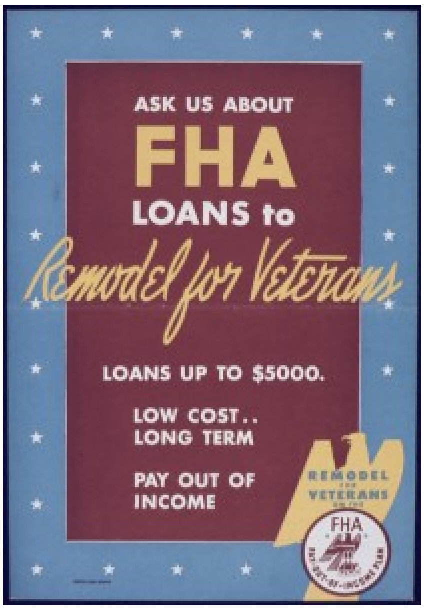
Debt Management In The Era of Ridiculous Student Loans



I had an insightful question from a two-doc couple recently that I thought would benefit the readership at large. This couple will be finishing their residencies in 1-2 years. They have $200K total in student loans and currently rent. They would like to buy a house shortly after finishing residency and are in the process of saving up a down payment. They're trying to decide whether to put 20% down on the house or take out a physician loan and put that money toward student loans.

My initial response was pretty standard financial advice- put down the 20% and get the cheaper mortgage, then work on the loans and retirement contributions after that. But the more I thought about it, the more I didn't think that was necessarily correct.

There's no doubt that a standard 20% down mortgage is a better deal than a physician loan. There is more competition among lenders and less risk to the lender so you get lower fees and points, and a lower rate. I saved up 20% for both of the houses I've owned as an attending, and I'm glad I did. But the scenario changes a bit when there is other high interest debt available to be paid off (which I didn't have, thanks to the military).

There's always the alternative to just rent and pay down high interest consumer or student loans, but some docs don't want to defer gratification any longer, and especially with mortgage to rent ratios looking pretty favorable in some parts of the country, I can understand why people would prefer to buy sooner rather than later. Plus, the sooner you start paying a mortgage, the sooner it's paid off.

So how do you weigh these factors? Here's how I'd look at it:

1) You can currently get a conventional 20% down 30 year fixed mortgage for 3.625% without points or significant fees. That goes down to 2.875% for a 15 year fixed mortgage. I'm told by lenders that a typical physician loan costs about 1% more, so say 4.625%, and there would also be a few thousand dollars in fees.

2) Mortgage interest may be deductible. Assuming a 38% marginal tax rate and fully deductible mortgage interest (reasonable assumptions for a two physician couple), that 30 year after-tax rate drops to 2.25% for a conventional and as low as 2.87% for the physician loan.

3) Student loan interest is pretty much non-deductible for a two physician couple. Federal graduate loans are at 6.8%. Private loans are now 7.9%. And forget about consolidating them at a lower rate.

4) Paying another 0.62% for your mortgage (plus a few thousand) in order to get rid of 7-8% loans seems pretty wise. Your mileage may vary depending on your individual circumstances, but I think most docs are probably going to be better off minimizing the down payments and paying down the student loans. Now that's totally different from my med school class, which refinanced their student loans at 1-2% back in 2003, but it's probably the reality for today's grads.

5) You can always refinance that mortgage later after the student loans are paid off, preferably into a 15 year fixed mortgage. But for a doc, mortgage debt is much preferably to student loan debt. Unlike mortgage debt, student loan interest isn't deductible at physician income levels, and the

debt isn’t discharged in bankruptcy (although it is in death). So swapping student loan debt for mortgage debt is probably a wise arbitrage given today’s interest rate environment.

Now, while mortgage debt is probably preferable to student loan debt, no debt is usually better than having debt, even at low interest rates. Even if you’re able to earn more investing than you’re paying in debt, there’s something wonderful about living debt free, especially since eliminating that fixed expense sucking up your cash flow gives you freedom to make lifestyle changes, like working part time or taking a lower paying job. But if you have to have debt, and you’re choosing between 7% non-deductible debt and 4% deductible debt, that’s a pretty easy decision.