

Considering borrowing a private education loan? Read on to learn more about how these programs work.

First off, it's important to remember that, unlike federal student loans, private education loans are subject to credit checks and/or other underwriting that can limit some students' and parents' ability to borrow. Private loans may also lack important protections for student and parent borrowers. Always consider your federal student loan options carefully before choosing a private loan.

Finally, watch out for student loan scams, and remember that the financial aid office is here to help you understand your education borrowing options.

## How private loans work

Unlike federal student loans, which require completion of the Free Application for Federal Student Aid (FAFSA), private education loan lenders — such as banks and other financial institutions — use their own application and approval processes. If the loan is approved, the funds will generally be disbursed directly to your school, usually at the start of the academic term. Most lenders offer a range of private student loan options, including undergraduate, graduate/professional, and parent loans.

## Eligibility criteria

Unlike federal student loans (which are based on basic federal student aid eligibility criteria and require no credit check or, for PLUS loans only, a minimal credit check), private education loans are based on creditworthiness and lender underwriting. Banks or other lenders may require a minimum credit score,<sup>1</sup> for example, or impose additional eligibility criteria, such as enrollment at an eligible institution, U.S. citizenship or permanent resident status, satisfactory academic progress, or compliance with a minimum debt-to-income ratio. The debt-to-income ratio measures the percentage of a borrower's gross monthly income (before taxes) that is allocated to existing debt payments, and is used to predict their ability to repay the loan.

Since many students lack a credit history, they often need a cosigner — usually a parent — with a strong credit record to increase the likelihood of loan approval and/or to secure better loan terms. The cosigner is legally responsible for repaying the loan if the borrower defaults. The cosigner may also be negatively affected by late payments on the loan. Additionally, some loans may automatically default or require full repayment if the cosigner passes away.

## Borrower cost

The total cost of private education loans includes the interest rate and any fees that are assessed. Interest rates depend on economic conditions, plus the borrower's (and cosigner's) credit profile and other factors. Lower interest rates are available for borrowers with better credit profiles, while borrowers with lower credit ratings will generally pay a higher interest rate and/or may not qualify for a loan.

Interest rates may be fixed (i.e., stay the same over the lifetime of the loan) or variable and can change over time, possibly leading to higher monthly payments. Many private lenders offer both fixed and variable-rate loan products. Variable interest rates may or may not have a cap on how high the interest rate can go. Other interest-related issues include when and how the interest accrues, and when it capitalizes.

---

<sup>1</sup> Borrowers can look up their credit scores through many major bank or credit card company apps, or from official credit reports through [AnnualCreditReport.com](https://www.annualcreditreport.com).

In addition to interest rates, there may be origination, disbursement, or other fees associated with a private loan. These fees may be subtracted from loan proceeds or added to the amount borrowed.

## Key Terms About Interest

- **Principal:** The actual amount borrowed.
- **Interest rate:** The amount charged by a lender to a borrower, expressed as a percentage of the principal.
- **Interest accrual:** The amount of interest that accrues (adds up) on loans over time, determined by an interest formula.
- **Interest method:** Simple interest is calculated only on the principal amount, while compound interest calculates interest on the principal plus previously accumulated interest. Calculation can be daily, weekly, monthly, etc.
- **Capitalization:** Any unpaid interest added to the principal; often accrues during times when payments are postponed (e.g., grace periods, forbearances, or deferments).

## Repayment

Depending on the loan type and lender, borrowers may have several repayment options and terms. Repayment plans can include different amounts:

- Fixed monthly payments — the same amount each month.
- Graduated payments — payments start lower and gradually increase over time.
- Income-based repayment — minimum monthly payments calculated as a percentage of the borrower's income. Income-based repayment is not common with private education loans.

Repayment may also be structured based on when payments begin:

- Deferred repayment — payments are postponed while the student is enrolled in school.
- Interest-only repayment — only interest is paid while the student is enrolled in school.
- Immediate repayment — full principal and interest payments begin immediately, even while the student is enrolled in school.

Borrowers may also have flexibility in the repayment term, which is the total length of time to repay the loan.

Each of these options may have different associated costs and trade-offs. For example, when a borrower defers payments, the total amount of the loan may be higher due to accrued interest that is capitalized. When a borrower has a graduated repayment plan, the borrower benefits from lower monthly payments in the beginning, but may have larger monthly payments later compared to borrowers on a fixed monthly plan. Making reduced payments and/or extending the time it takes to repay the loans ultimately increases the lifetime cost of borrowing.

---

NASFAA thanks Alisa Federico Cunningham for her assistance in researching and drafting this resource.