Loan Consolidation: What's the big deal?
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Consolidation loans can be traced back to 1985, but in recent years loan consolidation has become more prevalent. One might wonder why. The answer is quite simple. The consolidation program has morphed from a product of convenience into a product that allows students to refinance federal educational debt to save money; much like refinancing a home mortgage to take advantage of historically low interest rates.

To appreciate this basic change one must look at the original intent of the consolidation program and then understand how the economy has effected this program.

What is Consolidation?
Consolidation is basically paying off one or more eligible loans by borrowing a new loan. Another way to think of this is the "refinancing" of a borrower's educational debt into a new federally guaranteed loan. One must remember that only federal educational loans can be included in the new consolidation loan. For most borrowers this would include Stafford and Direct subsidized and unsubsidized loans and Perkins Loans. However there are several other federal loans that can be included in the consolidation loan program. These include health profession loans and other special federal loans.

Private, alternative, and institutional loans can not be included in a Consolidation Loan as they are not "insured" or "guaranteed" by the federal government. Some lenders have private loan consolidation and may even offer combined billing of federal and non-federal, but these private loans can not be included either of the federal consolidation loan programs.

The Original Intent:
The original intent of loan consolidation was to avoid borrower default on federal educational loans. Consolidation does this in two ways. First, it centralizes all federal debt by pulling multiple loans together. This eliminates multiple lenders and services. This benefits the borrower by allowing them to make one monthly payment on all their federal debt. Secondly, consolidation allows the borrower to extend their repayment window. The standard repayment window on Stafford/Direct loans is ten years. Depending on the level of debt, a consolidation loan can extend repayment to thirty years. By extending the repayment window, the monthly amount due from the borrower is reduced, making the borrower's monthly budget more manageable.

Consolidation Today:
The 91-Day Treasury Bill return rate has declined steadily in the last few years. Because student loan interest rates are driven off the 91-Day T-Bill there have been corresponding decreases in student loan interest rates. In 2000 the in-school/grace interest rate on Stafford/Direct loans was 7.59%. One year later in 2001, the rate had dropped 220 basis points to, what was then, an incredible rate of 5.39%. Since then the rates have continued to go down; 3.46% in 2002 to the current rate of 2.82%.

The interest rate on Stafford/Direct loans is variable with a cap of 8.25%. The biggest benefit of the consolidation loan program is that the interest rate of a consolidation loan is fixed - meaning that borrowers actually convert a variable interest rate loan to a new loan with a fixed interest rate. Currently borrowers are locking in rates that are historically low. Of course this can lead to significant savings over the life of the loan only if the borrower repays the loan within the standard 10-year window. As mentioned earlier, finance charges can increase significantly if the borrower takes a longer time to repay the loan in full.

Consolidation Loan Interest Rate

The interest rate of a consolidation loan is the weighted average of the loans being consolidated at the time the consolidation is made. For example: if a borrower had federal educational debt of $10,000 at 5% and $10,000 at 3%; the borrower would have a new consolidation loan of $20,000 at 4%. As stated earlier, this new consolidation loan would have a fixed rate that will never change.

Stafford and Direct loans have a two-tiered interest rate structure. The in-school rate/grace is determined by adding 170 basis points to the applicable 91-Day T-Bill. Following the grace period the loan interest rate is determined by adding 230 basis point to the applicable 91-Day T-Bill. As you can see, the in-school/grace rate is always 60 basis points lower than the repayment rate. So in general terms it is advantageous for a borrower to consolidate during the grace period because they will get a lower fixed rate compared to if they waited until the grace period ends.

However, the borrower should be aware that consolidation loans do not have any grace period, and payments are due shortly after the consolidation loan is made. Borrowers are in a tenuous position of wanting to take full advantage of their grace period, yet initiating the consolidation process so they can get the more desirable, lower rate.

When can a Borrower Consolidate?

This is a complicated question. For most FFELP borrowers the best time to consolidate is during the grace period (because of the lower interest rate applicable during grace). In any case a FFELP borrower must be in either grace or repayment to consolidate. Direct Loan borrowers can actually consolidate while they are enrolled in a Direct Loan participating school.

Is there a minimum?

Although there is no federally mandated minimum, lenders do have the authority to establish their own minimums. Generally speaking a borrower must have a minimum of $10,000 in federal debt to obtain a consolidation loan (although some lenders have lower minimums).

What about Deferment/Forbearance Options:

Consolidation Loans have the same deferment and forbearance option as the current Stafford and Direct loan programs. Deferment options include in school at least half time, economic hardship, graduate fellowship, rehabilitation and unemployment. Forbearance may be granted if the borrower is experiencing financial difficulties or illness. It is important for borrowers to know that they lose any deferment options that may be connected to an older loan (such as internship/residency deferments).

The “Single Holder” Provision
The “single holder” provision has led to much confusion for borrowers and financial aid administrators. This provision states that Stafford borrowers with one lender must first contact the holder of their loans for consolidation. In these cases the borrower is required to consolidate with that lender.

Borrowers with multiple Stafford lenders have the opportunity to consolidate with any consolidation lender they choose. It is important to note that Perkins loans do not count as a separate “holder” in the definition. Therefore, a borrower with Stafford loans held by one lender and Perkins loan(s) would need to go back to the Stafford loan holder for consolidation.

Borrowers with Direct Loans and Stafford loans (held by one lender) can consolidate with the Direct Consolidation Loan program or the holder of their Stafford loan. Again, if a borrower has multiple Stafford lenders the borrower can “shop ‘til they drop” when looking for a consolidation loan.

A Word of Caution
It’s true that Loan Consolidation allows a borrower to lock in historically low interest rates. These low rates, combined with extending the repayment window, allow for increased money for the borrower on a month to month basis. But one should be aware that extending the repayment window would significantly increase the finance charges associated with the loan (assuming the borrower utilized the entire repayment window). In addition, the borrower may lose the remaining grace period and any borrower benefits connected to the original loan(s).

Many in the financial aid profession anticipate significant changes to the consolidation loan program in upcoming reauthorization. Some possible changes include implementation of a variable interest rate on consolidation loans; charging a modest basis point increase to consolidation loans and possible increases in the standard repayment window of traditional Stafford and Direct loans. (In the mean time, the consolidation loan program offers tremendous benefits to borrowers who are able to take advantage of the program.