The Cost of Borrowing

It is always a good idea to do your homework before you make a major purchase or enter into a financial transaction, and private student loans should be no exception. The more you understand about the cost of borrowing – before you borrow – the better.

The concept of a loan is pretty straightforward: first you borrow money, and then you repay it. But the amount that you must repay is more than the amount you borrow. This is due to interest and fees, which is what a lender charges you for the use of its money. It is also referred to as a finance charge. A finance charge is the dollar amount that the loan will cost you.

Lenders generally charge what is known as simple interest. The formula to calculate simple interest is: principal x rate x time = interest (with time being the number of days borrowed divided by the number of days in a year).

Consider the following:

- If you borrow a $2,500.00 loan with an interest rate of 5.00% for a period of one year, the interest you owe will be $125.00 ($2,500.00 x .05 x 1). This means you would repay a total of $2,625.00 ($2,500.00 + $125.00).
- The table below illustrates how a loan payment is applied first to the accrued interest owed, then toward your current principal balance, assuming a 24-month payment plan.

Payment	Amount Applied to Interest	Amount Applied to Principal Balance	Principal Balance
			$2,500.00
$109.68	$10.42	$99.26	$2,400.74
$109.68	$10.00	$99.68	$2,301.06
$109.68	$9.59	$100.09	$2,200.97

APR (Annual Percentage Rate)

Federal law requires that lenders provide a Truth in Lending Act disclosure to consumers. This act requires the lender to disclose an annual percentage rate, or APR. The APR tells you the true cost of your loan. While the APR may not always include all costs, it does include the rate of interest being charged and all fees collected at the time the loan is made, so it is a reasonable indicator of the cost of your loan.

> APR: The cost of your credit as a yearly rate.

Other Fees

Some lenders charge additional fees, besides interest, for the privilege of borrowing money. Generally, these additional fees are a percentage of the loan amount that is deducted from the amount you receive, and they are charged immediately upon your receipt of the loan proceeds. For example, if the lender assesses a fee of 5% and the loan amount is $2,500.00, the fee will be $125.00 and you will receive $2,375.00. You must, however, pay back $2,500.00 to the lender. These fees are usually considered part of the finance charge; or, more specifically, a prepaid finance charge.

Other charges to be aware of include late charges, loan processing fees, and deferment and forbearance fees. Not all lenders assess these fees. The key to understanding the fees associated with your private student loan is to read the credit agreement, also known as a promissory note or note. This is a contract between you and the lender that says the lender will loan you money and you will repay it. Read it carefully, and do not hesitate to discuss it with the lender and your school financial aid administrator.

Compounding Interest

Many private student loan lenders allow borrowers to delay loan repayment until they either graduate or withdraw from school. During that time, the interest continues to accrue and may be added to the principal balance of the loan. Adding interest to the principal balance is known as compounding interest. Depending on the lender, interest can be added to the loan on a monthly, quarterly, semiannual or annual basis.

Some lenders compound the interest near the time the borrower graduates from school, while other lenders do not ever add the accrued interest to the loan's principal balance.

It is always best to pay accrued interest before it is added to the balance of the loan. You will save money in the long run by doing so. If your lender compounds accrued interest annually over a period of four years on a $2,500.00 loan with an interest rate of 5.00%, you will end up having $538.78 added to the balance of the loan by the time you begin repayment.

The more frequently a lender adds the interest to the principal loan balance, the more interest a borrower will pay. Look for a lender that does not compound the interest, or a lender that does so infrequently, and close to the time that repayment of the loan is scheduled to begin.

A Note About Private Student Loans

Private student loans are meant to supplement – not replace – federal student loans. Work with the financial aid office at your school to look into all other sources of federal, state and/or school aid prior to borrowing a private student loan.