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College loans 101

With direct government lending, the process will be smoother and less risky — after the initial mayhem

By Kiah Haslett

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When Joshua Oxley was an undergraduate at George Mason University in Fairfax, Va., the student aid office recommended a private lender to finance his studies and streamlined the application process. Student loans have been handled this way for decades, ever since a 1965 law established the Federal Families Education Loan program. The direct-lending program began in 1994.

As a first-year master's divinity student at the University of Chicago, which also participated in the private lending program, Oxley was "very surprised" to find a more complex system. He had selected a lender, which verified the amount he needed to borrow with the school. And because he was much more in charge of the process, he was much more lost, even with the school's student loan checklist and online help.

"There are so many different steps, and I always had the feeling in the back of my mind that I was forgetting something," he said. "I was hoping I wasn't going to end up without loans."

At the University of Chicago, 40 percent of students received federal loans through private banks for the 2009-2010 school year, borrowing a total of more than $125 million. About half of all U.S. schools participated in the private student-loan program, which generated about 40 percent of all student loans in the 2008-2009 school year. In the 2009-2010 school year, 6.5 million college students and parents participated in the private bank loan program and borrowed $119 billion.

That's changing. Students who once took out federal loans from credit unions and banks will now borrow directly from the government.

The private lending program is another victim of the banking crisis. Banks would make loans to students and then sell them to the Department of Education to stay capitalized. But major lenders such as Cleveland-based KeyBank and Minneapolis-based U.S. Bank began leaving the pool in the fall of 2009, deciding the program didn't fit with their lending strategies, representatives said.

"It was a sign of things to come," said Brian Drabik, associate director of undergraduate financial aid at Northwestern University, where 41 percent of the students participate in the program.

But not necessarily a bad one. He said direct loans from the Education Department will be a steadier source of student lending, unaffected by banking crises.

The Education Department will handle loan applications and disburse money to the school's financial aid office.

For the most part, the loans are exactly the same, but there are a few differences. The federal parents' loan interest rate, when issued directly, is 0.6 percent lower than when made through a bank. When consolidated, parents' loans will have a weighted average interest rate. Parents' loans require repayment to begin immediately, whereas repayment on student loans begins six months after graduation. Everything else about the programs is the same: The interest rate on an unsubsidized Stafford loan is 5.6 percent for both and the loans remain capped at $5,500 for freshman, $6,500 for sophomores and $7,500 for juniors and seniors.

Direct loans also offer student borrowers who enter public service professions, such as emergency management, law enforcement, the military or nursing, loan forgiveness, something not available from private banks. Students, however, must make 120 payments to qualify on loans that can have repayment plans of 25 years.

Though the transition may seem complicated, students and their parents who borrow from several private banks will be able to consolidate those loans from July 1 through June 31, 2011. If students or parents choose not to consolidate, they will need to pay two lenders, the federal government and the private bank, for the same types of loans.

Students will benefit from the simplified process and improved delivery of funds, said Eric Weems, director of student financial assistance at Loyola University Chicago, where about two-thirds of the students have loans through the program. The funds are delivered faster because verification steps that used to exist between the bank and the school have been eliminated.

And there's a good reason for the change. Private lenders that participated in the program received a federal subsidy to process the loans. That money, expected to total $61 billion over 10 years, can now be used for need-based loans to students as well as other federal programs.

"The cornerstone of this is to make additional funds available through (federal grants)," he said. "Anytime the outcome of something is additional grant assistance, I think it's a worthwhile outcome."