loan with an origination fee but a lower interest rate?

Answer: You will receive a **Disclosure Statement** that provides an A.P.R. (Annual Percentage Rate) which is an annual cost of credit that takes into account both interest rates and fees. Unfortunately, this statement is typically not provided until after you have signed the Promissory Note committing yourself to the loan.

There are calculators available to assist borrowers with these calculations. Finaid.org has a basic loan payments calculator. Here is an example:

- Lender A offers a variable rate loan with 10.5% interest rate and no fees.
- Lender B offers a variable rate loan with 9.0% interest rate and a 3.5% origination fee that is added to principal.

For a $5,000 loan with a 20 year repayment period, the figures would work out to the following (for simplicity, the interest rate on these loans is assumed to be fixed):

	Est. Monthly Payment	Total Payments
Lender A	$49.92	$11,979.98
Lender B	$46.56	$11,174.95

This example is important in that it demonstrates that the **combination of fees and interest rates is important in determining the cost of a loan**. In this case, the loan (from Lender B) with an origination fee but a lower interest rate is the **lower cost alternative by over $800.**

10. What other key elements within the Promissory Note should I review carefully?

Given the length of the Promissory Note, it is easy to ask "Who has time for all of this legalese?" Avoid that temptation as you may be able to save yourself quite a bit of money by avoiding loans with certain features:

- **Interest rate accrual – THIS HAS A LARGE IMPACT ON TOTAL LOAN COST**
  - Generally there are two options in terms of how interest is treated with student loans:
    - Some lenders accrue interest while a borrower is in school and add it to the principal amount borrowed **ONLY** after the borrower has left school.
    - Some lenders accrue interest and add it to the loan principal while the borrower is in school. **This has the effect of a student paying interest on top of interest and is therefore to be avoided at all costs**.
  - Here is an example to demonstrate the dramatic impact that this has on a no-fee $10,000 loan with 10% interest rate taken out by a college freshman at a 4-year school:
    - Lender A adds the accrued interest to the loan principal ONLY when a student leaves school.
    - Lender B adds the accrued interest to the loan principal EACH QUARTER that a student is in school.

  Helpful Hint: SLA estimates that selecting Lender A will save borrowers $1,500 in borrowing costs given their interest rate policy. Select a lender who will only add interest to your loan principal ONCE after you complete your school program.

- Loan amount
  - Be sure that the loan amount listed in the promissory note matches your expectations. Some lenders may increase your requested loan amount by the amount of the origination fees without notifying you of this fee.

  Helpful Hint: If you choose a lender with origination fees, **pay off this fee immediately** to minimize your interest expense. By not paying it, **you are effectively doubling the cost of this fee** given the impact of the interest you will pay on the origination fee over the life of the loan.

- Terms of Repayment
    - Many lenders will give borrowers several options in terms of repayment, including the following:
        - **Monthly payments of principal and interest within 30-60** days after loan is disbursed.
        - **Monthly payment of interest only** within 30-60 days after loan is disbursed.
        - **Monthly payments begin 6 months after borrower graduates** or is no longer attending school on at least a half-time basis.

Helpful Hint: The sooner you begin to make payments on your loan, the lower your overall total payments will be. While immediate payments of principal and interest may be difficult while you are in school, **paying interest off each month will keep your overall borrowing costs down while also establishing your good credit.**

Important: Even if lenders do not offer you repayment options, borrowers may voluntarily make payments while they are attending school. **Be sure that your lender does not have any prepayment penalties should you decide to pay your loan off early**.

About Student Lending Analytics
Student Lending Analytics provides independent research and advisory services to assist financial aid administrators in selecting the best lenders for their students. SLA utilizes financial models and proprietary surveys to provide a customized, objective and analytical approach to selecting the best student lenders. **SLA has no affiliation with any student lenders and is providing this information as a service to the financial aid community**. For additional information on Student Lending Analytics' research and services, contact Tim Ranzetta at tranzetta@studentlendinganalytics.com or visit www.studentlendinganalytics.com.