Student loans 101: The interest rate uproar

May 2 2012, By CANDICE CHOI , AP Business Writer

(AP) -- Lawmakers on both sides of the aisle agree: It would be a mistake to let interest rates on student loans double in July. Especially if they're going to be blamed for it in an election year.

Student loans have become a political football in recent weeks, with Democrats and Republicans maneuvering to point fingers in case Congress fails to pass legislation to prevent rates from rising this summer. The rhetoric has created confusion - and perhaps unnecessary alarm - about what's really at stake.

The issue centers on a type of federal loan that's reserved for undergraduate students. The interest rate on these Stafford loans is set to jump from 3.4 percent to 6.8 percent on July 1. The problem is that Congress can't agree on exactly how to fund a one-year extension of the current rate, which the government estimates would cost $6 billion.

The debate is touching a nerve because it underscores the broader problem of college affordability and ever-increasing levels of student debt. The average in-state tuition and fees at four-year public colleges rose about 8 percent from year ago, according to The College Board. That pushed the cost to an all-time high of more than $8,000.

"To look at the bigger picture, higher education is practically a necessity and it's getting harder and harder to afford," said Rich Williams, an advocate with US PIRG, which lobbies on student loan issues.

To make his case to young voters, President Barack Obama even made

an appearance on NBC's "Late Night with Jimmy Fallon." The president looked into the camera and said "now is not the time to make school more expensive for young people" as Fallon and his house band provided a slow-jam accompaniment.

But amid all the rhetoric, it's easy to forget that not everyone who has a student loan would be affected. For those who would be, the impact might not be as dire as feared.

Here's what you need to know:

WHO'S AFFECTED

To grasp what's at stake, it's important to first understand that Stafford loans are either subsidized or unsubsidized.

Subsidized loans alleviate the cost of borrowing for low-income students because the government pays the interest on the loan while the student is in school. Eligibility is determined based on financial need; about 70 percent who qualify for subsidized loans have a family income of less than $50,000.

With unsubsidized loans, interest accrues right away so the loan balance grows while the student is in school.

The current debate centers only on subsidized Stafford loans; the Education Department estimates that about 30 percent of undergraduates have this type of loan.

The other aspect of subsidized loans is that they currently come with a fixed rate of 3.4 percent. This is the rate that's set to double this summer; unsubsidized Stafford loans already carry a fixed interest rate of 6.8 percent.

If the rate on subsidized loans is increased, the higher rate would not apply retroactively to existing loans. This is because rates on all federal student loans are fixed over the life of the loan. (Separately, it's worth noting that the private student loans issued by banks typically have higher variable rates that rise and fall with a benchmark rate).

Only students who take out subsidized federal loans on July 1 or thereafter would be subject to the new rate. This means the rate on the subsidized loans a college sophomore took out to fund their first two years in school wouldn't be affected.

All told, the White House says that 7.4 million borrowers would be affected if the rate spikes in July.

WHAT IT COSTS

"The drama of a doubling interest rate catches your attention. It's a good way of beating the drum of college affordability," said Mark Kantrowitz, publisher of FinAid.org, which tracks the financial aid industry.

The exact impact of the higher rate will depend on the size of the loan and the repayment period. But in general, the White House says keeping the rate at 3.4 percent for another year would save borrowers $1,000 over the life of the loan. That's assuming a 12-year repayment on a $4,200 loan.

On a monthly basis, a typical payment would go up by about $8, according to FinAid.org.

As inconsequential as that might sound, Williams of US PIRG notes that the increase would come at a time when college costs are continuing to march steadily upward.

"It comes down to a death by a thousand cuts," Williams said.

HOW IT CAME ABOUT

Another aspect of the issue that gets lost in the uproar is that the 3.4 percent rate has only been in place for a year.

It's the result of legislation passed in 2007 on the eve of the financial crisis and was intended to help alleviate the cost of college. Rather than cut the rate in half right away, the legislation gradually lowered the rate to its current level over the past four years.

"Everyone's surprised that the interest rate is going to double. But we knew when this was going to occur," Kantrowitz said. "Like everything Congress does, it was for a short window."

Still, it comes full circle back to the reason for the legislation in the first place - reducing ballooning college costs. That's not a financial burden that has improved with time. It's why Williams of US PIRG thinks a one-year extension is a necessary stop gap.

"We need to buy some time to determine what the rate should be going forward," said Williams.

The House voted Friday to keep the rate from doubling, but the passage was largely symbolic because the package is going nowhere in the Democratic-dominated Senate. The Senate plans a vote when Congress returns from break next week. Since the Senate version has a different funding plan, the sides will need to hash out the differences.

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