Lending a Hand

An informed buyer's guide to borrowing and refinancing

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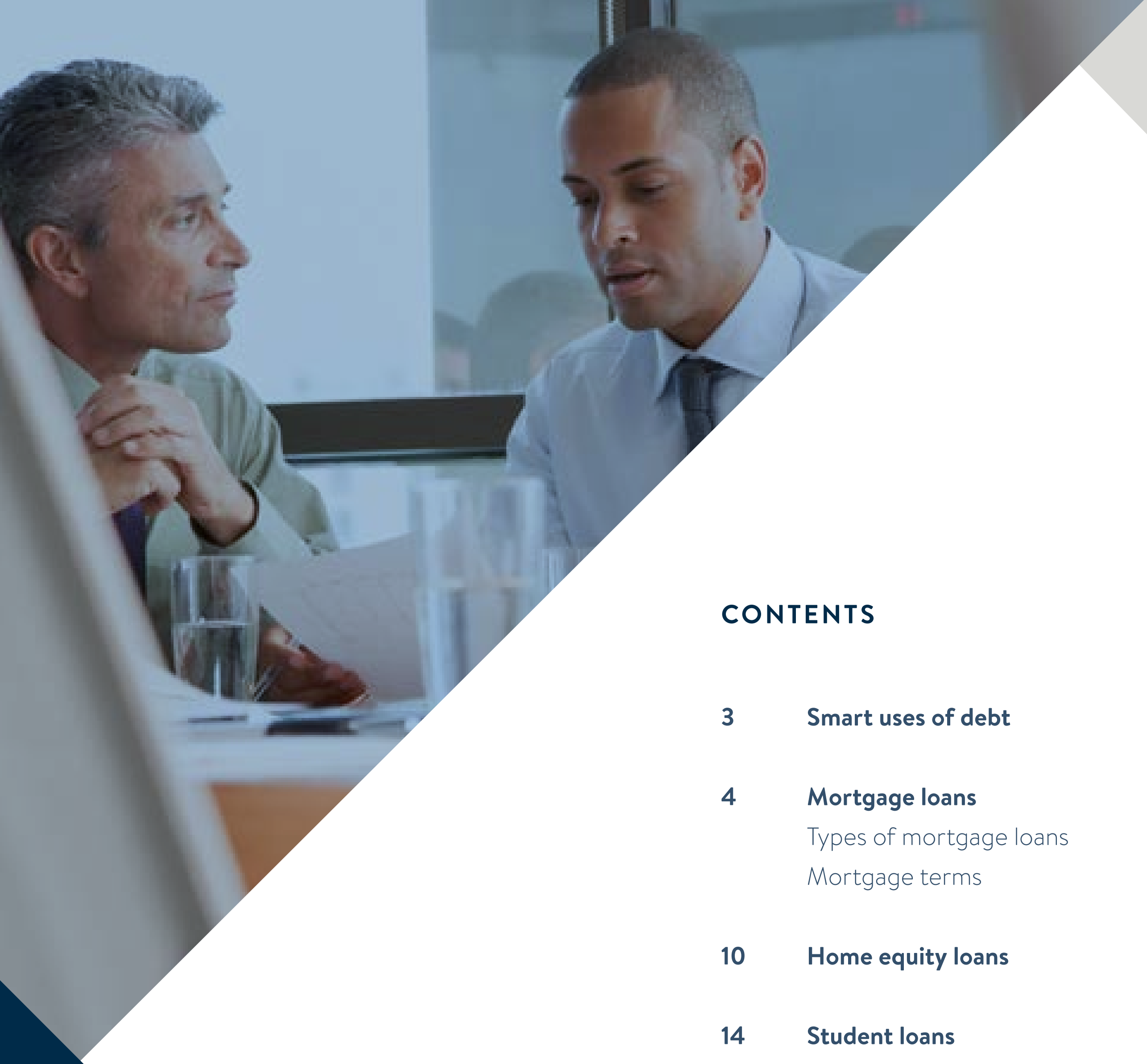

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Debt is a broad category that includes everything from high-interest credit card debt to low-interest, tax-advantaged home equity debt. Used creatively, debt can be a powerful tool for tax planning, purchasing, liquidity and even investing.

The goal is leveraging debt to maximum advantage—rather than becoming leveraged by it. Let's examine some of the uses for, and benefits of, well-managed debt:

High-cost acquisitions

Debt allows you to purchase "expensive" items or experiences without having to save for the entire cost. Debt can provide the opportunity to enjoy a home, drive a new car, help provide children with educations and much more.

Balanced liquidity

As long as you can manage the payments, borrowing can provide you the ability to balance large purchases while maintaining an adequate degree of financial flexibility.

Leveraging your assets

It can be useful to look at your current assets when trying to obtain a loan, particularly for short-term needs. Sources of equity in the form of your taxable brokerage accounts, permanent life insurance policies, home equity or even a 401(k) balance could be used as collateral to provide you the liquidity you require, without incurring certain income tax consequences which could result if funds were withdrawn from these sources. This type of borrowing allows you to obtain quick liquidity without credit checks or other underwriting steps, but each approach comes with its own advantages and disadvantages.

Here we discuss several forms of debt, inclusive of common terms, how each category can be beneficial in helping you accomplish goals and consideration points to help you evaluate your borrowing options. Taking smart steps in acquiring and managing debt can go a long way in creating a successful financial life.

Contact your Ayco advisor to discuss efficient use of debt to assist in accomplishing financial goals and strategies regarding how best to handle any outstanding liabilities.

Mortgages for every circumstance

Most of us are familiar with conventional mortgages. But that's just one type of home loan. There are many mortgage products and features available to meet varying circumstances.

Mortgages constitute one the largest components of American personal and institutional debt. By the end of Q3 2019, outstanding mortgage debt stood at over $15 trillion.[1]

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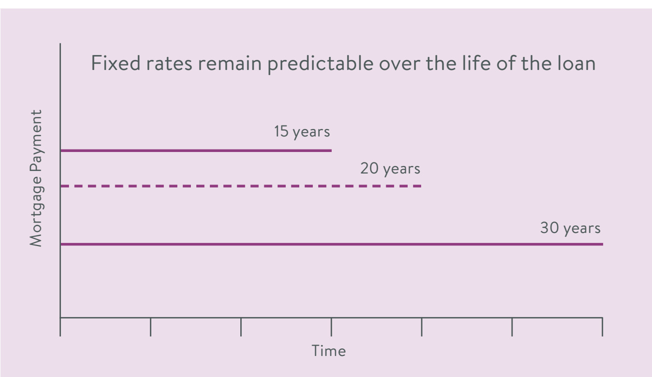
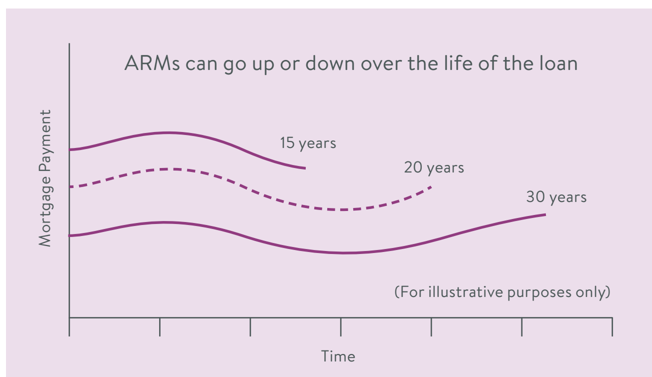
Homeownership is one of the most significant contributors to personal wealth. In fact, homeowners are worth 46 times more than renters.[2] However, mortgages come in many varieties and it's important to find the one that's right for you.

We'll explore some of the many strategies and mortgage products to help savvy buyers leverage their purchasing power into tangible, appreciable assets.

Mortgage rates and terms

The two most important considerations of any mortgage are the rate and the terms.





A fixed-rate mortgage features the same fixed rate over the life of the loan, which is usually 15, 20 or 30 years. The predictability of your monthly payment can be very attractive, especially in times of rising interest rates.

Adjustable-rate mortgages (ARMs) have variable interest rates which can go up or down depending on market conditions. Some ARMs feature fixed rates for the first few years (with possibly interest-only payments during that period), and then reset to variable rates for the rest of the loan period. If interest rates increase over time, your payment will go up, so make sure you understand the loan's caps, which limit the interest rate to which the loan can reset. These caps can impact the first rate adjustment (when the loan concludes its initial fixed-rate period), subsequent, periodic adjustments and the maximum lifetime rate.

When considering the mortgage term, also think about cash flow and interest. The longer the term extends, the lower the payment will be. However, you will also likely be dealing with a higher initial interest rate and face paying more interest over the life of the loan. If initially concerned about cash flow, there's always the option to pre-pay the debt through extra principal payments, which will likely come without penalty.

Types of mortgages

Conventional mortgage

Home loans that are not insured or guaranteed by the federal government are known as conventional mortgages. Of these, there are two types of conventional loans; **conforming** and **non-conforming**.

A **conforming loan** is defined by the loan amount falling within specified maximum limits[3], and compliance with other requirements. Those include credit score, loan-to-value and debt-to-income ratio thresholds. The criteria are set by the government agencies that back (i.e., purchase) the majority of American mortgages, Fannie Mae or Freddie Mac. Loans that fall outside of these criteria, such as jumbo loans or loans for those who do not meet credit score thresholds, are considered **non-conforming loans.**

Conventional mortgages can be used to finance a primary, secondary or investment property, and can be secured for as little as five percent[4] down while still falling within the guidelines established by Fannie Mae or Freddie Mac. Borrowing costs are usually lower than other mortgages, such as those backed by the government, although the interest rates may be slightly higher.

Private lenders usually require private mortgage insurance (PMI) on conventional loans if your down payment is less than 20 percent of the total loan. (This is a must for conforming loans.) This insurance provides protection for the lender, not the borrower, in the event that you stop making payments on your loan. Usually the monthly premium is added to your mortgage payment and is generally removed once your loan-to-value goes below the 80 percent threshold.

With a strong employment and income record, good credit and a down payment of five percent or more, conventional loans are a good choice.

Jumbo mortgage

These (typically) conventional loans have non-conforming loan limits, meaning the home prices exceed federal loan limits. Jumbo mortgages allow you to borrow more money for homes in highly competitive local real estate markets. The interest rates can be competitive, although possibly somewhat higher than conforming conventional loans. You'll tend to need a 10 to 20 percent down payment, but with additional underwriting flexibility not available with conforming loans. For example, greater savings may allow for a higher debt-to-income ratio. And, of course, higher FICO scores will still help you attain better rates.

These loans benefit high-earning buyers looking for homes in high-cost areas.

Construction loan/mortgage

This is a two-phase loan product that is used to finance the construction of the home. Once complete, it becomes a conventional mortgage. During the construction phase, money is advanced incrementally, reflecting the construction costs, and typically only the interest is due during this phase. Once construction is complete, the loan can be structured to become a conventional mortgage. Another option would be to have the construction loan and final loan be separate products. Having the two packaged together helps avoid two sets of closing fees, but possibly creates the need to come up with additional cash or financing should you go over budget.

Construction loans can be obtained through banks and credit unions which can, in turn, be offered through government-insured mortgage programs.

If you are building new and need cash for the project, a construction loan is a likely candidate. Note that building in subdivisions developed by a contractor may not require such a loan, although some degree of down payment may be required in those instances.

Refinancing[5]

A refinance essentially replaces your existing mortgage and creates a new loan. This can be done for various reasons, such as to lower your interest rate and/or reduce your repayment term. With a "cash-out" refinance you end up obtaining a loan for more than what you owed on your original debt. The additional cash goes to you for use in home improvements, debt consolidation or other needs. Or course, you need to have equity in your home before considering this type of refinancing.

If you are thinking about the cash-out route, also consider the option to acquire a secondary debt, such as a home equity loan or line of credit. There are various considerations when comparing these options, such as your overall interest rate, closing costs, impact on cash flow, whether all the extra funds are needed right away and whether the refinance (as compared to adding a second debt) might trigger PMI.

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[1]Mortgage Debt Outstanding (Table 1.54), September 2019, The Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/data/mortoutstand/current.htm

[2]Real Estate: 8 Things To Know Before You Buy or Sell in 2019., March 10, 2019, Thrive Global

[3]For 2020, the maximum conforming loan limit for one-unit properties is $510,400, except in high-cost areas where the loan ceiling for one-unit properties is 150 percent of that limit, or $765,600.

[4]This could be as low as three percent for a first-time homebuyer meeting certain income requirements.

[5]With the coronavirus pandemic, some may look to refinancing as an emergency source of funds. Talk to your Ayco advisor about the pros and cons of this approach to liquidity.

Understanding mortgage terms

Shopping for a mortgage can be exciting for a prospective home buyer, but also confusing due to the variables across different loan products. Before you look for a mortgage, it's a good idea to familiarize yourself with the industry terms.

ARM

An adjustable-rate mortgage (ARM) features a low fixed-interest rate (relative to a comparable fixed-interest loan) for an initial period, which is generally up to 10 years. Thereafter, the rate will be adjusted on a regular basis. With their lower starting rates, ARMs can be attractive initially, but uncertain market forces can cause the rate to climb, resulting in higher future payments.

APR

Annual percentage rate (APR) is the rate of interest plus other charges to be paid to the lender. A fixed-rate loan features a set APR for the life of the loan, whereas an adjustable-rate mortgage can vary at set intervals.

Amortization

A calculation that determines what your payment needs to be in order to pay off the mortgage balance by the end of the term. The amortization schedule will delineate the principal and interest repaid on a month-to-month basis. Some mortgages allow for bi-weekly payment schedules which can help reduce the overall interest paid and repayment term.

Appraisal

A real estate appraisal is a professional opinion determining the value of a property after a thorough inspection and comparison of similar properties in the market. Real estate transactions typically involve appraisals by a certified or licensed professional, as most transactions involve a lender who will require it.

Closing costs

These are fees levied by the lender, attorneys and recording agencies, and other costs associated with the mortgage closing process. They're typically paid primarily by the buyer (e.g., loan origination fee, appraisal, title search, etc.) and can sometimes be folded into the mortgage.

Down payment

The amount of the purchase price that the buyer pays toward the home purchase to secure the mortgage. Lenders typically require specific percentages depending on the type and amount of the loan. Conventional mortgages normally require a 20 percent down payment.

Equity

The difference between the market value of the property and the remaining balance of the property's mortgage(s).

Escrow

An account which the lender holds for making real estate tax or insurance payments associated with the financed property. Specified amounts are typically contributed by the buyer at closing. Additional payments into the escrow are usually folded into the overall mortgage payment, with disbursements made to the appropriate parties as bills come due.

Fixed-rate mortgage

A mortgage with a single, fixed interest rate and term. These can range from 10 to 40 years and offer predictability in budgeting monthly expenses.

MORTGAGE TERMS

Homeowner's insurance
Insurance which covers a home and its contents in cases of damage or theft, and provides some level of coverage for other circumstances, such as personal liability. It is required by a lender, which would be listed as loss payee in case there is recovery related to a damaging event. This insurance must be active prior to the loan activation.

Interest-only
A provision available through certain mortgages that allows for the repayment of only interest for a pre-established period of time, such as three, five or seven years. At the conclusion of this period, the mortgage may call for a single "balloon" payment to extinguish the debt in full; or for mortgage payments to continue and become fully amortized, thereby repaying both interest and principle for the remainder of the agreed-upon term.

Loan-to-value
When it comes to home ownership, this ratio represents the loan balance(s) secured by a home in relation to the home's value. For example, a $1,000,000 home with an $800,000 mortgage has an 80 percent loan-to-value ratio. Most lenders will set a maximum loan-to-value ratio which ultimately limits the mortgage amount that could be obtained.

Origination fee
A fee paid by the borrowers to the lender which may include an application fee, underwriting fee and other associated costs.

Points
A point is one percentage point of the loan amount ($100,000 loan = $1,000 point). Lenders offer lower percentage interest loans in exchange for points paid up front. This can potentially benefit homeowners who plan to stay in the home for a long time.

PMI
Private mortgage insurance is required with smaller down payments, usually less than 20 percent. This insurance guarantees the lender from borrower default until the loan-to-value ratio reaches 80 percent. Most commonly, the borrower pays a monthly PMI fee until that 80 percent loan-to-value ratio is achieved.

Rate lock
A commitment from the lender or loan originator guaranteeing a specified interest rate for a set period of time, typically 30 to 60 days.

Title insurance
Because the property is used as collateral in the mortgage transaction, lenders require borrowers to obtain a title search and this insurance to protect themselves in case of third-party claims to the property.

The power of your home

Are you thinking about home improvements? How about funding a child's education? When it comes to finding the necessary resources, your home can be a great place to start.

With pandemic adversely affecting the economy, some may look to the equity in their homes for liquidity. Consult with your Ayco advisor to discuss this important decision.[1]

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Understand the differences between home equity loans and home equity lines of credit, and the tax implications of each.

What is home equity?

Home equity refers to the portion of your property that you own outright. If you have enough equity in your home, you can borrow against it with one or more loans, possibly in addition to any currently outstanding mortgage(s) on the property. Use of a second mortgage, a home equity loan or line of credit can provide access to money at reasonable interest rates, assuming an otherwise solid credit rating.

How to calculate how much equity you have:

Assume that you originally purchased your house for $400,000 and made a 20 percent down payment; thus, you needed to borrow $320,000 from a bank. In this example, your value of equity is the $80,000 you used as your down payment.

Equity = **Fair market value of the home** – **Outstanding mortgage balances**

Usually, the equity in your home increases over time as the value of your home appreciates and you pay down the balance of existing mortgages. On the other hand, a drop in home values can have a negative effect on home equity.

Why care about your home equity?

Depending on how much equity you have in your property, you may be able to access it in the form of a loan, which could help you achieve other goals. There are two primary home equity loan structures available; a home equity loan or a home equity line of credit (HELOC). Understanding the differences between these borrowing strategies and the corresponding considerations are important.

- A **home equity loan** works like a traditional mortgage and, in fact, it's often called a "second mortgage." The terms are established up front: how much you are borrowing, the length of time or term of the mortgage (typically a minimum of five years to a maximum of 20 years) and the interest rate, which is typically fixed.
- A **HELOC** works more like a credit card, giving you a maximum limit from which you can borrow as needed. You borrow during a "draw" period, which is commonly 5 to 10 years. Once you access the line of credit, you'll be subject to a minimum monthly payment calculated by the lender. That could be interest-only during the draw period, or fully amortized. The repayment period (typically between 10 and 20 years after the draw period) and the interest rate will depend on the product terms (with, of course, the borrower's creditworthiness impacting the rate). One downside to this borrowing strategy is that the interest rate will be variable, most likely tied to an index like the Prime Rate. The main benefit to this strategy is flexibility. You can borrow as little or as much as you want, whenever you want it. Initially, interest-only payments would be relatively low and interest will only be charged on what you borrow, not your full limit.

Which strategy is better?

Each strategy's features may favor different needs. A home equity loan would be advantageous if the loan proceeds were needed and predetermined up front. For example, if you plan to remodel your bathroom. You get a firm quote from a contractor and the work is to be completed within a short period of time. This loan works well here because the expense itself is somewhat fixed. You might also consider this strategy if you have existing debt you wish to consolidate.

On the other hand, if you wanted to remodel a bathroom, kitchen and you needed a new roof, a HELOC might be the better solution. The costs may still be relatively fixed, but they will occur over an extended period of time. The HELOC gives you flexibility to draw different amounts at different times as project payments are required.

Tax implications of borrowing

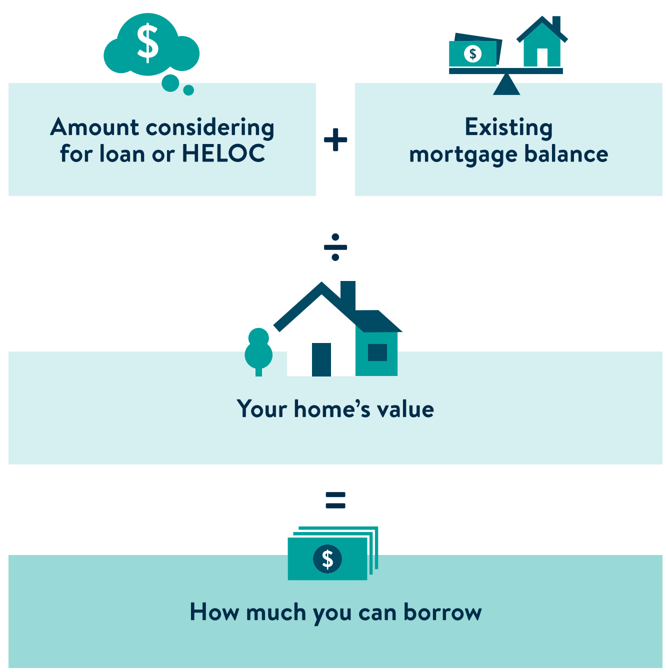
The Tax Cuts and Jobs Act (TCJA)[2] enacted in December 2017 brought significant changes to the interest deductibility of debt on a person's primary residence and on one secondary home. Some of these changes may affect you.

The most relevant change was the elimination of the deduction for interest paid on "home equity" indebtedness. A common misconception is that any debt from a home equity loan or HELOC is no longer deductible. Don't let the "product" name fool you. The term "home equity" is specifically defined by the IRS. Therefore, these borrowing strategies may actually still be deductible as long as the proceeds from the loans are used to buy, build or substantially improve your home (otherwise known as acquisition indebtedness). If you used the proceeds for any other purpose, such as debt consolidation, you would no longer get the deduction.

The second change impacting interest deductibility has to do with the total mortgage debt. The IRS does not limit you to a total amount of deductible interest since loan interest rates vary between lenders and over different time periods. Instead, the IRS has limited the amount of mortgage debt from which you can deduct interest. The TCJA lowered the maximum balance to $750,000 (from $1MM for debt incurred prior to or on 12/15/17), essentially for any debt incurred after 12/15/17. So, despite borrowing to "substantially improve" your home (like upgrading your kitchen), your total debt may exceed the new lower threshold and not get you the tax benefit you anticipated.

How much can I borrow?

Most lenders will limit the amount you can borrow based on your "Loan-to-Value." Loan-to-Value (LTV) is simply your current mortgage balance(s) divided by the current value of your home. Check with your lender first, but most limit you to an LTV of 70 to 90 percent (although 100 percent LTV loans are available). To figure out how much you can borrow, you would add the amount you are considering for a home equity loan or HELOC to any existing mortgage balance then divide by your home's value (a lender will typically require an appraisal). Your income, credit history and other existing debt obligations can also impact the amount made available to you.



HOME EQUITY

Home equity for college costs

With the rising costs of higher education, many students and parents are seeking creative funding solutions. Ideally, parents should start saving for college as soon as the prospective student is born. A 529 plan is a tax-advantaged savings plan sponsored by states, state agencies or educational institutions and is one of the preferred savings vehicles for future educational needs.

However, you may find that additional funding is needed beyond what you've saved. Student loans are popular options that offer some flexibility and potentially decent rates. However, parents looking to help cover these costs also might turn to home equity options because of the competitive rates usually associated with these products when compared against other various types of loans, such as personal loans or Parent PLUS loans. While home equity loans can offer a tax benefit when used for investing in or improving a home, there is no tax advantage if the proceeds are used for education.

High net worth families may find that bridge financing with **margin or equity-backed secure loans** presents another option for funding college costs

Are there any drawbacks?

In the event that you are unable to make payments on your loan or line of credit, your home may be at risk since it's used as collateral to secure these debts. In the example where perhaps a home equity loan may be used to consolidate high-interest credit card debt at a lower interest rate and hopefully lower debt payments, you would be transforming uncollateralized debt into collateralized debt—with your home at risk! You must also consider the possibility that your home may decrease in value as a result of market conditions or local factors, such as a natural disaster. In this instance, there may be a situation where you owe more on your house than it's actually worth. This is referred to as being "underwater."

Closing costs are another potential drawback. These costs are similar to the typical mortgage closing costs. HELOCs may have additional fees to look out for, like an annual fee or a minimum loan/initial draw requirement. However, some lenders will waive these fees altogether or at certain times, so be sure to discuss costs with them. These additional closing costs and fees should be considered when determining the opportunity cost of taking advantage of one of these avenues.

Nevertheless, borrowing equity may be a cost-effective financial planning tool that could help you accomplish several goals with potential tax benefits as well. Make sure to focus on the goal/need tied to the debt acquisition and borrow with a plan that doesn't strain your budget.

We suggest reviewing your situation with an Ayco advisor to clarify how these strategies may be beneficial for your personal financial and tax situation.

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[1]Home Equity is Skyrocketing; Here's Why People Aren't Tapping It, Aly J. Yale, September 27, 2018, Forbes, https://www.forbes.com/sites/alyyale/2018/09/27/home-equity-is-skyrocketing-heres-why-people-arent-tapping-it/#5eed803a1b9c

[2]For calendar-year taxpayers, these changes in the tax code became effective after December 31, 2017 and are expected to sunset after December 31, 2025.

Student loans:

A guide for students and parents

One of the most popular and affordable funding mechanisms for higher education, student loans have made the dream of a college degree a reality for millions of people. Without these loans, countless students would not be able to attain a college education. However, student loans come at a price.

According to Forbes, student debt is the second highest consumer debt category. Only mortgage debt beats it. With more than 44 million borrowers owing a collective $1.5 trillion in the U.S. alone, student debt ranks higher than both credit card and auto loan debt.[1]

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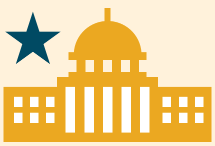
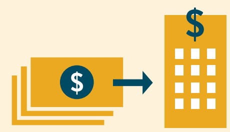
More than 44 million borrowers have student loan debt. This guide is designed to help both parents and students understand their financing options—no matter who is assuming responsibility for the loan(s).



Federal student loans
types of loans, advantages and applying with FAFSA

Private student loans
types of loans, advantages and comparing loan products



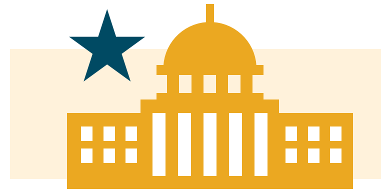
Repayment options
standard repayment plans, consolidation and alternative repayment options

Student loans: Where to begin?

Student loans are offered both from the federal government and from private lenders. Typically, Federal Direct Loans are more affordable, feature a fixed interest rate and are easy to qualify for. We recommend researching those before looking at a private lending option. Typically, private lenders require the borrower to qualify for approval with their credit rating and income. Since most students don't have an established credit rating or substantial income, private lenders will likely require a co-signer such as a parent, making both the borrower and the co-signer responsible for loan repayment. Private loans can feature fixed rates, or variable rates that may fluctuate over the life of the loan.

Items that impact financial aid availability

Financial aid is determined by using a comprehensive look at the students' and the parents' assets, earnings and investments. Students' savings accounts are taken into consideration, as are the parents' savings accounts, plus any college savings plans such as education savings accounts, known as Ed IRAs and 529 plans.



Federal student loans

Federal student loan options

Direct subsidized loans are loans made to eligible undergraduate students who demonstrate financial need to help cover the costs of higher education at a college or career school.

Direct unsubsidized loans are loans made to eligible undergraduate, graduate and professional students, but eligibility is not based on financial need.

Direct PLUS loans are loans made to graduate or professional students and parents of dependent undergraduate students to help pay for education expenses not covered by other financial aid. Eligibility is not based on financial need, but a credit check is required. Borrowers who have an adverse credit history must meet additional requirements to qualify.

Direct Consolidation Loans allow you to combine all of your eligible federal student loans into a loan with a single loan servicer.

Advantages of federal student loans

- A fixed interest rate which may be lower than private loans
- No credit check or co-signer on most federal student loans; PLUS loans are an exception
- Repayment doesn't begin until after you leave college or drop below half-time attendance
- If you demonstrate financial need, the government pays the interest on subsidized loans while in school and during certain periods after school
- Flexible repayment plans and options to postpone payments if you qualify for deferment or forbearance
- Jobs with a qualifying employer provide eligibility to have a portion of your loans forgiven if you meet certain conditions

Applying for federal student loans

1. The first step in applying for a federal student loan is to complete and submit a Free Application for Federal Student Aid (FAFSA®) form. The FAFSA® can be filled out and submitted beginning on October 1 for the following year's academic school year. File a FAFSA® for each academic year in school
2. Once your form is evaluated, your college or career school will send you a financial aid offer which may include federal student loans and possibly grants
3. You may accept some or all of the offered loans after you've completed entrance counseling and sign a promissory note which contains information on the interest that will be charged, repayment plans and deferment and cancellation provisions

Private student loans

While federal student loans afford borrowers certain protections, private student loans have different advantages. There are dozens of types of private student loans for different purposes. Private loan borrowers must complete and file a Private Education Loan Applicant Self-Certification Form before private loans can be received.

Private student loan options

- **State loans**
  Certain states have their own loan programs, which are more similar to private loans than federal offerings
- **Credit union loans**
  Community banks and credit unions offer private loans which may favor existing customers with better rates and terms than larger lenders
- **Commercial banks and other commercial lenders**
  Loans from commercial lenders offer an alternative to federal loans. These credit-based loans have variable interest rates and don't offer many of the benefits associated with federal student loans
- **Student loans without a cosigner**
  If you don't have access to a cosigner, several lenders offer loan products based on their assessment of your ability to repay
- **Specialty loans**
  These include loans for medical school, dental school, law school, Bar exams, international students and loans for those with bad credit

Advantages of private student loans

- Variable interest rates as well as fixed rates are offered; hybrid rates, which combine both fixed and variable rates, may be offered as well
- In some cases, borrowers may receive a lower interest rate than a federal loan or additional discounts for good grades or automatic payments, or other sign-up perks
- A strong credit history can help to lower your rate, but cosigners are almost always required
- Cosigners may be released from the promissory note after the borrower makes a number of on-time payments and meets other requirements

Comparing private student loans

With loan products offered by banks, credit unions and private loan companies, there are many choices in private student loans. But because these lenders set their own rates based on the borrower's credit history and other criteria, there can be a wide range of interest rates.

Sallie Mae is a corporation that began as a government entity, but is now offering a wide range of private student loans. Their website offers resources and information that are useful when considering a loan. U.S. News & World Report released a report in July, 2019 comparing loan products from several vendors that can help you as you make decisions.

Other loan options for families:

401(k) loans: If you've built up funds in your 401(k), you might consider borrowing against that. However, you can usually only borrow up to $50,000, and the payment terms are up to five years, and likely require a spousal "sign-off." Learn more about 401(k) loans.

Home equity loans: You can borrow against the amount of equity that you own in your home in the form of a lump sum or a line of credit that you use as needed, so you could stagger the payouts throughout the years in school.

Paying it back

Just as there are strategies for researching and applying for student loans, there are options and strategies for repayment of those loans.[1]

Refinancing private loans

Those with several outstanding private loans (and possibly federal loans, too) may find it more convenient and cost-effective to refinance their loans into a single loan—possibly at a lower rate. Beyond that, you may find the unpredictability of variable-rate loans unsettling and want to change into a fixed-rate loan.

Advantages

- Simplifies monthly bills
- May lower the total interest rate based on your current (improved) financial picture
- Locks in interest rate (if a fixed-rate loan)
- No application fee

Disadvantages

- May increase the payback period and total interest paid for some loans
- May not be able to pyramid payments
- Certain federal debt relief programs do not transfer to private refinance loans if federal loans are refinanced to a private loan provider

In some cases, private lenders may allow federal and private loans to be consolidated together resulting in a private loan. Private loans are available for consolidation based on a lender's discretion.

Consolidating federal loans

Consolidating your federal education loans can simplify your payments, but it also can result in the loss of some benefits. A Direct Consolidation Loan (from the U.S. Department of Education) allows you to consolidate multiple federal student loans into one loan.[2]

Advantages

- One monthly payment/one lender
- May qualify loans for alternative repayment options not previously available
- Fixed interest rate based on weighted average of those existing federal loans consolidated
- No application fee
- Can prepay anytime without penalty

Disadvantages

- Not able to pyramid payments
- May increase the total cost of repaying your loans (as you may have a longer period of time to repay, more interest will be incurred)
- May lose some borrower cancellation benefits offered with the original loans
- Does not result in a lower interest rate

Once your loans are combined into a Direct Consolidation Loan, they cannot be removed—the loans that were consolidated are paid off and no longer exist.

[1]The CARES Act was passed into law on March 27, 2020, and affects student loans in two ways. If your employer sponsors an educational assistance program, benefits provided by the employer to the employee can be reimbursed on a pre-tax basis subject to a $5,250 limit. Eligible expenses is expanded to include the payment of principal and interest on student debt before January 1, 2021. Additionally, principal and interest payments on federal student loans can be deferred through September 30, 2020 without penalty or accrued interest.

Standard repayment plan for federal loans
(default repayment plan)

Federal loans offer a straightforward repayment plan that allows for predictable payments, and the ability to prepay some or all of the outstanding balance without penalty.

- Fixed monthly payments
- 10-year maximum term
- Lower total interest payments than other repayment options
- Can prepay all or part at any time without penalty

You may be able to get a 0.25 percent rate discount as a repayment incentive for automatic payments electronically debited from your bank account.[3]

Federal Student Aid offers a downloadable PDF that outlines options for repaying federal student loans.

Alternatives to the standard repayment plan for federal loans

Alternative repayment is available for federal student loans in the Direct Loans program. Depending on your individual situation, alternative repayment plans may be available on a case-by-case basis. Not all repayment plans are available for all federal loans and for all borrowers; only your loan servicer can make an official determination of your eligibility for particular payment plans.

Income-based plans are designed to set monthly payments at an affordable amount based on income and family size.

- Up to 15 percent of discretionary income
- Up to 25-year maximum term
- Must submit annual documentation to set payment amount each year

Pay as you earn and REPAYE plans

- Generally 10 percent of discretionary income
- Up to 20-year maximum term (up to 25 years for graduate loans), then any remaining balance is forgiven[4]
- Must submit annual documentation of income and family size to set payment amount each year
- Revised Pay As You Earn (REPAYE) Plan introduced in December 2015 expands loans eligible for this income-driven repayment plan

Income-contingent and income-sensitive

Income-contingent repayment plan

- Payments determined each year based on a percentage of income and family size
- Up to 25-year maximum term

Income-sensitive repayment plan

- Payments determined each year based on a percentage of income
- Up to 15-year maximum term

Graduated repayment plans have lower starting payments

- May be appropriate if income low now but expect steady increases
- Generally 10-year maximum term; payments increase every two years

Extended repayment plans stretch the payback period over a longer timeframe

- May be appropriate if you need to make lower payments over a longer time
- Balance must be at least $30,000; up to 25-year maximum term
- Payments can be fixed or graduated

Other repayment considerations for federal loans

Deferment
Temporary suspension of loan payments for specific situations.

- At least half-time enrollment in college or career school
- Unemployment (up to three years)
- Economic hardship (up to three years)
- Active military service
- Other reasons

Forbearance
Temporary postponement or reduction of payment for a certain period of time due to financial hardship or illness, and you do not meet the eligibility requirements for deferment.

- Usually granted in intervals of 12 months at a time, up to three years

Your overall strategy

By employing some of the strategies listed here, you can minimize your student loan payments. Work with your loan servicers as your situation changes to view the federal loan repayment plan that reflects your ability to pay, and with any private loan providers to see if refinancing to an alternate loan type or term makes sense.

- Consider your overall long-term savings goals
- Create a spending plan and emergency fund
- Pay down high-interest debt
- Accelerate payments or make additional payments on student loan debt

Steps to tackle your student loan debt

1 Get the facts

- How many loans do you have?
- What types of loans are they?
- How much do you owe?
- What is the interest rate?
- When do you have to start repayment?

2 Weigh your options

- Do you qualify for alternative repayment plans?
- Does consolidating make sense?

3 Consider the big picture

- What other debt do you have?
- Do you have an emergency fund?
- Are you addressing other financial goals?
- Can you find extra money to accelerate payments?
- Does pyramiding your payments make sense?

4 Take action

- If you have Ayco as a benefit, sign on to the digital platform, where you can find student loan resources

[1]Student Loan Debt Statistics in 2018: A $1.5 Trillion Crisis, Zack Friedman, June, 2018, Forbes, https://www.forbes.com/sites/zackfriedman/2018/06/13/student-loan-debt-statistics-2018/#4334b58c7310

[2]Federal Student Aid, an office of the U.S. Department of Education, accessed 7.25.19, https://studentaid.ed.gov/sa/types/loans

[3]Federal Student Aid, an office of the U.S. Department of Education, accessed 8.9.19, https://studentaid.gov/manage-loans/make-payment

[4]Federal Student Aid, an office of the U.S. Department of Education, accessed 1.28.20, https://studentaid.gov/manage-loans/repayment/plans/income-driven

Navigating college finances: A discussion guide for parents and students

In the quest for higher education, it's important to be rational about the associated costs. Whether it's a degree or a certification, how you finance your education should be a major factor in where you attend school. A two- to four-year degree can result in loans that stretch far into the future, affecting your ability to buy a car or a home, or save for retirement. Honest discussions between students and parents can help prioritize these important decisions.

Regardless of your financial standing, we encourage students and parents to form a partnership and determine accountability for each party. Decide who will be responsible for education research, funding and repayment. It may be valuable for the student to lead the process in the early stages. Once a preliminary plan is formed, consider dividing the tasks among all the parties so that it's less daunting.

As a prospective student, here are some conversation starters to help guide your family's discussion

1 Junior/senior year of high school:

Start to formulate a plan

- What do you want to study?
- Which colleges, universities or career schools offer that course of study?
- What learning culture/environment feels like a good fit?
- Have you researched all the programs and their costs?
- Have you looked into state schools, community colleges and online institutes?

Open the discussion about finances

- Do you know the average salary for this profession?
- How will expenses be covered, and who will be responsible for them? How much can each party contribute?
- Have you submitted your Free Application for Federal Student Aid (FAFSA®)?
- Have you contacted the high school guidance office or a private college counselor to discuss financing?

2 Once accepted, fall to spring of senior year:

Get more specific

- Have you calculated the total price of each school: Tuition, room and board, travel and books?
- Have you spoken to the financial aid office?
- How much federal financial aid can you expect?
- Is their offer final or negotiable?
- Is their offer good for the full four years?
- What scholarships are available?

3 Once a school is chosen, spring of senior year:

Look into creative solutions

- Are there options for work/study, or an off-campus, part-time job?
- Would taking a few courses during the summer semester help save on the total cost?
- Are there summer jobs or internships in your prospective field that might provide valuable experience?

4 In college:

Find a way to pay

- Have you found an on-campus, part-time job or a work/study opportunity?
- Are you working over school breaks and summer vacation?
- Are you searching for internships?
- If graduating, have you reached out to companies/organizations for employment?

5 After graduation:

Know what you owe

- When do loan payments start?
- Would any particular repayment plans make sense?
- Have you considered consolidating loans?
- How are student loans being prioritized with other financial needs and goals?

Tapping into retirement savings

If you're in need of a loan, your 401(k) may be an option. But it's important to understand a bit about 401(k)s before making a decision. We'll examine the pros and cons of this convenient—but potentially risky—lending option.

Americans hold $5.3 trillion in 401(k) plans.[1] This represents a huge potential opportunity for those savers to leverage their retirement savings for personal liquidity.

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Taking a loan from your 401(k) may be a good solution if you're facing a short-term liquidity need, like replacing an appliance, paying tuition or making an unexpected repair.

The cost advantage, speed and convenience of these loans are appealing, as is the logic of a quick, scheduled payback.

Characteristics of a 401(k) loan:

Rules vary

Every plan has specific rules and federal rules that all plans must follow. Check with your employer to see if your plan allows loans

Loan limits

Borrowing limited to $50,000—you can only borrow up to the lesser of 50 percent of your balance or $50,000

Repayment terms

Maximum repayment term is five years (or as long as 15 to 30 years to purchase a home if the plan allows)

Fully-amortized

All loans are fully and immediately amortized—principal and interest repaid in set, predictable payments

Payroll implications

You typically pay through payroll deductions. If you leave your job, you may be required to repay in full

Spousal sign-off

May require spousal "sign-off" to acquire

Is a 401(k) loan right for you? Advantages and disadvantages to consider

Advantages

- Easy to obtain—no underwriting, as is typical with a conventional loan
- Pay yourself back—in repaying the loan, you pay yourself instead of another lender

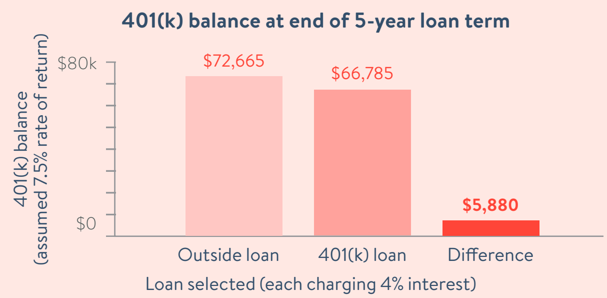
Disadvantages

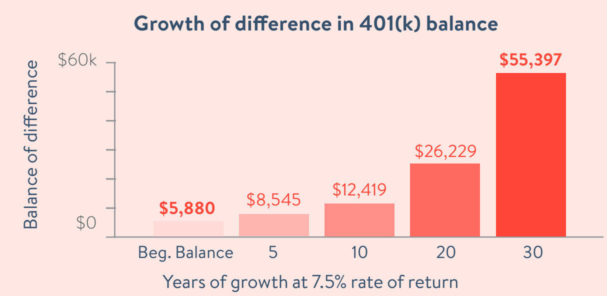
- "Opportunity cost"—when you borrow from your 401(k) account, you're usually removing an otherwise invested portion of the balance which could negatively impact your long-term savings goal if markets go up. However, taking the loan out before unpredictable market downturns hit could be temporarily beneficial.
- Job loss—your company's plan may require an immediate repayment of the loan balance at termination. If not repaid, the balance becomes a taxable distribution. Depending on your age and circumstances, this distribution might result in income tax and a 10 percent additional tax (Special note: It is possible to roll this amount into an IRA to avoid taxation.)

Comparing options

A 401(k) loan is likely not your only financing option. Loans outside of a 401(k) might provide greater variety—different repayment periods, interest-only periods, fixed vs. variable rates, etc. Above we referenced several aspects of 401(k) loans to consider, as they are rather rigid. But if all loans were the same structure—for example, a five-year fully amortized loan—how would you choose? You would be looking at two "costs": 1) The outside loan's (e.g., a personal loan) interest rate, and 2) The 401(k) investment rate of return (which is assumed lost to the extent a loan is taken from the account).

When the outside loan rate is below the assumed 401(k) rate of return, the lean is toward going with the "cheaper" outside loan. When outside finance rates rise above that assumed investment rate of return, the tide shifts to the 401(k) loan, which would then be less costly.





While the 5-year difference between an outside loan and a 401(k) loan is only $5,880, the second chart shows the opportunity cost of that $5,880 when left in the 401(k). Figures predicated on a 7.5% annual rate of return.

Finally, you'll need to review the impact of any loan-related fees on such a comparison, which are also important to consider.

The choice between a 401(k) and a conventional loan requires some research. Ultimately, you want to choose the financing option that's best for your circumstances.

Reviewing the options with a financial advisor can help you make a decision that's right for you.

[1]Ten Important Facts About 401(k) Plans, 2018, Investment Company Institute. www.ici.org/pdf/ten_facts_401k.pdf

Alternative loan sources

While we often discuss the use of debt where borrowing is sourced from more traditional means of lending—mortgages, home equity loans and lines of credit, student loans, etc.—there are other avenues that can be explored to obtain needed liquidity without the time, underwriting and/or expense of traditional lending mechanisms.

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If you have significant taxable investments and/or a permanent life insurance policy with significant cash value, these two areas can be explored as additional borrowing resources.

Security-backed lending

- **Margin loans** can be used for any purpose
- **"Non-purpose" loans** can be used for most purposes except to purchase additional securities
- **Competitive interest rates**
- **No underwriting or credit check**

Margin loans

The more familiar loan associated with collateralized securities (stocks, bonds, etc.) is a margin loan. Margin loan proceeds could be used for generally any purpose, with one of those being to purchase additional securities. "Non-purpose" loans, which are also backed by an investor's eligible[1] underlying accounts and securities, can be used for any reason except to purchase additional securities.

The available loan limit is a percentage of the collateralized securities' overall value. Within a portfolio, specific securities may be subject to limits based on attributes such as volatility. Those limits can range initially from 50 percent to over 90 percent. The limits can potentially increase with fluctuations in the value, and necessitate a "maintenance call," wherein cash payments or selling of securities may be required to bring the loan-to-value ratio back in line.

Competitive interest rates

Interest rates are commonly based on a financial index plus a spread (such as Prime + two percent). These are competitive when compared to other forms of financing, particularly personal loans and credit cards which lack the direct backing from assets. Fixed rates may be available.

Non-purpose loans

Non-purpose, security-backed loans are often structured as lines of credit with a demand loan feature (meaning the lender could demand repayment at any time). While the loan is outstanding, interest payments would be due, but outstanding principle can be repaid in part or in full at any time.

No underwriting or credit check

There is no underwriting process or credit check for these loans, since the collateral is the key factor to obtaining them; however, it must be determined that the loan is "suitable" for the borrower, with a financial advisor analyzing things such as the prospective borrower's financial circumstances and risk tolerance. And certain programs can require fairly high minimum collateral amounts (i.e., account values)—the SEC has indicated that this is commonly $100,000 or more.

Therefore, for someone with significant taxable assets who also meets suitability standards, obtainment of a security-backed loan can be a relatively quick and easy way to expand one's liquidity. Those funds could be used to pay a large expense, such as a tax bill or home renovation, or as bridge financing for the purchase of a home, to name a few potential goals. Use of the borrowed funds helps to avoid the need to liquidate other invested assets. As these loans are meant to be short-term in nature, repayment should be targeted from future cash flow or a liquidity event (e.g., annual bonus, stock option exercise or the vesting of some other performance award), or through more traditional financing options used to replace this debt.

The largest concern tied to this financing involves the potential for the collateral to decline in value. Should that happen, there is a chance that a maintenance call occurs, requiring action to be taken by the borrower. If the debt balance gets too high in relation to the value of the underlying assets supporting it (e.g., the debt exceeds 70 percent of the asset value), a "curing" of the situation must occur. This could be accomplished in a couple ways: 1) More assets would need to be added to the supporting account(s), 2) Some of the debt would need to be repaid, and/or 3) Securities would be sold to the extent an adequate loan-to-value ratio is achieved. Further, if action is not taken by the borrower, the broker will sell securities to the extent necessary to bring the account back into compliance with applicable limits. If assets were sold, an untimely taxable event could occur. Therefore, if obtaining such a loan, consider keeping it at thresholds well below the maintenance level to the extent possible to avoid a maintenance call.

Borrowing against life insurance cash value

- **May provide tax-free access** to cash
- **Competitive loan rates**
- **Quick liquidity** without credit reviews or underwriting
- **Reduces the death benefit**

Tax-free access to cash

Another option to consider, should you need to expand your liquidity in the short term, would be to borrow from a permanent life insurance policy. These policies come in various forms—whole, universal and variable life, each with distinct features, but generally with some degree of cash value. In many cases policies allow for tax-free access to the cash value via a loan.[2] With a newer insurance policy you may need time for the cash value to build up to the point where such a loan would become available or be large enough to help meet your needs. These loans therefore have the potential to provide a solid borrowing option should the policy be mature enough and contain significant enough value.

Competitive loan rates

Like the security-backed loans, these loans involve the use of collateral. In this case, it's the policy's cash value. Given that, loan interest rates may be competitive, particularly when compared to uncollateralized borrowing alternatives. The loan limits are stipulated by the policy provisions. For example, you may not be able to obtain a loan for more than 90 percent of the policy's cash value. While such loans technically do not need to be repaid, interest does accrue, resulting in continued growth of the loan balance if not paid. The interest rate charged may be fixed or variable; something elected by the policyholder at the time the policy was obtained.[3] Depending on the type of loan, the cash value growth on collateralized funds will generally be equal to the loan rate less a "spread." This cash value growth helps to offset the interest that is accrued on the loan balance, in an attempt to maintain a cash value greater than the loan to avoid a lapse.

Quick Liquidity

Life insurance policy loans provide quick liquidity without going through credit reviews or underwriting, and without incurring added immediate cost to access these funds. There are, however, some consequences to consider should you go down this path:

- As referenced above, policy loans that are not repaid continue to grow and may ultimately cause the policy to lapse, thereby terminating your coverage. This happens if the loan balance exceeds (or comes close to exceeding) the policy's cash value (which would include the investment sub-accounts of a variable policy). If such a lapse occurs, there can be a further income tax consequence. The difference between the cash value and your basis in the policy (i.e., generally the premiums paid, assuming no withdrawals), would become taxable; however, there would be little or no cash value to help pay the tax bill because that would be used to pay off the policy loan.
- Policy loans reduce your death benefit. This impact happens immediately when you take out the loan. Should you pass away after that point without having repaid the balance, your beneficiary(s) would receive a reduced benefit. That could possibly be offset by how you used the loan proceeds (such as to help purchase a vacation home); or maybe you feel you don't necessarily need that higher level of insurance coverage anymore, so the reduction is not a significant issue for you. In any case, this is important to understand.
- If you borrow from a universal life or variable life policy, the amount borrowed (depending on the type of loan taken) may be extracted from where it would typically be invested and placed in a fixed-rate account. A universal life policy provides varying interest credits, whereby a variable policy would normally provide growth related to a selected underlying pool of investments. By restricting the growth potential to interest applied to a loan-related, fixed account, additional premium payments may be required (currently or in the future—depending on your payment schedule) to ensure the policy would remain in place for the period you initially desired.

Due to the items noted above, it's important to monitor a policy's performance on a consistent basis after taking a loan.

As with the security-backed loan, the goal of taking a life insurance loan should normally be a short-term need or goal, with anticipated policy replenishment occurring within a few years, or even months, after the borrowing occurs. It certainly could be accessed for assistance in other planning areas, such as to help fund retirement; however, we would recommend, to the extent possible, planning your retirement savings through other means and approaching this liquidity access point with caution. As noted above, doing so can impact other important financial goals.

In any case, it is essential to review policy loan provisions both when purchasing a policy and at the time you decide to borrow from it, should you consider doing so. Reviewing pros and cons with an Ayco advisor can help guide you toward your ultimate borrowing solution.

[1]Not all accounts are eligible to be used as collateral, such as Individual Retirement Accounts. Further, certain securities, such as privately-held stock or stock with very low trading volume, may be ineligible.

[2]Due to IRS rules pertaining to modified endowment contracts (MECs) (for ease of discussion here, these are life policies considered to have excessively front-loaded cash values), loans from these policies could create an immediate taxable event, possibly including the 10 percent additional tax normally associated with qualified retirement plans and annuities.

[3]Variable life insurance policies may provide for loans which use the policy's investment sub-accounts directly as collateral. If such a loan is taken, there is risk similar to that noted for security-based lending whereby market volatility could reduce cash value to near or below the loan balance. At that point action would need to be taken to increase cash value or pay down or off the loan to keep the policy from lapsing and to avoid potential related income taxation.

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