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Financial Aid 101

What counts the most?

Your current income is the most important factor in determining need, but other factors play a role, such as your total assets, how many family members are in college at the same time, and how close you are to retirement age.

Many parents pay for college with a combination of savings and financial aid. By learning the basics, you'll be able to understand how the financial aid process works, properly fill out aid applications, and compare the aid awards your child receives.

What is financial aid?

Financial aid is money distributed primarily by the federal government and colleges in the form of student loans, grants, scholarships, and work-study jobs. Loans and work-study must be repaid (through monetary or work obligations), while grants and scholarships do not. A student can receive both federal and college aid.

Financial aid can be further broken down into two categories: need-based, which is dependent on your child's financial need, and merit-based, which is awarded according to your child's academic, athletic, musical, or artistic merit. Most financial aid is need-based.

How is financial need determined?

The federal government's aid application, the FAFSA, uses a formula known as the federal methodology. A detailed analysis of the formula is beyond the scope of this discussion, but generally speaking, parent and child income and assets are tallied and assessed at certain rates. There are certain deductions and allowances against income, and certain assets are excluded from consideration, specifically, home equity, retirement plans, annuities, and cash value life insurance. The result is a figure known as your expected family contribution, or EFC. This is the amount of money you must contribute to college costs to be eligible for aid. Your EFC remains constant, no matter which college your child applies to.

Your EFC is not the same as your child's financial need. To calculate financial need, subtract your EFC from the cost at a given college. Because tuition, fees, and room-and-board expenses are different at each college, your child's financial need will vary depending on the cost of a particular college.

Example: *You fill out the FAFSA and your EFC is calculated at $5,000. College A costs $20,000 per year and College B costs $40,000 per year. Your child's financial need at College A is $15,000 and $35,000 at College B.*

Colleges have their own way of determining financial aid. Basically, the process works the same way as with the federal government, except that the institutional methodology embodied in the standard college PROFILE application typically takes a more in-depth look at your income and assets to determine how "needy" your child really is. For example, colleges often consider your home equity and retirement accounts in assessing your ability to pay college costs.

Tip: *Just because your child has financial need doesn't necessarily mean that colleges will meet 100% of that need. In fact, it's not uncommon for colleges to meet only a portion of that need, a phenomenon known as getting "gapped." If this happens to you, you'll have to make up the shortfall, in addition to paying your EFC. College guidebooks compare how well colleges meet their students' financial need under the entry "average percentage of need met" or something similar.*

How do I apply and when?

The FAFSA can be completed manually and mailed to the regional processor listed on the form, but the better option is to complete and file it online at www.fafsa.ed.gov. The online version flags suspected mistakes immediately and takes only one week to process (compared to four to six weeks for paper FAFSAs).

The FAFSA relies on information from your previous year's tax return, so it can't be filed before January 1 in the year that your child will be attending college (the official federal deadline for filing the FAFSA is June 30, but many colleges have an earlier deadline). Parents should try to submit the FAFSA as close to January 1 as possible because some financial aid programs operate on a first-come, first-served basis.

Even if you haven't completed your federal income tax return, Uncle Sam lets you base your FAFSA answers on an estimated return, though you will have to provide a copy of your final income tax return later.

After your FAFSA is processed, your child will receive a Student Aid Report in the mail highlighting your EFC (the colleges that you list on the FAFSA will also get a copy of the report). Then, the financial aid administrator at each school will try to craft an aid package to meet your child's financial need.

Comparing aid awards

Sometime in early spring, your child will receive financial aid award letters that detail the specific amount and type of financial aid that each college is offering. When comparing awards, first check to see if each college is meeting all of your child's financial need. Then, look at the loan component of each award and compare actual out-of-pocket costs. Remember, grants and scholarships don't have to be repaid and so don't count toward out-of-pocket costs.

If you'd like to lobby a particular school for more aid, tread carefully. A polite letter to the financial aid administrator followed up by a telephone call is appropriate. Your chances for getting more aid are best if you can document a change in circumstances that affects your ability to pay, such as a recent job loss, unusually high medical bills, or some other unforeseen event. Also, your chances improve if your child has been offered more aid from a direct competitor college, because colleges generally don't like to lose a prospective student to a direct competitor. Remember, the fewer loans, the better.

The most common federal aid programs

Here are some names you'll be hearing as you navigate the world of financial aid:

- Stafford Loan--The most common federal student loan for college and graduate students. Interest may be subsidized (paid by the government during school, the grace period and deferment periods) or unsubsidized. The interest rate is fixed at 6.8% for new unsubsidized loans and is currently 4.5% for subsidized loans first disbursed on or after July 1, 2010 and before July 1, 2011 (the rate will drop to 3.4% for loans disbursed on or after July 1, 2011 and before July 1, 2012.
- Perkins Loan--A federal student loan for college and graduate students with the greatest financial need. The interest rate is fixed at 5%.
- PLUS Loan--A federal education loan for parents of college students (and independent graduate students) available through financial institutions. A separate application is required, though filing the FAFSA first is a prerequisite. Parents can borrow the full cost of their child's education, minus any financial aid received; the only criteria is a good credit history. The interest rate is fixed at 8.5% for new loans.
- Pell Grant--The Pell Grant is available to undergraduates with exceptional financial need.

A word about merit aid

In recent years, merit aid has been making a comeback as colleges (especially private colleges) use favorable merit aid packages to attract certain students to their campuses, regardless of their financial need. However, the availability of college-sponsored merit aid tends to fluctuate from year to year as colleges decide how much of their endowments to spend, as well as which specific academic and extracurricular programs they want to target.

Besides colleges, a wide variety of groups offer merit scholarships to students meeting certain criteria. There are several websites where your child can input his or her background, abilities, and interests and receive (free of charge) a matching list of potential scholarships.

How much should you rely on financial aid?

With all this talk of financial aid, it's easy to assume that it will do most of the heavy lifting when it comes time to paying the college bills. But the reality is you shouldn't rely too heavily on financial aid. Although aid can certainly help cover your child's college costs, student loans make up the largest percentage of the typical aid package, not grants and scholarships.

As a general rule of thumb, plan on student loans covering up to 50% of college expenses, grants and scholarships covering up to 15%, and work-study jobs covering a variable amount. But remember, parents and students who rely mainly on loans to finance college can end up with a considerable debt burden.