Managing educational debt can be a daunting task for a young physician in the United States. Tuition continues to rise at public and private schools across the country. Higher tuition typically necessitates increased borrowing. In the 2002 Medical School Graduation Questionnaire: All School[s] Report, the Association of American Medical Colleges reports that the mean debt load for an indebted medical student graduating from a private medical school was $118,546, or $86,630 for those graduating from a public medical school. The Association of American Medical Colleges further reports that the mean debt load of graduating medical students in the United States was $99,089, nearly a 5% increase from the previous year. This article will familiarize young physicians and medical students with debt management strategies, specifically direct and federal loan consolidation programs, available loan deferments, and tax incentives—as well as the effect of lengthy repayment schedules on total interest accrued.

**Stafford/Ford student loans**

The most common way for prospective students to fund a medical education is through a Stafford/Ford loan. The lending source and terms of repayment determine the type of Stafford/Ford loan students receive.

A Stafford/Ford loan can be issued by a private source (eg, bank, credit union, or another participating lender) or by the federal government. Stafford/Ford student loans issued through private sources are administered through the Federal Family Education Loan Program (FFELP); loans issued by the government are administered through the Federal Direct Student Loan Program (FDSLDP). Most medical students and young physicians have FFELP loans as the FDSLDP was launched only 7 years ago.

Stafford/Ford loans are variable-interest loans insured by the federal government. Government-insured loans protect the lender in the event that the borrower defaults on the loan through death, “total and permanent” disability, school closure, or (in rare cases only) personal bankruptcy. In those instances, the federal government would step in to pay off the debt on the borrower’s behalf and the borrower’s estate or remaining assets would not be applied to the debt. Private loans (eg, mortgages, home-equity loans) are debts that are not forgiven under any circumstances, and any assets of the borrower would be applied to the remaining balance in the event of a default on such a loan.

Stafford/Ford loans from either funding source accumulate interest and are categorized as subsidized or unsubsidized. The benefit of obtaining a subsidized Stafford/Ford loan—which can be obtained only through meeting an eligibility requirement based on financial need—is that the federal government pays the interest that accumulates (1) while the student is attending school at least half time (ie, in-school status), (2) during the 6-month grace period after graduation, and (3) during any authorized deferment periods (Figure 1). Conversely, a student who obtains an unsubsidized Stafford/Ford loan must either (1) pay the interest as it accrues (ie, during in-school and grace periods) or (2) add the accrued interest payments to the principal amount borrowed in a process known as capitalization. All graduate students can borrow up to $8500 annually in subsidized Stafford/Ford loans, but medical students can borrow up to $38,500 annually in unsubsidized Stafford/Ford loans (less any amount borrowed through subsidized Stafford/Ford loans).

In addition, every Stafford/Ford loan, regardless of when it was disbursed, carries two “fixed” interest rates. The first fixed interest rate is in effect while the student is in school, during the grace period, and during any authorized deferment periods. The second fixed interest rate is effective during active repayment periods or approved forbearance periods (Figure 1). This second fixed interest rate is 0.6% higher than the interest rate charged during the in-school, grace, and authorized deferment periods (Table 1).

For example, as of July 1, 2002, a Stafford/Ford loan disbursed on or after July 1, 1995, but before July 1, 1998, has an initial interest rate of 4.26%, and then the interest rate increases to 4.86% during the active repayment period or forbearance. A direct loan (subsidized or unsubsidized) disbursed on or...
Interest rates on Stafford/Ford loans are adjusted only once annually, on July 1.

**Student loan consolidation**

Student loans eligible for consolidation are those processed through FFELP or FDLP (Figure 2). Loan consolidation of two or more loans creates a single new loan, which is still government insured. A weighted average is calculated—based on the principal amount due and the interest rate charged for each existing loan—to form a composite interest rate, which is then rounded up to the nearest eighth of a percent. Any interest accumulated on the loans before consolidation is capitalized at the time of consolidation. In addition, there are no fees charged to the borrower when consolidating these types of loans. The old loans are paid off by the new lender, and a single new loan with a single fixed interest rate is opened for the borrower. For certain consolidation loans, however, interest rates must remain variable. For example, a HEAL refinancing in FFELP maintains a variable interest rate for the HEAL portion of the loan consolidation, whereas HEAL refinancing is fixed in FDLP loan consolidation (Table 2).

To lock in the lower of the two interest rates set for the Stafford/Ford loan (ie, the in-school rate), it may be advanta-
An FFELP loan for which the lender does not offer income-sensitive repayment terms that the borrower finds acceptable.

Disadvantages of consolidation

Disadvantages of consolidation include the loss of non–loan consolidation incentives (eg, rate reductions and rebates on origination fees). In addition, the weighted average of loan rates is rounded up to the nearest eighth of a percent, and any accumulated interest is automatically capitalized at that time.

Incentives for consolidation

Almost all lenders offer a repayment incentive, usually a 0.25% discount on the loan’s interest rate for borrowers who make their monthly loan payments using an automatic debit program (an authorized automatic removal of funds from a checking account). Such a payment program ensures that the lenders will receive their payments on time. Obviously, a lender cannot grant an automatic debit discount when a loan is in deferment because the borrower is not repaying the loan.

Some lenders also offer consolidation incentives, usually a discount in the subsequent interest rate after a specified number of on-time payments. For example, lenders commonly offer borrowers a 1% discount on interest charges after payments are made on time for 36 months. For physicians, this period usually begins after residency is complete.

Such incentives can be extremely valuable because, regardless of the interest rate charged, a 1% interest rate reduction on a loan of $120,000 saves $100 every month in interest. With a direct or federal consolidation—including HEAL loans in FDSLP loan consolidation, which remain variable—the borrower is immune from future rate increases because the interest rate of the loan is fixed.

Deciding whether to consolidate existing loans and which consolidation plan is the best fit for any individual’s situation is a difficult personal decision. Many factors should be carefully considered and weighed, and many options should be investigated, most especially lifestyle issues, including housing and family priorities.
Lender incentives are revocable if a loan payment is late for any reason. A 30-year payback means that the borrower will need to make 360 payments on time to maintain any incentive discount.

Further, if interest rates decline in the future, the consolidated loan will remain at its fixed interest rate. The primary risk of consolidation then is that borrowers who consolidate become ineligible to take advantage of future rate decreases—again with the exception of HEAL loans in FFELP. Therefore, borrowers seeking loan consolidation in 2000 or 2001 may have “locked in” their interest rates prematurely as rates have continued to fall through 2002. Further, though it would seem unlikely, interest rates may be even lower in July 2003, making a new interest rate reduction a lost opportunity for borrowers who consolidated in 2002.

Deferments

Internship/Residency Program Deferment
An Internship/Residency Deferment, which is available for 2 years to borrowers who have an FFELP loan disbursed before July 1, 1993, postpones the borrower’s repayment period. During this deferment, the federal government pays the interest on a subsidized Stafford/Ford loan.

To qualify for this type of deferment, the borrower must hold at least a bachelor’s degree and must be participating in a supervised internship or residency program that leads to a degree or certificate from an institution of higher education, hospital, or a healthcare facility that offers postgraduate training.

Economic Hardship Deferment
An Economic Hardship Deferment, during which the federal government pays the interest on a subsidized Stafford/Ford loan, is available 1 year at a time for up to 36 months without consolidation. However, a borrower may qualify for an additional 36 months of Economic Hardship Deferment after obtaining direct loan consolidation (although not federal loan consolidation), subject to income restrictions. The only other deferment that makes a similar provision for a medical resident is the Rehabilitation Training Deferment (see http://www.dl.ed.gov/defforb/page23idq_is_rt_req.asp), which requires full-time enrollment in a rehabilitation training program.

There is an advantage of direct loan consolidation over federal loan consolidation for borrowers who have already exhausted some of the 36-month limit on this type of deferment. A loan consolidated through the direct loan consolidation program is considered a new loan, and “new” borrowers who choose this method of loan consolidation (and qualify for it) will find they may qualify for up to an additional 36 months of Economic Hardship Deferment. This option is of particular interest to physicians who complete rotating internships.

(continued on page 551)
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those years if qualifying conditions for the credit are met. Learning Tax Credit, may amend the tax return for any of years (1999, 2000, or 2001) who did not file for the Lifetime Individual completing a course of study in the past 3 tax years. The changes as a result of the Tax Relief Act of 2001 are expanded for tax year 2002 from the Tax Relief Act of 2001 and allows borrowers to take a deduction on any interest paid toward student loans, subject to income restrictions. Up to $2500 of interest payments per year (without the prior 60-month limit) are deductible for couples with an adjusted gross income of up to $100,000 (income phaseout is set at $130,000).10,11 The same amount is deductible for single filers earning up to $60,000 (income phaseout of $75,000).10,11 Conversely, the 2001 limits were much stricter, with an income phaseout of $40,000 to $55,000 for single filers and $60,000 to $75,000 for married individuals filing jointly.10 Individuals with incomes in the phaseout ranges provided will qualify only for a portion of the tax credit.

The changes as a result of the Tax Relief Act of 2001 are of benefit for student borrowers and were lobbied for heavily during 2001 by the American Association of Colleges of Osteopathic Medicine, the American Osteopathic Association, the American Medical Association, the American Medical Student Association, and others across the United States. When considering this tax deduction, do not confuse the accumulated interest on loans with interest paid on a loan. The deduction is for interest paid per year, not principal paid on a student loan, regardless of loan status. Prior to the 2002 tax year, an individual was eligible to qualify for a federal income tax deduction on interest paid only if the interest payments were required and those payments occurred during the first 60 months of repayment status.10

Student loan interest deduction

Individuals completing a course of study in the past 3 tax years (1999, 2000, or 2001) who did not file for the Lifetime Learning Tax Credit, may amend the tax return for any of those years if qualifying conditions for the credit are met. To claim the credit on a tax return, students must not have been claimed as a dependent by anyone during the year or years in question. In addition, if students qualify, they may offset income from any source with the credit if they made payments on billable tuition during the tax year in question, subject to income restrictions. These restrictions include a $40,000 to $50,000 eligibility phaseout for individuals filing federal tax forms singly and $80,000 to $100,000 eligibility phaseout for individuals who are married and filing federal tax forms jointly.10,11 Eligible individuals may receive a tax credit from this program for 20% of the first $5000 of tuition paid, with a maximum limit of $1000 per year.10

Examples

To illustrate how loan consolidation affects repayment, two examples follow. Two other hypothetical situations are presented. One discusses forbearance status, and the other discusses accelerated repayment strategies. The $180,000 of starting debt used for all subsequent examples represents an approximate debt of a full Stafford/Ford borrower of $38,500 per

ships prior to a categorical residency and residents who enter a residency program that lasts longer than 36 months because an Economic Hardship Deferment would otherwise be exhausted.

For example, at an interest rate of 6%, $34,000 (or $8500 for 4 years) of subsidized Stafford/Ford loans requires the borrower to pay $2040 per year in interest payments, all of which would be paid for by the federal government while the borrower is in Economic Hardship Deferment. It is important to note that applying for an Economic Hardship Deferment does not preclude loan consolidation as long as the same qualifying criteria for loan consolidation is met (see “Eligibility for consolidation”). Similarly, the borrower may defer the loans, enter repayment status using any of several repayment plans, switch repayment plans if necessary (subject to restrictions), and prepay loans without penalty.

If an Economic Hardship Deferment is obtained during the grace period, the interest rate is frozen for the length of the deferment (aside from the annual July 1 rate adjustment) and maintains the initial interest rate. Economic Hardship Deferment that extends over a July 1 period is adjusted according to the following year’s applicable rate. For more information on Economic Hardship Deferment, visit http://www.dl.ed.gov/defforb/page23dq_eh_req.asp or any of the other resources listed in Figure 3.

Tax savings

Lifetime Learning Tax Credit

Individuals completing a course of study in the past 3 tax years (1999, 2000, or 2001) who did not file for the Lifetime Learning Tax Credit, may amend the tax return for any of those years if qualifying conditions for the credit are met. To claim the credit on a tax return, students must not have

Figure 3. Online resources.
year for 4 years of medical school plus hypothetical interest.

Example 1—It is often less expensive to repay loans that have been disbursed since July 1, 1998. Payments are calculated for paying off the principal and interest over a 10-year period. Table 3 illustrates the interest rates and the monthly principal required for paying off a loan of $180,000. The interest rates shown are the current (2002) rates for Stafford/Ford loans. Unfortunately, the rates are determined by the date the loan was first disbursed; older loans have a higher interest rate. Direct loans (subsidized and unsubsidized) disbursed since July 1, 1998 (4.06% repayment rate through June 30, 2003) are less expensive than the older Stafford/Ford loans carrying a higher interest rate. The interest rates required for paying off a loan of $180,000. The interest rates shown are the current (2002) rates for Stafford/Ford loans.

Table 3

<table>
<thead>
<tr>
<th>Interest rate</th>
<th>Disbursed July 1, 1995, through June 30, 1998</th>
<th>Disbursed on or after July 1, 1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>4.26%</td>
<td>3.46%</td>
</tr>
<tr>
<td>In-school period</td>
<td></td>
<td></td>
</tr>
<tr>
<td>60-Day grace period</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Authorized deferment period</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Secondary</td>
<td>4.86%</td>
<td>4.06%</td>
</tr>
<tr>
<td>Active repayment period</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forbearance period</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* The 91-day Treasury Bill for both time periods discussed is 1.76%.
† The spread (i.e., lender’s profit) is calculated at 2.5%.
‡ The spread (i.e., lender’s profit) is calculated at 1.7%.

Table 3 shows how the interest rates and the monthly principal required for paying off a loan of $180,000. The interest rates shown are the current (2002) rates for Stafford/Ford loans. Unfortunately, the rates are determined by the date the loan was first disbursed; older loans have a higher interest rate. Direct loans (subsidized and unsubsidized) disbursed since July 1, 1998 (4.06% repayment rate through June 30, 2003) are less expensive than the older Stafford/Ford loans carrying a 4.86% interest rate this year.

Many individuals choose to spread payments over a longer time, making monthly payments smaller and improving cash flow. However, short-term gain may be more expensive in the long run than many may think. Table 4 shows how spreading a loan over 30 years (FDSLP extended repayment plan) is a much more expensive prospect than simply paying the principal and interest back through the standard repayment plan over 10 years. Interest that accrues over an extended term and annual increases that keep pace with interest rates all add up over the long term. As seen in Table 4, a 30-year term has about half the monthly payment of a 10-year term, but the loan accrues nearly 350% more in interest payments.

Example 2—Many individuals graduate from medical school and exhaust the 6-month grace period before applying for an Economic Hardship Deferment. Two years after graduation (with 18 of the 36 months of Economic Hardship Deferment consumed), he decides to seek direct loan consolidation. On receiving a consolidated loan, he may reapply for Economic Hardship Deferment for an additional 36 months, 1 year at a time. Essentially, those who choose to consolidate using direct loan consolidation will find their 36-month limit on Economic Hardship Deferment renewed. Individuals must reapply and qualify every 12 months. Further, for each year they qualify for the Economic Hardship Deferment, they retain the benefits of the interest subsidy on their subsidized loan payments.

Table 5 demonstrates the savings advantage for this individual. During his 4 years of medical school, up to $8500 per year ($34,000 at the end of 4 years) may be borrowed as a subsidized Stafford/Ford loan. The individual’s Stafford/Ford loans are rounded up to the nearest eighth of a percent from consolidating after year 2, from 3.46% to 3.50% in this case. Additionally, the federal government pays $5882 ($2353 plus $3529) of interest on the subsidized Stafford/Ford loans during these years in Economic Hardship Deferment status, lessening the growth of the total loan balance. Without consolidation and qualifying for renewed deferment, the individual would be responsible for the interest subsidy the last 2 years. As Table 5 shows, extending Economic Hardship Deferment through direct loan consolidation slows the growth of interest, which in turn slows the growth of the principal amount. It should be

In this example, a resident finishes his grace period 6 months after graduation and then applies and qualifies for an Economic Hardship Deferment. Two years after graduation (with 18 of the 36 months of Economic Hardship Deferment consumed), he decides to seek direct loan consolidation. On receiving a consolidated loan, he may reapply for Economic Hardship Deferment for an additional 36 months, 1 year at a time. Essentially, those who choose to consolidate using direct loan consolidation will find their 36-month limit on Economic Hardship Deferment renewed. Individuals must reapply and qualify every 12 months. Further, for each year they qualify for the Economic Hardship Deferment, they retain the benefits of the interest subsidy on their subsidized loan payments.

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Table 5
Interest Subsidy Savings During 5-Year Residency Program on Consolidated Stafford/Ford Student Loan for $180,000 in Economic Hardship Deferment

<table>
<thead>
<tr>
<th>Accrued interest</th>
<th>$34,000 Subsidized</th>
<th>$146,000 Unsubsidized</th>
</tr>
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<tbody>
<tr>
<td>☐ First 24 months postgraduation‡</td>
<td>$2,353</td>
<td>$10,103</td>
</tr>
<tr>
<td>☐ Next 36 months in deferment after direct loan consolidation§</td>
<td>$3,529</td>
<td>$15,330</td>
</tr>
<tr>
<td>☐ Total loan amount¶</td>
<td>$34,000</td>
<td>$171,433</td>
</tr>
<tr>
<td>☐ Total Debt Load§ on $180,000 After 5-Year Residency Program: $195,330</td>
<td></td>
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</tr>
</tbody>
</table>

Table 6
Effects of Accrued Interest During 3-Year Forbearance Period Stafford/Ford Student Loan for $180,000 Without Benefits of Loan Consolidation

<table>
<thead>
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<th>Interest rate</th>
<th>4.86%</th>
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<tr>
<td>□ Principal balance at end of grace period</td>
<td>$180,000</td>
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</tr>
<tr>
<td>□ Accrued interest in forbearance</td>
<td>$26,244</td>
<td>$24,640</td>
</tr>
<tr>
<td>☐ Total loan amount¶</td>
<td>$206,244</td>
<td>$204,840</td>
</tr>
</tbody>
</table>

Table 6 notes that this interest subsidy can be realized only through subsidized direct loan consolidation, not through federal loan consolidation.

Example 3—There are times, however, when deferment is not an option. In this case, borrowers may wish to pursue qualifying for forbearance. Without the benefits of Economic Hardship Deferment, borrowers who must apply for forbearance status watch as interest accrues on their subsidized loans—interest that is not paid for by the federal government. Table 6 illustrates how interest accrues for borrowers in forbearance with the current year’s interest rates applying to each of the next 3 years.

Debt grows exponentially during forbearance if individuals are unable to make payments on the interest charged, requiring that interest charges be capitalized. Interest accrues at repayment rates (0.60% higher) during forbearance if the loan is not consolidated while the loan interest is locked in at the in-school or grace period rate.

Example 4—Loans can be repaid more quickly when borrowers make additional payments. For example, consider an individual in repayment status whose loan balance is $180,000 at an interest rate of 6.79% (ie, last year’s interest rate for Stafford/Ford loans that are in repayment status and were dispersed before July 1, 1998) within the standard 10-year repayment schedule. The lender determines the borrower’s estimated payments for 120 months (ie, 10 years multiplied by 12 months), making a monthly payment of approximately $2079. However, if the borrower is able to repay an extra $400 with each monthly payment for 94 months (nearly 8 years), the loan will be paid off 26 months (more than 2 years) early.

Although many residents wisely defer repayment of their educational loans during their residency programs, they do not consider the option of making payments toward deferred loans to halt the rapid growth of interest accrual during this time. Residents allotting a small amount monthly (eg, $400) to a loan in deferment would find the balance at the end of residency would be cut significantly. In addition, any payments made during this time toward the interest already accrued on the loan would provide financial gains in the short run in the form of tax benefits on the resident’s 2002 federal income tax return.

Debt management
The Lifetime Learning Tax Credit, Economic Hardship Deferment, and student loan interest deduction can be used with or without loan consolidation to help manage debt. One possible pathway for combined savings is to try to qualify for the Lifetime Learning Tax Credit during medical school, to use the student loan interest deduction, and then apply for Economic Hardship Deferment at the end of the grace period.

Suppose an individual has accumulated $100,000 in Stafford/Ford loans at graduation ($34,000 subsidized and $66,000 unsubsidized). His current salary is $35,000, and he is currently in a 5-year residency. This resident applies for the Lifetime Learning Tax Credit during his medical school years (he had some investment income or income from part-time work to offset), including the graduating year as tuition happened to be billed during the year he graduated. This tax

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* Subsidized amount, $34,000. Unsubsidized amount, $146,000.
† The loan in this sample was disbursed on or after July 1, 1998, when the interest rate for Stafford/Ford student loans in the in-school, grace, or deferment period was set at 3.46%.
‡ The loan in this sample was disbursed before July 1, 1998, when the interest rate for Stafford/Ford student loans in the in-school, grace, or deferment period was set at 3.46%.
§ Through the direct loan consolidation program, the resident secures an interest rate of 3.5%.
¶ The total loan amount shown includes principal and accumulated interest.
credit applies only to federal income tax returns, not to the Stafford/Ford loan.

Next, the borrower applies for Economic Hardship Deferment at the end of the grace period. He then chooses to apply for loan consolidation 2 years after graduation. He may consolidate the loans at the lower in-school rate because he applied for the Economic Hardship Deferment during the grace period. This individual then applies for up to 36 months of additional Economic Hardship Deferment, 1 year at a time for the remainder of the 5-year residency program. Both of these actions directly impact the interest rate and subsequent principal of the loan.

Additionally, the borrower may choose to pay up to $2500 toward the interest accrued during the current calendar year—even though the loans are deferred. This step qualifies the resident for a tax deduction of up to $2500 on student loan interest, subject to income restrictions. Further, although this tax deduction has no impact on either the interest rate of the loan or on the principal of the loan, paying off the interest early helps reduce the growth of the principal amount before the borrower enters repayment status.

Finally, during repayment the individual elects to join an automatic debit program and receives an additional $250 in interest savings per year (ie, a 0.25% discount on a loan for $100,000). Further, if the borrower then applies this interest savings toward the loan’s principal, he will further accelerate repayment of his loan, shortening its term.

Another option is to apply the foregoing decisions without consolidation and to take advantage of possible repayment incentives offered by the lenders of the loans.

Comment
Two major federal programs provide the backbone of funding for prospective students in the United States. Both programs do so through the common vehicle of Stafford/Ford student loans. The Federal Family Education Loan Program (FFELP) issues Stafford/Ford loans through private lending institutions, whereas the Federal Direct Student Loan Program (FDSL) issues Stafford/Ford loans directly through the government. Stafford/Ford loans from either source can be subsidized or unsubsidized by the federal government. All Stafford/Ford loans are federally insured to protect the lender; this type of insurance offers no protection to the borrower. Each program has different rules pertaining to borrowing and loan consolidation.

Similarly, loan consolidation is pursued through the same channels. Federal loan consolidation is available through FFELP, and direct loan consolidation is available through FDSL. Loan consolidation may or may not be an appropriate vehicle for a borrower, depending on the individual’s circumstances. If desired, loan consolidation can help improve cash flow, lock in a desirable interest rate, or expand the temporary assistance offered through the Economic Hardship Deferment for those who have obtained direct loan consolidation.

The Economic Hardship Deferment, the student loan interest deduction, and the Lifetime Learning Tax Credit are three popular ways of managing debt load.

Debt management can be complicated. Young physicians and medical students should review all options carefully and seek out professional help if necessary before making any decisions that will have a long-term impact on their overall financial health.

Further, all medical students should take advantage of any financial counseling services offered by the alma mater medical school. It is extremely important to understand all the requirements, benefits, and limitations of each available option.

Before undertaking any of the options presented in this article, it is highly advisable that prospective medical students, medical students, residents, and young physicians carefully review and weigh their personal financial situations thoroughly and that they consult a professional financial advisor or tax accountant when in doubt.

References


