The Student Loan Tipping Point

When to Move from Income-based Repayment to Refinancing

by Dan Macklin

Over the past several years, the government's Income Based Repayment (IBR) and Pay As You Earn (PAYE) programs have become attractive options for federal student loan borrowers with high debt-to-income ratios. These plans allow borrowers who qualify for "partial financial hardship" to make lower monthly payments based on their current financial situations. They also extend the life of the loan from the standard 10 years to 20 or 25 years, with any remaining debt eligible for forgiveness at that time.

Given these benefits, it's little wonder that these income-based repayment plans have been widely used by dentists with student loans. The American Dental Education Association estimates that the average dental school student accumulates more than $241,000 in debt. At a 6.8 percent interest rate (the rate on unsubsidized loans between 2006-2013) and with a 10-year term, that translates to a monthly bill of more than $2,700. For newer dentists who are still building a practice and growing their income, these reduced payment plans can provide some much needed relief.

But while these programs can be valuable tools early on in your career, in most cases they're not a good solution for the long haul. In fact, if you continue to use them past a certain "tipping point," they can have negative financial consequences. The key is to know when to use an income-based repayment plan, when to stop using it and when to consider the next step — student loan refinancing. So how do you know when that tipping point has occurred? By keeping these things in mind along the way:

When to say when

With six figures in education debt and a starting salary that's well below the industry's median range, most dental school grads have no trouble meeting initial financial hardship requirements for IBR or PAYE. After you've qualified, these plans use a sliding scale based on your income and number of family members to determine what your monthly payment will be, capping it at the amount you would've paid under a standard 10-year loan.

Because of the flexible structure, some borrowers continue to use IBR or PAYE beyond their cash-strapped early years — with potentially costly results. The problem? The reduced monthly payments typically aren't large enough to cover interest, which continues to accrue and is added to the loan's principal as soon as you stop using the program (for PAYE, the interest accrual is limited to 10 percent of the loan. IBR does not have such a cap). Essentially, the longer you take advantage of the lower payments, the higher your total debt will be — and it doesn't take long for that debt to spiral out of control.

Interest matters

Let's compare two borrowers with $241,000 in student loan principal at a 6.8 percent interest rate. The first borrower uses a standard 10-year repayment plan, has a fixed monthly bill of $2,773 and spends $91,812 in total interest over the life of the loan. The second borrower, a single person with no dependents, uses the PAYE repayment plan and, based on a yearly adjusted gross income (AGI) of $150,000 (the median dentist salary according to the Bureau of Labor Statistics) with an annual 5 percent increase, qualifies for graduated monthly payments as low as $1,104—but pays a whopping $284,471 in interest.

Forgiveness isn't free

Of course, these income-based repayment programs offer more than just lower payments. The promise of loan forgiveness after 20 (PAYE) or 25 (IBR) years can be a tempting prospect, but the truth is that most dentists won't qualify for significantly lower payments that entire time. And when you finally do switch to a standard repayment plan, most of the unpaid interest that accumulated during the time you used income-based repayment can be capitalized, or added to your loan's principal. Which means you're now essentially paying interest on that interest.

If for some reason you make it to 20 or 25 years on an income-based repayment program, it's important to know that loan forgiveness under these plans comes at a price — the amount forgiven is considered taxable income, which is further incentive to keep that debt in check.[1] In the example mentioned, the borrower would have $79,359 eligible for forgiveness after 20 years of using PAYE. That represents a significant tax hit for a single person making $150,000.

To PAYE or not to PAYE

Can you still use IBR or PAYE and keep interest relatively in check? Absolutely. When you're first

> "Reduced monthly payments can feel like a blessing when you're first starting out, but it's important to remember how that discount effects your bottom line."

1. *U.S. Department of Education. This article provides general information about the subject matter and does not purport to provide individualized tax or financial planning advice.*

continued on page 42

 continued from page 41

starting out, those lower payments can be crucial to helping you gain your financial footing. But when reduced payments become a convenience rather than a necessity, it's time to move on.

Of course, every borrower's situation is different, so it's important to do the math on your own loans before deciding to use or discontinue using IBR or PAYE. But the bottom line is that the longer you use one of these programs, the longer it will take to pay off your loans — and the more interest you'll pay in the long run.

A good rule of thumb is to revisit your student loans on an annual basis, and switch to a more aggressive repayment plan as soon as it's financially feasible.

The next phase

Once your income starts to grow and your student loan payments become more manageable, you may benefit from refinancing your student loans at a lower interest rate through a lender. Refinancing is the most effective way to save money on student loan interest, and can have added benefits such as lower monthly payments or reduced payment term. Plus, if you refinance multiple loans you'll also get the advantages that come with loan consolidation — the simplicity of one monthly bill and payment. Some consolidators allow you to refinance both private and federal loans, so you may be able to drastically reduce your interest rate on costly Grad Plus and unsubsidized government loans.

Just how effective is refinancing at reducing your debt burden? Using the example (a borrower with $241,000 in loan principal at a 10-year term), reducing interest rate by just one percentage point — from 6.8 percent to 5.8 percent — would lower payments by $122 per month and save more than $14,000 in interest over the life of the loan. Not a bad trade-off for an application that takes less than 15 minutes to complete. So how do you know when it's time to refinance your student loans? While there's no exact formula, the typical SoFi[2] refinance candidate tends to have the following characteristics:

- An undergraduate, masters, law, medical or dental degree.
- A job
- A track record of working and earning income
- A good credit score
- A manageable debt burden when compared with income.

If you are looking to refinance federal loans, it's important to note that some of these loans offer forgiveness programs in addition to IBR and PAYE that don't transfer to private lenders. The most relevant program for dentists is probably the Public Service Loan Forgiveness Program (PSLF), which allows borrowers who work in the public sector for 10 consecutive years to have their remaining loan balance potentially forgiven at that time. To find out if you're eligible, contact your current loan servicer. But if you've moved on from IBR or PAYE, and you don't qualify for other federal loan forgiveness programs, refinancing may be a cost-saving option for you.

Conclusion

Reduced monthly payments can feel like a blessing when you're first starting out, but it's important to remember how that discount affects your bottom line. In order to keep interest under control, try to use IBR or PAYE only for as long as necessary, and then move to a standard payment plan as soon as you're ready. And when your financial situation has improved to the point where you're eligible, refinancing can be a great way to get out of debt quickly and cost-effectively. ■

---

2. *SOFI is the company by which the author is employed.*

Dont' be afraid to ask questions about student loans! Go to Dentaltown.com.

Author's Bio

Dan Macklin is the VP of Business Development for Social Finance (SoFi). For more information, visit SoFi.com/dentaltown or call 1-855-456-SOFI.