How Student Loans Work: Guide for First-Time Borrowers

Brianna McGurran
Updated on June 29, 2021

Note that the situation for student loans has changed due to the impact of the coronavirus outbreak and relief efforts from the government, student loan lenders and others. Check out our Student Loan Hero Coronavirus Information Center for additional news and details.

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You borrow money for your education and agree to repay it, almost always with interest — that's the crux of how student loans work.

While these loans may seem complicated, you can improve your understanding of them by learning about the types of loans available. Federal and private loans carry varying interest rates, fees and rules for repayment.

If you've ever asked "How do student loans work?", here's what you need to know.

How do student loans work: federal

The Department of Education provides federal student loans that are managed by loan servicers on the government's behalf.
Federal loans made up about 84% of the Class of 2019's student debt, according to The Institute for College Access and Success. In general, it's best to take out federal loans before considering private loans. Why?

- They don't require a credit check for undergraduates
- They may come with lower interest rates
- They offer multiple protections for borrowers in repayment

How to get federal student loans

You must first submit the Free Application for Federal Student Aid (FAFSA). This form provides the government with information about your family's finances and helps determine the financial aid you qualify for.
Once you've completed the FAFSA, the Department of Education will calculate how much it thinks your family can pay, known as your Expected Family Contribution (EFC).
As an undergraduate, you'll be subject to federal loan borrowing limits. You can borrow $5,500 to $12,500 annually, depending on your school year and whether you're financially dependent on your parents.
Federal student loans must be paid back. But, depending on your circumstances, you may be eligible for federal grants or work-study, which typically don't need to be repaid.
Types of federal student loans

- **Direct unsubsidized loans:** These are available to undergraduate, graduate and professional students with no regard for your financial need. Annual limits for direct unsubsidized loans range from $5,500 for first-year undergraduates to $20,500 for graduate and professional students.
- **Direct subsidized loans:** These are for undergraduate students who show financial need. The government pays the interest on subsidized loans while

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you're in school at least half time, during your six-month grace period after leaving school and when your loan payments are postponed through deferment.
- **Direct PLUS loans:** These are for parents of undergraduates, as well as graduate and professional students. PLUS loans may help cover costs that aren't covered with other forms of federal financial aid, but they come with higher interest rates and fees than direct subsidized or unsubsidized loans. They also require a credit check.

There are also direct consolidation loans, which let you combine all your federal student loans into one.

How does student loan interest work: Federal rates, fees

Interest rates for loans disbursed on or after July 1, 2021, and before July 1, 2022, are:

- **Direct unsubsidized loans:** 3.73% for undergrads and 5.28% for graduate and professional students
- **Direct subsidized loans:** 3.73% for undergrads
- **Direct PLUS loans:** 6.28% for parents, graduates and professional students

Congress determines student loan interest rates and sets them each year according to a formula. Federal student loan interest rates are fixed for the life of the loan, meaning the interest rate you initially received won't change throughout your loan term.

Origination fees for loans disbursed on or after Oct. 1, 2020, and before Oct. 1, 2022, are:
- **Direct unsubsidized and subsidized loans:** 1.057%
- **Direct PLUS loans:**4.228%

These fees are calculated as a percentage of your total loan amount. They are subtracted from your balance when you receive your loan money.

For even more detail, check out our guide to how student loan interest works.

How federal student loan repayment works

The standard repayment plan for federal student loans breaks up your balance into 10 years' worth of payments. But only about 30% of borrowers paid off their federal or private loans within 10 years, according to a 2019 Student Loan Hero analysis.

Other federal repayment plan options include:

- **Graduated repayment plan:** Starts off with lower monthly payments that increase every 2 years; payments are still made for 10 years
- **Extended repayment plan:** Draws out your repayment timeline to up to 25 years, with the option of fixed or graduated monthly payments

Deferment and forbearance could allow you to take a break from loan payments for a certain period if you're experiencing financial difficulty. But since interest will continue to accrue — unless you have subsidized loans and you're in deferment — these programs can leave you with a heftier balance when they end.

If you're looking for a way to lower payments or take more time to pay off your loans, one of the four income-driven repayment (IDR) plans could be your best bet. Your options are:
- Income-Based Repayment (IBR)
- Income-Contingent Repayment (ICR)
- Pay As You Earn (PAYE)

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- Revised Pay As You Earn (REPAYE)

These plans typically reduce your monthly bill to a percentage of your income, offering forgiveness after 20 or 25 years of payments — though, you'll likely have to pay income tax on the forgiven balance.

It's important to note that your student loan servicer will generally provide an interest rate discount of 0.25 percentage points if you choose to use autopay each month for your loan payments.

How do student loans work: private

Banks, online lenders, credit unions, colleges and state agencies provide private student loans.

Private loans don't have the same borrower benefits as federal loans. They also require a credit check, and applicants with good or excellent credit will get access to the lowest interest rates. Undergraduates who lack long credit histories will generally need a cosigner to take out private student loans.

While you should prioritize borrowing federal loans, private loans can be useful because they don't have the same borrowing limits — and may offer lower interest rates, depending on your circumstances. Private loans can also fill funding gaps as a last resort to pay for college.

How to get private student loans

Private lenders may allow prospective borrowers to receive quotes that only require a soft credit inquiry. This means checking your potential annual percentage rate (APR) wouldn't affect your credit score (your credit report will reflect it only after you've submitted a full loan application).

Private loans require sufficient credit or a cosigner. There are private loans available without a cosigner, but the options are limited. Plus, you may have to meet certain requirements, such as being in your junior or senior year of college or studying at the graduate level.

Types of private student lenders

There's a variety of private student lenders, including:

- Major banks, such as PNC and Discover
- Online lenders, such as CommonBond and Earnest
- Credit unions, many of which offer student loans through the LendKey marketplace

The bank with which you have a checking account may not offer student loans. As such, you should widen your search, comparing loan interest rates and features across several different lender types.

Take a look, too, at the protections lenders offer:

- Is deferment or forbearance an option?

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- Is it possible to release your cosigner after a certain number of payments?

How does student loan interest work: Private APRs, fees

Private loan interest rates can vary. Here is a sampling of APRs available to undergraduates:

- **Citizens Bank:** 1.16% – 11.02% (Variable) 4.18% – 11.70% (Fixed)
- **College Ave Student Loans** : 1.04% – 11.98% (Variable) 3.24% – 12.99% (Fixed)
- **Navy Federal Credit Union**: 4.62% – 0.00% (Variable) 5.75% – 0.00% (Fixed)
- **Sallie Mae** : 1.13% – 11.23% (Variable) 4.25% – 12.59% (Fixed)

The average undergraduate borrower won't qualify for the lowest interest rates, so they're likely to pay a higher APR than if they borrowed federal loans.

But, as we noted above, private lenders typically offer variable and fixed APRs. Variable APRs often start out lower than fixed APRs, but they may increase in the future — and only the most creditworthy borrowers receive the lowest APRs.

Compare multiple offers from private lenders to get your best mix of interest rates and benefits possible. Try using an online comparison tool as a starting point to explore private student loans.

How private student loan repayment works

Repayment plans on private student loans typically range from five to 15 years.

These loans don't come with the same range of repayment programs, so you won't have the option to choose an income-driven plan. Plus, private lenders won't cover your interest payments during certain periods, as is possible with federal direct subsidized loans.

You could, however, generally receive an autopay discount, and lenders often provide access to at least some forbearance if you need to postpone payments. Lenders may offer 12, 18 or 24 months of forbearance over the course of your loan term, for instance.

If your credit and income qualifies you, or if you're able to use a cosigner, you could refinance your student loans later if a better interest rate is available to you through a different lender.

Before you borrow student loans

First, apply for scholarships, make use of work-study and grant aid, and check in with your employer about tuition reimbursement if you'll work while in school. Student loans should be one of the final options to consider when planning how to pay for college.

Carefully evaluate how much you can safely borrow in student loans. That means taking the time to calculate how much your monthly payment will be after you graduate, and understanding the options your lender offers for lowering or deferring bills if necessary.

Andrew Pentis and Miranda Marquit contributed to this report.