Four Mistakes Students and Parents Make When Getting Student Loans

Too many people borrow first for college, and contemplate the long-term impact later. They can pay the price.

By Cheryl Winokur Munk
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With the financial-aid season in swing, many families will find themselves borrowing to pay for higher education.

Done strategically, it can be a sound financial decision (even apart from any loan-forgiveness help that might come from the federal government). But debt is still debt. And many people make financial decisions about college without fully considering the possible long-lasting financial impact.

“You want to make sure the dream school doesn’t become a nightmare school upon graduation, when you find out you can’t afford student-loan payments, plus rent, plus everything else,” says Scott C. Gibney, an educational and career consultant in Northport, N.Y.

Planning is especially important given that 41% of families said the student, the parent or both borrowed to help cover education costs in the 2021-22 academic year, according to a recent Sallie Mae.

With that in mind, here are four of the biggest traps that families fall into when taking on debt for college.

Mistake No. 1

Not adequately exploring debt alternatives

Make sure you are fully investigating scholarships and grants, says Bruce McClary, senior vice president of membership and communications at the National Foundation for Credit Counseling, which provides free or low-cost credit-related advice to consumers. Organizations such as the College Board, Going Merry and Sallie Mae offer online help for students seeking scholarship opportunities. Students can find additional scholarship resources at the website for the National Scholarship Providers Association, a nonprofit member group that serves scholarship-program professionals.

Students should also consider the field they plan to work in and whether they might be eligible for the federal government's Public Service Loan Forgiveness program—for borrowers working in government or a qualifying nonprofit—though they shouldn't base all their borrowing decisions on this since career or job plans could change, Mr. McClary says.

Another option could be to consider a corporate degree program, which some companies, including Starbucks, Target and Walmart, offer to their employees. Citigroup recently announced an expanded tuition-reimbursement program that offers employees no-cost, fully funded degrees from five partner schools.

Mistake No. 2

Taking on too much debt

As a general guideline, some experts typically recommend that 8% to 20% of take-home pay can safely be allocated toward student-loan payments. To figure out if a student can meet those demands, do some research online.

First, consider what the student's salary could be after graduation, using an online tool such as Salary.com or Glassdoor. An online calculator such as the Tax Form Calculator can help determine what the new worker's take-home pay might be after federal and state taxes. Prospective borrowers should also take advantage of the federal government's loan simulator tool to calculate what their monthly repayment obligation could look like.

Remember to consider rent, clothing costs, commute, food and other living expenses and "leave a little cushion" as you are thinking about what you may be able to afford, Mr. McClary says. This is especially important given inflation and high housing-related costs, he says. (Undergrads, meanwhile, should also anticipate the potential debt they would shoulder if they go to graduate school.)

Parents who are taking out loans to pay for college should consider their credit health, Mr. McClary says. Ideally, no more than 35% to 40% of the parents' monthly budget should be allocated toward debt, including mortgage, car loans and college-related debt, he says.

Parents of college students also need to understand what it means to be a cosigner.

Mistake No. 3

Turning to private loans before maxing out your federal loan eligibility

Michele Streeter Shepard, senior director of college affordability at the Institute for College Access & Success, a research and advocacy nonprofit, strongly recommends that borrowers avoid private loans, if possible. Federal loans offer several protections, including repayment plans tied to a graduate's income and family size, and the potential for forgiveness based on the borrower's profession or after a certain number of years in repayment. There are also several potential relief programs that are available only to federal borrowers, Ms. Streeter Shepard says.

If you have exhausted other options and are considering a private loan, "be a savvy consumer," says Jennifer Schott, managing director at the AccessLex Center for Education and Financial Capability, which offers financial education programming for students and graduates. Look at factors such as the interest rate, whether it is fixed or variable, when repayment starts, origination fees and what protections, if any, exist if repayment becomes difficult.

Parents also need to understand what it means to be a cosigner and what cosigner relief options, if any, exist. "It really is important for families to do their research, because there are so many private loan products out there," Ms. Schott says.

There are state-based and nonprofit programs that offer low interest rates, low or no origination fees, and lower monthly payments and lower total debt than many other education loan options. Families can research some of these options on the website of the Education Finance Council, a national trade association representing nonprofit and state-based higher-education finance organizations.

Interest-free loans might also be worth investigating, especially for borrowers with considerable financial need. For example, some of these programs apply broadly to students from lower-income families, and others are for specific groups such as military families. Loan amounts, eligibility requirements and repayment terms vary by program, and finding relevant opportunities may require research. One option is to visit the website of the International Association of Jewish Free Loans, a membership organization of interest-free lenders.

Mistake No. 4

Not understanding loan specifics

Being educated about how loans actually work is important, Mr. Gibney says. Federal loans, for example, can be subsidized, meaning borrowers don't pay interest while attending school at least half time, and for a six-month grace period after the student leaves school, as well as during deferment periods.

There are also unsubsidized loans, available regardless of financial need. With this loan type, borrowers are responsible for paying the interest during all periods. Borrowers can choose not to pay the interest while in school or during grace or deferment periods, but that interest will accrue and be added to the loan principal.

Families also need to understand who is responsible for the repayment. Federal loans taken by the student are the student's responsibility. Federal parent Plus loans are a parent's responsibility and can't be transferred to the student. Some private-loan companies also offer parent loans. These details sometimes trip people up, Ms. Schott says.

Remember, these decisions can have an impact on your life. Among Americans with student loans, 81% agree or strongly agree that student-loan debt affects their ability to save for retirement, according to June data from Voya Financial, a New York-based financial-services company for individual, workplace and institutional clients. Meanwhile, 80% worry about their ability to pay off student-loan debt, the survey found.

"Many families say, 'We'll apply first and figure out the cost later.' Then it becomes emotional, not a financial decision," Mr. Gibney says.

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