THE WALL STREET JOURNAL.

The Pros and Cons of Federal vs. Private Student Loans

Both have advantages and drawbacks. Here's how to decide what's best for you—which could be both.

By Cheryl Winokur Munk

Nov. 1, 2018

For many families and students taking out college loans, one of the thorniest questions is this: federal or private?

It's easy to get confused. Here is a guide to what families need to know to make an informed decisions.

Federal student loans

The Education Department awards more than $120 billion a year in grants, work-study funds and low-interest loans to more than 13 million students, according to the Federal Student Aid office's website studentaid.gov. There are different types of federal loans available, depending on factors such as a family's income and whether the student is attending an undergraduate or graduate program:

• Direct subsidized loans. These loans are available to undergraduate students who demonstrate financial need. Students don't have to make any payments while they're in school or during a six-month grace period after they leave school. In addition, the government pays the interest that accrues while a student attends school at least half time and during the grace period, as well as any interest that accrues during a deferral of loan payments, which is allowed under certain circumstances.

• Direct unsubsidized loans. These loans are available to undergraduate, graduate and professional students. Eligibility isn't based on financial need. As with a subsidized loan, students don't have to make any payments while they're in school or for six months afterward. But unlike with a subsidized loan, students are responsible for paying the interest that accrues during all periods.

PROS AND CONS: Federal student loans may carry lower interest rates than private loans, and they have more repayment options for students. Even if the rate offered by a private lender is lower, federal student loans offer important protections such as income-based repayment and loan-forgiveness opportunities, says Michele Streeter, communications director at the Education Finance Council, a national trade association representing nonprofit and state-based higher-education finance organizations. "You should never replace a federal student loan with a private student loan," she says.

However, federal loans have yearly and aggregate limits on what a student may borrow, depending on the student's year in school and whether he or she is considered a dependent. For instance, a first-year undergraduate student who is considered a dependent may generally borrow up to $5,500; no more than $3,500 of this amount may be in subsidized loans. The aggregate limit for such a student is $31,000, and no more than $23,000 of this amount may be in subsidized loans. Federal student loans also charge a loan fee, currently 1.062% for loans disbursed from Oct. 1, 2018, through Sept. 30, 2019.

For families who need to borrow additional money (after exhausting federal student loans, federal and state grants, college-specific scholarships, outside scholarships, work-study and savings) there are a number of options:

Federal parent loans

• Direct Plus Loans. These are federal loans available to parents of dependent undergraduate students. Interest is charged during all periods and none of it will be paid by the government. Payments of principal and interest on federal parent loans generally begin immediately once the loan is fully disbursed, but parents may request a deferment while their child is enrolled at least half time and for an additional six months after he or she graduates, leaves school or drops below half-time enrollment. The interest rate is 7.6% for Direct Plus Loans disbursed from July 1, 2018, through June 30, 2019.

PROS AND CONS: Families can borrow up to the cost of attendance, minus any other financial assistance received. Under some circumstances, such as a parent's death or permanent disablement, the loan may be discharged. On the downside, borrowers can't have an adverse credit history; if they do, they must arrange for an endorser who agrees to repay the loan if they cannot. Also, the interest rate may be higher than some private loan options, and Plus loans charge an origination fee, which is 4.248% for loans disbursed from Oct. 1, 2018, through Sept. 30, 2019. These loans can't be transferred to the student, meaning the parent is legally responsible for the debt.

Private student or parent loans

Private loans are nonfederal loans made by a lender such as a bank, credit union, state agency or school. Within this category there are many choices.

• Large private lenders. A number of large lenders focus on the private student-loan market, including Sallie Mae, College Ave Student Loans and Discover Student Loans. Comparison sites like credible.com or edvisors.com/compare-lenders can help students and families compare options among these lenders and others.

• Smaller private lenders. This category—often overlooked by families—includes credit unions and state lenders that may offer rates and terms comparable to those of large private lenders and Direct Plus Loans. To compare rates offered by credit unions, families can visit culearn.org/find-a-lender. To compare nonprofit loans by state-related organizations, families should visit foryounotforprofit.org and click on the link for finding nonprofit loans. The site displays potential options based on a student's residency and school location.

PROS AND CONS: Private lenders have flexibility to determine the rates and terms of the loans they offer, with most offering a choice of variable or fixed interest rates and the option for students to defer payments while they are enrolled in school. Many private lenders also offer loans for parents with terms that may be more favorable than a Direct Plus Loan.

On the other hand, private loans can be more expensive for families with poor credit history. The rate and the amount available to borrow will depend on factors such as the borrower's credit history, the credit quality of the cosigner if there is one, and the school's cost. Terms, rates and repayment options vary by lender, so students and families need to pay close attention to these details. Experts say families should also weigh the benefits of taking out a secured loan, such as a home-equity line of credit or home-equity loan, to pay education costs.