



## Insight

# A Debt-free Education Funding Option: Income Share Agreements

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As college tuition prices climb and the volume of student loan debt continues to rise, policymakers have sought a new financing mechanism to solve the problem. One idea generating considerable interest is Income Share Agreements (ISAs), which are proposed as a debt-free alternative to traditional student loans. In this paper, AAF explains ISAs and examines the benefits of and concerns surrounding ISAs.

## The Student Debt Crisis

Most American families have lost ground in college affordability. Over the last three decades, tuition at four-year colleges has more than doubled. In 41 states, tuition at four-year public colleges rose faster than family income between 1992 and 2001. [1]

Meanwhile, student debt is rapidly growing in America. About 43.3 million students borrowed money from the government between 2004 and 2014.[2] The total volume of federal student loan debt increased from \$260 billion in 2004 to \$1.2 trillion in 2014, and the average debt per college graduate increased from \$18,650 to \$33,000 during the same period.[3] The cohort default rate increased sharply from 5.1% to 14.7% between 2004 and 2013, and then slightly decreased from 2013 to 2015.[4] [5]

Though the Obama Administration has worked to expand income-based repayment (IBR) programs in an attempt to lower borrowers' monthly payments and ease the burden of debt, the policy option has come at great expense to the taxpayer. Reflected in President Obama's 2016 budget proposal is a \$21.8 billion shortfall largely attributed to the rapid growth of the Pay as You Earn initiative (an IBR program).[6]

## Policy Option: Income Share Agreements

### Exploring ISAs

ISAs are financial vehicles that allow a student to raise money from private sources today in return for a fractional share of the student's income in the future. Under ISAs, investors provide dollars that can be used to cover all or part of students' higher education costs. In return, the student agrees to pay back an affordable percentage of their income for a set period of time after graduation.

There are different ways of constructing ISAs but investors and fundraisers will typically negotiate the percentage of income and the length of the repayment period based on a wide array of personal and performance-based measures. Typically, students do not have to pay back any of their income unless they earn at least \$18,000, and terms usually tend to range from 5 percent to 10 percent of income for 10 to 15 years.[7] Ultimately, a student may pay more or less than the amount financed. ISAs transfer part of the financial risk

from taxpayers and students to the investors.

## ISA Sources

Potential ISA investors can be any type of entity, such as for-profit companies, nonprofit organizations, or individual investors. Several pilot programs have already launched ISAs, including Upstart and Lumni. For instance, Purdue University is seeking a partner firm to establish and manage ISA funds, and will launch ISAs in Spring 2016.

States could also become investors and launch state-funded ISA plans. For example, Oregon proposed a Pay It Forward Plan, which allows students to attend an in-state college for free. In return, students contribute a small, fixed-percentage of their income to a public higher education trust for a fixed number of years to fund the next generation of students.

## Current Legislative Proposals

There is growing interest in legislation to create a necessary legal framework to guide ISAs and encourage the development of ISA market. Last year, Rep. Tom Petri (R-WI) and Sen Marco Rubio (R-FL) introduced the Investing in Student Success Act of 2014 ([H.R. 4436](#) and [S.2230](#) respectively). On July 29th, 2015, Reps. Todd Young (R-IN) and Jared Polis (D-CO) proposed the Investing in Student Success Act of 2015 ([H.R. 3432](#)).

Both bills define what ISAs are and provide necessary regulations for investors and borrowers. For example, both bills specify what will be considered the individual's income, the percentage of future income the individual will be obligated to pay, and the minimum amounts of income that must be exempt each year. Both bills prevent the investor from obligating more than 15 percent of the individual's future income and making payments more than 360 months after graduation. The bills also allow early termination and specify the terms and conditions for early termination.

The bills explain required disclosures before an individual enters an agreement, which include the following: (1) ISAs are not debts and repayment can vary based on income, (2) obligations are not dischargeable in bankruptcy, and (3) the terms of the agreement. The bills also prohibit ISAs from being construed as giving the investors any rights over an individual's actions and exclude payments that are made under an ISA from the calculation of gross income for tax purposes.

## Benefits of ISAs

ISAs are considered to be less financially risky to student borrowers. Unlike traditional student loans, there is no principal balance or interest rate to repay with ISAs. Although students do not know the exact amount to repay, ISA guidelines may very well ensure more affordable payments compared to traditional student loans.

Students also benefit from the ISA market signaling that tells them which fields are most likely to provide high future earnings. For example, investors may offer a lower repayment rate or shorter repayment terms for students majoring in STEM programs than students majoring in non-STEM programs. Therefore, investors have a strong incentive to help students find worthwhile programs and students are able to identify fields and schools that provide the best economic value for their investments.

Investors can, of course, earn a return on their investment. The economic benefit for investors is derived from

the difference between how much money is paid out for the costs of higher education versus how much money is repaid by students after graduation. To make a profit, investors would likely spread their risk across a large group of students with different majors in different universities and collect their repayments to cover the education costs for which they pay out. In the long run, investors can use historical data to figure the potential education outcomes and then provide reasonable terms to cover the costs while building in a profit for themselves.

## Concerns Surrounding ISAs

One major concern is that investors might not invest or might be less willing to invest in students who pursue careers with low expected earnings. Ultimately, ISAs may not focus on students who major in less profitable fields, and force them to continue using federal student loans. Another concern is that ISAs may lead to adverse selection. Students who know they will go into high-paying jobs may stay away from ISAs because they may could potentially pay more in an ISA than under the standard federal repayment plan.

In response to those concerns, experts argue that if fewer students choose to study majors with low economic returns, in time the salaries of those majors would rise. ISAs vary with the predicted risk associated with lending. ISAs will offer expensive terms for programs that are not expected to generate outcomes aligned with the costs. The different terms that ISAs offer to students in different majors would reduce the potential for adverse selection.

## Conclusion

Interest in the use of ISAs as an education finance instrument is growing. Both investors and students need better information to make decisions. Without knowing the labor market outcomes of graduates from different institutions and majors of study, investors and students are unable to negotiate the percentage of income and the length of the repayment period. In order to better develop ISA market, policymakers should take steps to clarify the regulations, and allow investors to collect information from past students who have signed such agreements.

[1] The National Center for Public Policy and Higher Education (2002), *“Losing Ground: A National Status Report on the Affordability of American Higher Education”*. Retrieved from:

[http://www.highereducation.org/reports/losing\\_ground/ar2.shtml](http://www.highereducation.org/reports/losing_ground/ar2.shtml)