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POLICY BRIEF 2017-04

A Risk-Sharing Proposal for Student Loans

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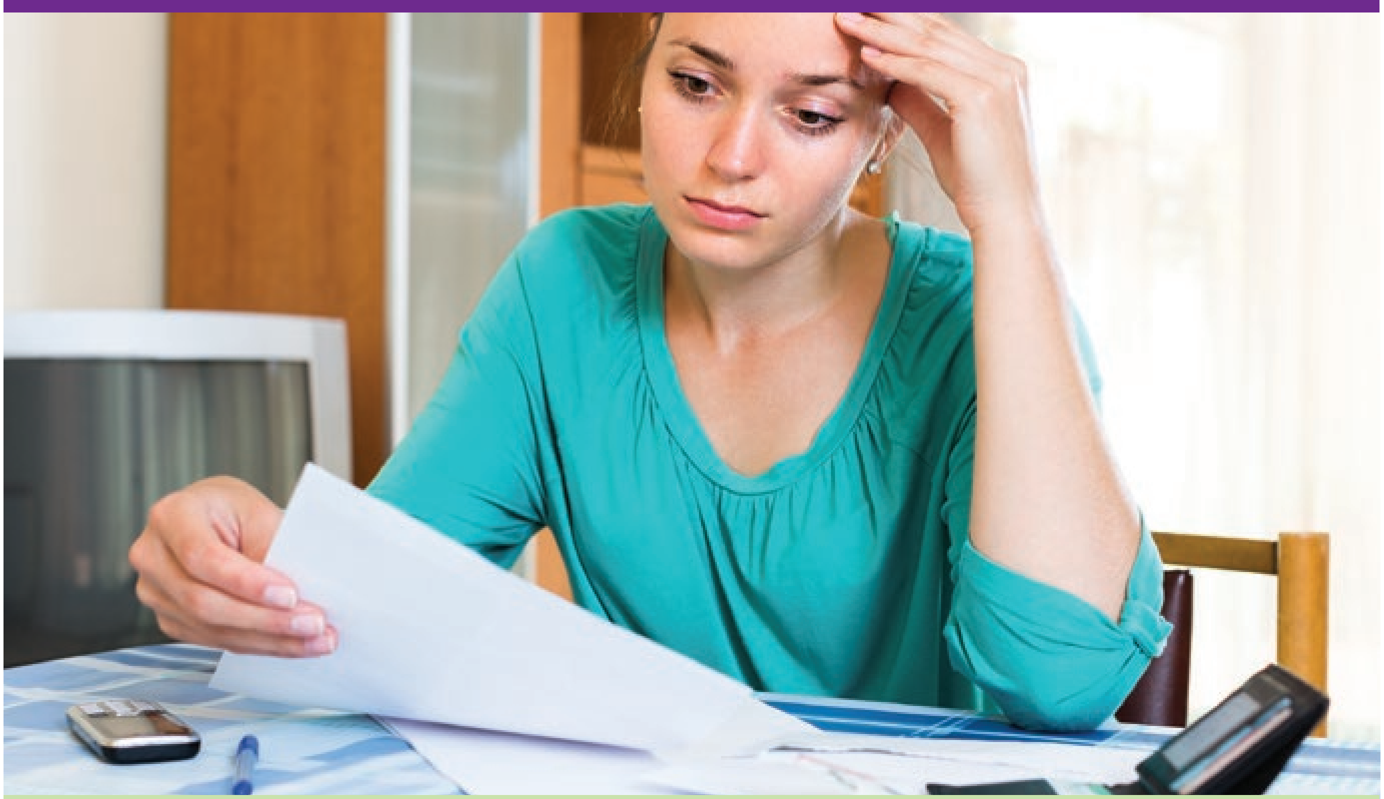

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A Risk-Sharing Proposal for Student Loans

A high-quality college degree remains one of the best economic investments a person can make. However, many students struggle with the cost of higher education, experience poor labor market outcomes, and have difficulty repaying their loans. For example, 13.4 percent of borrowers entering repayment in 2009 had defaulted by 2011. Fully a third of postsecondary institutions have repayment rates below 15 percent, corresponding to a repayment term longer than 20 years. Moreover, such poor outcomes are concentrated among students who are less likely to complete a degree and—even if they do—are less likely to have earnings sufficient to repay their loans.

A new policy proposal by Tiffany Chou of the U.S. Department of the Treasury, Adam Looney of the Brookings Institution, and Tara Watson of Williams College calls for the creation of a new risk-sharing program for federal student loans to address the proliferation of unmanageable debt and incentivize institutions to improve employment and loan repayment outcomes of their graduates. They propose using a cohort repayment rate, defined as the aggregate share of federal student loans repaid by students five years after they leave school, as the measure of performance. Institutions with cohort repayment rates below 20 percent would be required to reimburse the federal government for a fraction of the shortfall.

According to the authors, this performance standard will ensure that institutions adequately share in the risks that students and taxpayers face from poor outcomes, providing them with a stronger incentive to maximize the long-term financial outcomes of their students. Finally, the authors call for using the revenue raised from the proposal to establish a system of mobility bonus payments, which reward institutions that improve outcomes for low-income students.

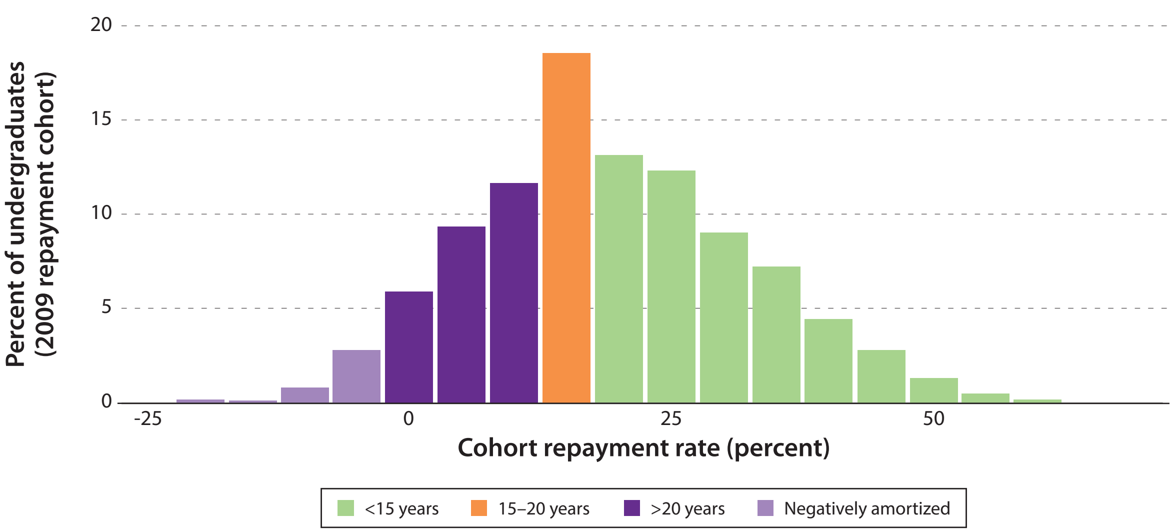
The Challenge

The Student Loan Problem

Currently there is $1.2 trillion of federal student debt outstanding, up from $0.5 trillion in 2007. In fiscal year 2009, approximately 3.8 million students entered repayment with an average initial loan balance of $15,100 per borrower. However, the authors note that loan repayment outcomes for students vary considerably depending on the postsecondary institution they attended, and a sizeable number of institutions exhibit consistently poor loan outcomes for federal student loans. At 255 educational institutions, students as a whole owe more five years after graduating than they initially borrowed.

FIGURE 1.

Distribution of Cohort Repayment Rate across Institutions



Source: Tiffany Chou, Adam Looney, and Tara Watson (2017), "Measuring Loan Outcomes at Postsecondary Institutions: Cohort Repayment Rates as an Indicator of Student Success and Institutional Accountability," National Bureau of Economic Research working paper 23118.

Note: Covers undergraduate loans that began repayment in 2009 and observed five years after. Calculations are weighted by the school's undergraduate borrower count.

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Figure 1 depicts the range of undergraduate repayment outcomes for postsecondary institutions. Many students are enrolled at institutions with repayment rates above 20 percent, indicating that the overall debt burden is manageable and that students are generally on track to repay their loans in less than 15 years. However, many institutions have lower repayment rates, implying worse borrower outcomes.

Many student borrowers would be unable to attend college in the absence of the federal loan program. However, with funds available for use at any participating institution, students make varied enrollment choices, some of which lead to poor outcomes. For students, an ill-informed debt-financed investment in education can have significant consequences. Student loans cannot be discharged in bankruptcy, and defaulting on federal student loans can result in serious consequences for borrowers, including damaged credit, wage garnishment, and offsets of tax refunds and Social Security payments. Even for borrowers who do not default, student debt that is not matched by sufficiently high earnings might cause other financial hardships or make it difficult to reach economic goals.

According to Chou, Looney, and Watson, the misalignment of schools' incentives with those of students and taxpayers contributes to poor loan repayment rates as well as to the growth of high-cost programs that leave students with unmanageable debt. Schools, which likely have better information than students about the monetary return to a particular program, must weigh their desire to wisely advise the student about enrollment and borrowing against their financial incentive to maximize overall enrollment. This dynamic can contribute to students making poor choices that lead to difficulty in repayment. The authors estimate that half of all institutions fail to meet the cohort repayment target of 20 percent after five years; among for-profit institutions, this share rises to 90 percent.

Low-income students face the most significant hardships. They disproportionately attend low-repayment institutions, rely more on loans to finance their educations, and are less able to rely on their families for help with loan repayment.

In addition to the costs borne by students, taxpayers face considerable risks from unmanageable student debt. Responsible stewardship of federal dollars requires that the taxpayer investment in higher education be targeted to institutions that do well by their students.

Shortcomings of Current Policy

The authors discuss two main approaches that student loan policy has taken to address the problem of poor loan repayment and high default. The first is to provide more flexibility for borrowers to repay their loans over a longer period of time, thereby minimizing defaults arising from temporary hardships. Loan deferment and forbearance are part of this strategy, as are income-driven repayment (IDR) programs, which allow monthly payments to fluctuate according to student earnings. Borrowers in these programs pay a fixed share of their discretionary earnings—and higher interest payments on the principal than conventional loans—and the remaining balance is forgiven after a certain number of years. After considerable recent growth, 24 percent of borrowers and 40 percent of outstanding federal Direct Loans are now enrolled in IDR.

The second approach used to address poor student loan outcomes is to rely on accountability systems that govern institutions and borrowers. After high default rates in the late 1980s, Congress enacted new rules limiting institutions' reliance on federal dollars. In their current form, these rules require that at least 10 percent of an institution's financing come from outside the federal aid system. In addition, institutions must not exceed certain default rate limits.

However, IDR, deferment, and forbearances have made it easier for institutions to avoid default rate limits. Many students are still incurring unmanageable debt at the same time that default rates are becoming less reliable as an indication of financial distress. The authors, therefore, argue that a new approach to student loan accountability is required.

A New Approach

To better align incentives between students and institutions, Chou, Looney, and Watson propose a new accountability metric: the institutional cohort repayment rate, defined as the fraction of a cohort's initial loan balance that is repaid within five years of leaving a given school. They propose setting a performance target using that metric, a formula for the reimbursement paid by schools that fail to meet that target, and a system of bonus payments for institutions that serve low-income students well.

Setting a Performance Target for Repayment

The authors propose a cohort repayment rate standard of 20 percent, consistent with a cohort repaying its loan after about 15 years. Institutions with repayment rates below this threshold would incur penalties. Undergraduate and graduate loans are to be considered separately, so institutions with each loan type must meet the target in each instance to avoid triggering reimbursement.

Schools that fail to meet the repayment target are required to reimburse a fraction of their students' loans, with the reimbursement determined by the distance from the target and the initial loan balance for the cohort. A marginal rate of 25 percent would be applied to the shortfall between repayment rates of 15 and 20 percent, with a higher marginal rate of 100 percent applied to repayment rates below 15 percent.

For example, a particular cohort at an institution might have $10 million in initial loan balances. If the cohort had repaid only 13 percent, the required reimbursement would be $325,000: (0.25 x 0.05 x $10 million) + (1 x 0.02 x $10 million).

This structure means that missing the target by just a few percentage points is only modestly penalized, but additional percentage points of shortfall are charged a higher rate, as with a progressive tax schedule.

Exemptions and Target Adjustment

To minimize the burden for institutions with limited participation in the federal student loan program, Chou, Looney, and Watson propose an exemption for institutions with few borrowers. They exempt institutions where fewer than one quarter of students borrow, and build in a linear dial-down of the reimbursement for schools with between one quarter and one half of students borrowing. They stress the importance of a dial-down, rather than a binary cutoff, to avoid sudden changes in the risk-sharing penalty associated with making one additional loan.

Notably, IDR participants would not be exempt. IDR is a safety net program for students but should not serve as a way for institutions to avoid accountability.

Finally, the authors argue that unforeseen circumstances, such as a recession, should trigger a temporary relaxation of the accountability system. They propose that the Secretary of Education have discretion to reduce the repayment target for cohorts affected by economic downturns.

Mobility Bonus Payments

The expected revenue from the proposed risk-sharing system could be used to support institutions that serve disadvantaged students well. Some institutions provide low-income students with a high-quality education, but still have low repayment rates due to preexisting disadvantages of their students.

Chou, Looney, and Watson therefore propose awarding institutions a fixed-dollar bonus payment for every low-income student in the undergraduate borrowing cohort that meets an earnings standard five years after entering repayment. Low-income students would consist of Pell Grant recipients and the earnings standard would be $25,000—roughly the median earnings of a high school graduate—five years after entering repayment. The per student mobility bonus would be calculated so as not to exceed $1 billion annually, which is the approximate expected revenue generated by the risk-sharing proposal.

Roadmap

- Congress will direct the U.S. Department of Education to implement a new performance standard for institutions receiving federal student loans, with risk-sharing assessments conducted beginning seven years after the rule is adopted.
- Institutions that have an aggregate cohort repayment rate of less than 20 percent for students who have been out of school for five years will be assessed a risk-sharing penalty.
- The risk-sharing penalty applied to initial loan balances will be assessed at a 25 percent rate for each percentage point of shortfall from the 20 percent standard, followed by a 100 percent marginal rate for each percentage point below 15 percent.
- Institutions where fewer than one quarter of students participate in the federal student loan program will be exempt from the standard, with a linear dial-down of risk-sharing penalties for institutions with one quarter to one half of students borrowing.
- Using revenue collected from risk-sharing penalties, a set of mobility bonus payments will be made to institutions that raise career outcomes for low-income students.

Learn More about This Proposal

This policy brief is based on The Hamilton Project policy proposal, "A Risk-Sharing Proposal for Student Loans," which was authored by

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Benefits and Costs

To understand how institutions would be affected, the authors perform an analysis using the 2009 cohort entering repayment for 4,722 institutions representing a total of 3.9 million borrowers. The effects of their proposal are summarized in table 1.

With no change in school behavior, expected annual revenues from this risk-sharing proposal are roughly $1.09 billion, with 2,171 schools required to pay some reimbursement. Among those schools, the average reimbursement rate would be below 3 percent for public institutions, around 5 percent for private nonprofit four-year institutions, and 7 to 9 percent for other institutions, including for-profits.

Conclusion

Institutional accountability in the federal student loan program has been weak and is increasingly obsolete in light of income-driven repayment policies. Problems of loan repayment are exacerbated by the concentration of low-income students at low-repayment institutions that leave students with unmanageable debt burdens. The current accountability system does little to ensure that federal loan dollars flow to institutions that serve disadvantaged students well, and that ensure they are in a good financial position after enrollment.

In a new Hamilton Project paper, Tiffany Chou, Adam Looney, and Tara Watson propose a risk-sharing program in which poorly performing institutions would be required to reimburse the federal government when student repayment is sufficiently low. The accountability system would be based on the institutional cohort repayment rate, or the share of initial loan balances paid back by members of a school cohort five years after they leave school. They propose using the revenue raised to support institutions that are serving low-income students effectively. The authors propose that the standard be progressive, so as to target the institutions with very low repayment rates while giving all institutions some incentive to improve and do better by the students they serve.

TABLE 1.

Incidence and Average Effective Rate, By Sector

Share of schools in each sector that are fined

	Public	Private nonprofit	For-profit
Less than 2 year	42.7%	53.6%	59.8%
2 year	23.2%	40.2%	76.2%
4 year	38.3%	33.8%	80.0%

Average effective rate among fined schools

	Public	Private nonprofit	For-profit
Less than 2 year	3.1%	7.3%	8.0%
2 year	2.4%	7.6%	8.8%
4 year	3.5%	4.9%	7.9%

Source: Authors' calculations based on proprietary data provided by Federal Student Aid.

Note: Unweighted. Restricted to the 2,171 schools that are charged a risk-sharing fee.

1. The findings and conclusions expressed are solely those of the authors and do not necessarily represent the views of the U.S. Treasury or any other institution.

Questions and Concerns

1. Will the proposal have the unintended consequence of reducing educational opportunities for disadvantaged students?

Schools might be tempted to discourage the enrollment of students who appear to be poor credit risks. To be sure, one goal of the proposal is to reduce the risk that students will attend programs that are unlikely to provide them with educational value. The authors contend that risk-sharing, coupled with mobility bonus payments, will encourage low-income students to attend schools that serve them well. There are many open enrollment and minimally selective schools that offer reasonable repayment and earnings outcomes for low-income students.

2. Do institutions that serve disadvantaged students have the resources to sufficiently improve their repayment outcomes?

Though policy makers might want to consider a temporary exemption for some schools before they are expected to come into compliance, the authors do not include such an exemption. The mobility bonus system will help offset the cost of risk-sharing for many of these institutions, while preserving incentives for all institutions to improve loan repayment outcomes.

3. Would the proposal encourage a shift from student loans to parent loans?

Chou, Looney, and Watson acknowledge the importance of minimizing the degree to which loan reimbursement causes substitution away from student loans toward parent loans, which have inferior loan terms from the perspective of the borrower. One option would be to require that families take advantage of all federal student loan options before becoming eligible for the Parent PLUS program.

4. Would students ultimately bear the cost of risk-sharing?

The authors acknowledge that some of the cost of loan reimbursement might be passed through to students in the form of tuition increases. They expect that market pressures will prevent a full pass-through, particularly in the for-profit sector, because the payments will apply to a small share of institutions competing in a common market. The mobility bonus system can be used to offset some of the resource constraints at under-resourced schools that serve low-income students well, helping these schools to avoid raising tuition.

Highlights

Tiffany Chou of the U.S. Department of the Treasury, Adam Looney of the Brookings Institution, and Tara Watson of Williams College propose a new risk-sharing program for federal student loans to address the proliferation of unmanageable debt and incentivize institutions to improve employment and repayment outcomes of their graduates.

The Proposal

Implement a new performance standard for student loan accountability. Underperforming institutions would be assessed a risk-sharing penalty that depends on their students' progress in repaying federal loans in their first five years after leaving school.

Reward institutions that effectively serve low-income students. Using the budget savings achieved by the risk-sharing system, institutions that improve career outcomes for low-income students would receive bonus payments.

Benefits

These reforms replace outdated institutional accountability systems in the federal student loan program based on default rates, which have eroded as new income-based repayment systems have reduced defaults but have not reduced the underlying sources of poor economic outcomes. In particular, these reforms respond to the proliferation of high-cost, low-return postsecondary programs that have left students with unmanageable debt and low earnings. These reforms provide clear incentives for institutions to improve their students' career outcomes and post-graduation financial circumstances, by encouraging students to seek programs they can finish and which lead to well-paying jobs, to borrow appropriately, and to improve the quality and value of their educational offerings.

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