Becoming an 'Informed Buyer' of College

Borrowing for College – Student

First, you need to understand that it is important that all students take on some of the financial responsibility for their education expenses. After all, they are going to benefit the most from this expense, so having some 'skin' in the game to help insure completing college in four (4) years or less. This is the number one way to save money for college, four instead of five or six years.

Your student should learn something they will never hear from an economics professor at any college, at any time, but they will hear it here and it will be an extremely valuable lesson you can pass onto your student. It goes like this. They get a summer job for 15 week's, it should pay about $200 a week and most students tell me that this is pretty conservative and doable. And after 15 weeks that represents $3 000. They should be able to save at least $1,250 to $1,500 of that to take to college for miscellaneous expenses. Over 4 years this represents $5,000/$6,000 that you as the parent do not have to spend. But there is something a lot more fundamental to all of this. Just before my son Danny went off to college I said to him I would never send him a dime (for misc. expenses) while he was in college, that what he spent while he was there had to be earned the summer before, or he had to get at job at school. Now, after he got over the thought that his dad was Mr. Mean, here is what he was able to do after four years as a result of earning and budgeting his money. He was able to demonstrate very clearly to a perspective employer that he had experience in earning and budgeting his money, had the experience of knowing how to economize, had the experience in being able to plan his activities based on his financial resources, so that on his resume he had a very powerful statement. This made a huge impression on employers; a statement that they very seldom see. Four years of experience in money management.

We recommend that each student take on the goal of covering between $27,000 and $33,000 of their four year college education. How do they accomplish this? We just discussed how they come up with the first $5,000/$6,000. We suggest (very strongly) that they take on the maximum amount of student Stafford loans. These loans are available to any student who fills out the Free Application for Federal Student Aid (FAFSA), which is the ONLY requirement. These loans are not based on need. They have a fixed interest rate (today at 6.8% if unsubsidized) and the student doesn't start the repayment plan until 6 months after they graduate (or leave school for any reason). If the loan is subsidized, government covering interest during college years, they can borrow $3,500 in year one, $4,500 in year two and $5,500 in years three and four. With the unsubsidized versions (not need based), we suggest that the interest be paid annually so as not to accrue. You can borrow the same amounts as above, plus in July of 2008 congress passed H.R. 5715 that allows each student to take on another $2,000 a year in unsubsidized loans.

If subsidized, the total over four years would be $19,000. Add $8,000 for the unsubsidized amount and you have $27,000 of deferred expenses that become the student's responsibility after college. Add this to the summer work for covering miscellaneous expenses and the student has covered $33,000 of their expenses. The ability to defer paying this money truly takes advantage to the 'time value of money'. Your most valuable dollars are the dollars you have in your pocket today and the longer you can delay paying for anything the less those dollars will be worth.

If they take on the maximum of $27,000 they will start their repayment plan six months after graduation. This amount will be amortized over 10 years, and at today's rate of 6.8% that equates to a monthly payment of $310. At a 3% inflation rate that will feel like $230 in 10 years. With the student loan tax deduction program they will be entitled to deduct the interest on their income taxes, just like a mini mortgage. This amount should not be a tremendous burden for any college graduate who gets a decent paying job after graduation.

If you are in a position to help your student with the payments (have your own financial future secure, or had money put away for college) then you can help, but not by paying the loan off after they graduate. Our suggestion would be to gift them the amount (or some of it) annually. Again, this delays having to pay it for as long as possible.

If the student has money, you have been saving for college in their UTMA/UGMA, you are probably going to want to use this money for college. I expect that these assets are currently earning some type of return. If you use these assets you lose forever the ability to earn anything from that asset. Anytime you spend money, you lose the opportunity to save and invest that money, this is called 'lost opportunity cost'. The longer you can keep that money saved/invested, the larger the amount you will have to cover expenses. If we educate the student on how this works he/she will more want to have some money left over after college. They can then decide on whether to pay the loan off in a lump sum or with monthly payments over the 10 years.

By taking on this financial burden they will begin their education on the importance of fiscal responsibility. Having done so will definitely position them for a more successful career. Employers like individuals who have taken some of the responsibility for their own education. They will also build up their credit history. All of these benefits will help the child with their future, and help the parents pay for college in the most 'informed manner'.

Borrowing for College – Parent

Obviously, $33,000 won't cover any four year college expense at today's prices, and regardless of what other expense saving strategies you use there will always be some left over for the parent to cover.

The choice many people feel they should use would be to pay from cash flow (lifestyle). This is the 'most inefficient' from a TAX standpoint. If the total cost of attendance of a college is $100,000 and your student covers $30,000 of it you still have to come up with $70,000. If you are in the 25% tax bracket it means that you have to earn $93,333 to cover that $70,000. This means paying the tax man $23,333 prior to paying the college. Not the most tax-efficient method of paying for college.

The next choice is borrowing. The best place to borrow from is your self. You look at your assets and decide where best to borrow from. If the student has money, you have been saving for college in their UTMA/UGMA, you are probably going to borrow from them. If your college funds are in a 529 plan you will definitely use these for college first, to maximize the tax benefits. If you have other assets designated for college in your name then you will consider borrowing from these assets. Why do I say borrow from these assets? I expect that these assets are currently earning some type of return. If you use these assets you lose forever the ability to earn anything from that asset. Anytime you spend money, you lose the opportunity to save and invest that money, this is called 'lost opportunity cost'. Not calculating the 'lost opportunity cost' will give you the false impression of having used the most efficient method of covering these expenses, because you will not be paying any interest on the use of someone else's money. The 'lost opportunity cost' may be much more than the interest expense.

In almost everyone's case they have an asset that is earning "0" (yes zero), is not tax favorable, not guaranteed (as we have discovered these last few years) and it is not very liquid (you must qualify to get your own money). Yes, I am talking about your home equity. It turns out that that is the best place to start, because paying for the use of this equity is tax-deductible, and you can't beat that. Now we aren't talking about appreciation. Your home will appreciate (or depreciate) regardless of how much equity is in the home. If it was paid off or mortgaged to the maximum, it would appreciate the same. That is why the equity has a rate of zero. Once you think about it, it is not the best place to store your money.

Once you have decided to use your home equity (assuming there is any left to use) to solve your college expense situation, you must decide how best to do it. This is where you need an expert on all of the various mortgage methods. There is not enough time in this short document to cover all of the possibilities. I will just say this. It comes down to two key decisions. How much is it going to cost to use the equity and where should it be stored during the college years. You must be able to afford the additional monthly expense, and you must store it where you have complete liquidity and safety, for you will need this money in the very near future and you don't want it being at risk to fluctuating market conditions.

A couple of suggestions when looking at mortgage options - use as long a term as possible to keep the monthly payment as low as possible. Maybe even interest only as long as you understand what you are doing and have the discipline to eventually redirect principle payments to some interest bearing vehicle. If done properly you should still be able to pay off your mortgage when you desire. We are in agreement with having your home paid off as early as possible, just not the way the banks want you to do it, by giving them the money. The more principle you give them the more secure they become. You are basically loaning them money and getting nothing in return and they get to invest this money to make profits for themselves. Why shouldn't you take that principle and make the profit or interest you could earn by putting it somewhere else (you should). With proper discipline you can have your home paid off much quicker than giving them more of the principle.

If you have no assets to borrow from then it might become necessary to borrow from someone else. The next place would be the Parent Loan for Undergraduate Students (PLUS). This loan is offered to all parents to cover any shortfall in the award from the college (must have filled out the FAFSA). You do have to qualify so they will check out your credit and ability to pay. Interest rates are locked in today at 7.9% (as of July 2010). Normally you would start paying this type of loan 60 days after you took it out. But, HR 5715 passed in July of 2008 allows you, should you want, to delay the start of payments until after you child has graduated. We suggest that you pay the interest during the years so as not to let it accrue. Currently the normal payback is over 10 years, but it is possible to apply for a longer term should the amount be large enough to justify (usually over $80,000).

If for some reason, as a parent, you don't qualify for the PLUS loan, your student will be eligible for $4,000 in additional money via the Stafford loan program.

We are firm believers that there are two distinct prices for college - one for the 'informed buyer' and one for the 'uninformed buyer'. Our goal is to help every parent become an 'informed buyer.' This can only be done by educating parents on above type of information.

There are numerous alternatives to the above suggestions, but they should give you a start to your education. Remember, knowledge doesn't become Wisdom until it is used in your every day life. Another suggestion would be to go to either of our websites for more information. At www.americancollegefunding.net you can download our FREE '*Seven steps to becoming an informed buyer of college'*, you can sign up for one of our FREE workshops, you can sign up for our monthly newsletter or you can watch the one hour workshop on your computer in the comfort of your home. Obviously, you can call us at 847-920-9680 and request a FREE one hour consultation to review your situation and get help specific to your challenges.

Regards,

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