Personal Finance: The Savage Truth

Student Borrowers Must Consolidate Now

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If you still have outstanding student loans, Congress is about to sock you with much higher interest rates as part of a plan to close the budget deficit gap.

Several proposals now before the House and Senate tinker with the formulas for calculating student loan interest, and with graduates' ability to refinance their loans and lock in current low rates. If you take action now, you may be able to escape this irrational punishment. And you might want to contact your legislators to protest. But first you must understand the process.

Last week I gave you tips on refinancing your mortgage. If rates come down, you can refinance again. But college students and grads that hold $300 billion of outstanding student loans don't get that same privilege of refinancing at lower rates. Until recently, you could only consolidate your student loans once in your lifetime to lock in a fixed rate. That meant many grads who consolidated five or six years ago were stuck paying rates as high as 9% for the life of their loan.

Rates on student loans change yearly, based on the rate of 91-day Treasury bills set at the last weekly auction in May. New rates go into effect each July 1. Students who consolidate their loans within six months of graduation get an extra rate break. Many lenders even cut rates an extra quarter of a percent if you agree to have loan payments made by automatic deduction from your checking account.

The bottom line: Students who consolidated their loans by June 30 of this year locked in rates as low as 2.875% for the life of their loan. The current consolidation rate is 4.75%. As the general level of interest rates dropped in recent years, many students elected to use their one-time consolidation opportunity to lock in the low rates. But those who consolidated in previous years were stuck paying those higher rates from the time they consolidated.

Then, last January, the Department of Education ruled that graduates could sidestep existing laws against reconsolidation by moving their loans into the Department of Education's Direct Consolidation program. That done, they could reconsolidate *again* with a private lender offering better terms. Under current law, that's the only way to get a second chance at a low-rate consolidation. And thousands of savvy borrowers are doing just that.

Now, if legislation proposed by the House of Representatives passes, that opportunity will disappear. If the House bill passes, the vast majority of borrowers, who have already "refinanced" or "consolidated" student loans one time will never be able to do so again.

Not only is that a rotten deal, but the House is in the process of making it worse. New legislation proposed by the House would prohibit students who are in school from locking in their current rate of 4.75%. Instead, the rate would jump to 6.3% for this year's graduates, then to 7.9% for those graduating after this coming June.

A bill now pending in the Senate has similar, but less onerous, changes proposed. While the Senate bill would raise rates for new Stafford loans to 6.8% beginning next July, it doesn't prohibit in-school consolidation or charge the much higher consolidation rates that the House bill proposes. Instead, it continues to allow borrowers to consolidate at the weighted average of their current loans.

It was only last May that the Department of Education ruled that borrowers need *not* wait for graduation to consolidate. And thousands of current students immediately stepped forward to lock in last year's rates, which were the lowest in history. Unfortunately, not everyone found out about this break, and millions didn't take advantage of it. Now, if pending legislation passes, they'll miss a great opportunity.

Interest rates are on the rise, and the rates set in July are likely to be higher. Ordinarily, I'd wait until springtime to bring up the subject of student loan consolidation. But, given the pending legislation, I am recommending that all students — even those still in school — move to immediately consolidate their existing loans at today's low rate of 4.75%. Of course, current students will have to pay next year's rates on subsequent loans — and may ultimately want to consolidate those loans. But consolidating at current rates on whatever loans you already have could save you a small fortune in interest.

Just at the time when our country needs college graduates to keep up with technology changes in this competitive world, we're punishing students who borrow to finance their education. Why? In two simple words: money and politics. With over $300 billion in student loans outstanding, there's big money to be made by the relatively few lenders who dominate the market for student loans.

In fact, for years a quasi-governmental organization called Sallie Mae (Student Loan Marketing Association) dominated the entire market. Awhile back, the organization dropped its federal charter and morphed into a non-governmental, profit-making company that still uses the Sallie Mae nickname but is now officially SLM Corp (SLM:NYSE) . It controls so much of the student loan market — nearly 25% of loans outstanding — that in 2004 SLM was among the most profitable companies in the country.

Profit isn't a dirty word in this column. But these lenders get a guarantee against default on 98% of the student loan balance, as well as a guaranteed yield of 2.34% over the commercial paper rate on consolidation loans. That and other yield guarantees on in-school loans, have resulted in a net profit of over 1% of loan volume. You do the math. On a portfolio of nearly $100 billion, that's over $1 billion in profit!

Now SLM — the old "Sallie Mae" — is strongly behind the current proposals to make it more difficult and expensive for students and graduates to refinance the loans that Sallie Mae and big banks currently hold. If you're a student, graduate, or parent, it's time to make your voice heard as the proposals are currently before Congress. Making a college education more expensive is no way to solve our nation's global competitive problems. And that's The Savage Truth.

Terry Savage is an expert on personal finance and also appears as a commentator on national television on issues related to investing and the financial markets. Savage's personal finance column by the Chicago Sun-Times is nationally syndicated, and she released her fourth book, The Savage Number: How Much Money Do You Need To Retire? in June 2005. Savage also was the first woman trader on the Chicago Board Options Exchange and is a registered investment adviser for stocks and futures. A Phi Beta Kappa graduate of the University of Michigan, Savage currently serves as a director of the Chicago Mercantile Exchange Corp. She also has served on the boards of the McDonald's and Pennzoil corporations.