How to Make Smart College Loan Decisions and Evaluate Loan Forgiveness Options

Sticking to federal direct student loans can help limit debt accumulated in college and give you the flexibility of income-driven repayment plans after college.

KEY INSIGHTS

- An important step in college preparation is researching the types of student loans and their repayment terms.
- We recommend limiting debt to federal direct student loans, which have reasonable interest rates and offer flexible repayment options.
- If your loans are significant in relation to your income, choosing an income-driven federal repayment plan can help lower your monthly payments.
- In some situations, you could benefit from forgiveness of a portion of your debt—but you have to pay attention to the details.

Roger Young, CFP®
Thought Leadership Director

Summer and fall are important seasons for families to research student loans. If your household includes a student preparing to apply to colleges, you'll want to factor cost into the decision and be mindful of the amount of debt that could be accrued.

If you have a recent college graduate, congratulations! If student loans were part of their funding plan, repayment of those loans will start soon, and the graduate should carefully evaluate the available options. Student loan payments were paused during the pandemic, but interest charges resume September 1, 2023, and payments will be due starting in October 2023.

In June 2023, the Supreme Court struck down a plan by the Department of Education (DOE) that would have forgiven up to $20,000 of federal student loans for certain borrowers. At the same time, however, the DOE finalized a new income-driven repayment plan with very attractive terms. Families should take time to understand the new student loan landscape.

First things first—limit your debt

As a financial planner, I recommend that families limit their education debt to federal direct student loans, if possible, or at the very least, take them as the primary source of student debt. These loans are provided by the U.S. Department of Education, and they have several advantages:

- They offer reasonable interest rates and do not require a credit check. Currently, the interest rate for new loans to undergraduates is 5.5% (as of July 2023).
- They limit the amount that you can borrow. Holding yourself to this limit can help you choose a college that is financially reasonable and avoid

...you may want to consider income-driven repayment plans if your loans are significant in relation to your post-college income.

accumulating too much debt. Over the full course of an undergraduate program, the most that dependent students can borrow is $31,000.

- If you demonstrate financial need, some of these student loans may be subsidized. This means that the government will cover the interest until you graduate or leave college.

- They provide a variety of repayment options, including income-driven repayment plans.

- If you face economic hardship or unemployment, these student loans may allow for a temporary pause or reduction of loan payments through deferment or forbearance.

After leaving school—consider the federal direct loan repayment options

The standard repayment method for federal direct student loans is a fixed monthly payment for 10 years. Using the standard method (or even paying down your loans faster than that allotted time) limits the interest you'll incur and helps you eliminate student debt in early adulthood. However, you may want to consider income-driven repayment plans if your loans are significant in relation to your post-college income.

There are several income-driven federal repayment plans, which will see major changes effective July 1, 2024. The Revised Pay As You Earn (REPAYE) Plan is currently available and will be transformed into the Saving on a Valuable Education (SAVE) Plan. (See New SAVE Income-Driven Repayment Plan Offers Attractive Features on the last page.) Here's how REPAYE works, as of fall 2023:

- Your monthly payment is no more than 10% of your discretionary income (in other words, your gross income minus 225% of poverty-level income).

- Poverty level is the same throughout the continental U.S. (it's higher for Alaska and Hawaii) and depends on your household size. It is adjusted annually for inflation.

- Payments are recalculated yearly via a recertification process.

- After successfully making 20 years' worth of payments, any remaining balance will be forgiven.

For example, suppose you graduate with $34,000 of federal direct student loans (including accrued interest) with a 5.5% rate. The standard repayment would be around $369 per month for 10 years. Under the REPAYE plan, your payment would depend on your income relative to the poverty level. If you're single with no dependents, your applicable poverty level is $14,580 per year, and 225% of that is $32,805. If you earn $40,000 per year, that makes your discretionary income $7,195. Your annualized payments would be 10% of that—$720—and dividing that amount by 12 would result in an initial monthly payment of $60.

Because of the 2023 change in how discretionary income is calculated, this option is very attractive. Obviously, $60 is much lower than $369. And even though you'll be paying off your loans over 20 years instead of 10, there's a good chance a significant amount could be forgiven at the end. For example, if your income increases—let's assume by two percentage points faster than inflation—your monthly payment will increase gradually, but never get as high as the $369 standard payment. In total, your payments would be around $3,000 lower under the REPAYE plan than with the standard plan.

There are several reasons an income-driven plan may be preferable:

- If your cash flow is tight, reducing the monthly payment could help you pay essential expenses without high-interest credit card debt.

- Alternatively, you could use the extra cash to increase your retirement plan contributions or other investments. While investment returns aren't guaranteed, you could potentially benefit from returns higher than the loan interest rate.

- If you work for a government or not-for-profit organization, you could be eligible for Public Service Loan Forgiveness (PSLF). The benefit is that your loan could be forgiven after 10 years instead of 20. This program requires you to enter an income-driven repayment plan at some point.
- If PSLF doesn't apply, but your household income is modest, you may still benefit from having part of the balance forgiven. As described in New SAVE Income-Driven Repayment Plan Offers Attractive Features, starting in 2024, some borrowers could achieve forgiveness in as little as 10 years.

Finally, pay attention to the details

- There is helpful information available at studentaid.gov, including a loan simulator to evaluate options for your specific situation.
- Follow the rules. It's critical to complete recertification paperwork to capture changes to your income or household size each year.
- If you choose an income-driven plan with investing or reducing high-interest debt in mind, remember that reaping these benefits takes discipline. Setting up automatic investments and budget guardrails can help enforce good habits.
- Remember that things can change over time—your income, marital status, dependents, and other factors. Continue to reevaluate your situation and whether lower payments still help you. You can always pay extra principal on federal loans without penalty.

Understanding the available student loan repayment options is important; the decisions that are made today can greatly affect your child's financial situation in the future.

NEW SAVE INCOME-DRIVEN REPAYMENT PLAN OFFERS ATTRACTIVE FEATURES

In June 2023, the Department of Education finalized rules for a new income-driven repayment plan called the Saving on a Valuable Education (SAVE) Plan. SAVE replaces the Revised Pay As You Earn (REPAYE) Plan and will be significantly more attractive to borrowers.

Two key enhancements take effect in 2023 (including for current REPAYE borrowers) before the student loan payment pause ends:

- The calculation of "discretionary income" would exclude income up to 225% of the poverty level, as opposed to 150% of the poverty level currently.
- If the monthly payment is less than the interest on the loan, that remaining interest will no longer be charged. This is a major change, intended to prevent borrowers' balances from ballooning even when they make the required payments.

Other changes will take effect July 1, 2024, including:

- Monthly payments for undergraduate loans would be limited to 5% of discretionary income versus 10% currently.
- The time period for borrowers to receive forgiveness on remaining balances may be reduced—to as low as 10 years for those who initially borrowed $12,000 or less.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

T.RowePrice®

Important Information

This material has been prepared by T. Rowe Price for general and educational purposes only. This material does not provide recommendations concerning investments, investment strategies, or account types. It is not individualized to the needs of any specific investor and is not intended to suggest that any particular investment action is appropriate for you, nor is it intended to serve as the primary basis for investment decision-making. T. Rowe Price, its affiliates, and its associates do not provide legal or tax advice. Any tax-related discussion contained in this material, including any attachments/links, is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding any tax penalties or (ii) promoting, marketing, or recommending to any other party any transaction or matter addressed herein. Please consult your independent legal counsel and/or professional tax advisor regarding any legal or tax issues raised in this material.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

©2023. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc. All other trademarks are the property of their respective owners.