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Subject: **UW Analysis: Income Share Agreements (ISAs)**

Income Share Agreements (ISAs) are designed to give students an alternative to typical loans and loan repayment plans. Under the terms of a privately funded ISA, an investor would offer to pay the upfront cost for some or all of a student's education in exchange for a fixed percentage of their income for a set number of years following graduation. To manage risk and maximize return on investment, the investor would most likely offer different rates and terms to different students based on factors such as field of study, family income, and institution. These rates could vary greatly, but most estimates put the range between 5 to 15 percent of income over a term of 10 to 30 years.

In 2014, Senator Marco Rubio introduced legislation that would remove some barriers to offering private ISAs but also place regulations on ISA providers, including an exemption on the first $10,000 of annual earnings, a maximum income take of 15 percent, and a maximum debt period of 30 years. Representatives Jared Polis and Todd Young introduced similar legislation this year. Though both bills have stalled in their respective chambers, they have drawn more national attention to rising student loan debt and to creative approaches to increase higher education access.

Over the past few months, ISAs have received significant attention from political candidates, higher education advocates, and news sources including the *Washington Post* , *U.S. News & World Report*, Bloomberg, Forbes, Brookings, and others. In addition, Purdue University recently announced plans to partner with Vemo Education, a financial services firm, to explore the use of privately funded ISAs to help students pay for college.

***Privately* funded ISAs differ from *publicly* funded ISAs, such as the one recently discussed in the state of Washington and many other states, known as Pay It Forward (PIF).** To learn more about PIF, please see our blog and brief. In a *publicly* funded ISA, initial funds come from a state rather than an outside investor. Oregon became the first state to enact legislation to study the feasibility of publicly funded ISA programs in 2013, and now 22 other states, including Washington and California, have considered similar studies.

Private ISAs are already in place in several countries in Latin America. Lumni, a self-described "human capital investment" company founded in Colombia in 2010, has paid for the education of over 7,000 students in Chile, Colombia, Mexico, and Peru. ISAs are viewed as an attractive option in Latin America in part because few student loan options are available.

How do privately funded ISAs compare to Federal Income Based Repayment?

Private ISAs: As previously noted, private ISAs establish a long-term financial relationship between students and private investors. Importantly, the amount repaid by the student would not equal the amount paid upfront by the investor to cover the student's education; rather, the student would owe a fixed percentage of their future earnings to the investor for a set number of years following graduation. Thus, before deciding whether to pursue an ISA, the student would need to evaluate the terms of the ISA in the context of their expected future earnings and weigh their expected ISA payment against expected payment amounts under other options, such as federal income-based repayment plans.

Federal Income-Based Repayment (IBR): Students who take out federal student loans have a number of options for paying their debt, including both the current form and the previous form of income based repayment. Under the current

IBR plan for new borrowers, a student pays 10 percent of their *discretionary*[1] income until either the loan is paid off or 20 years has passed – at which point the remaining balance is forgiven[2]. Most student loans that were disbursed before July 1, 2014 are subject to the old terms of IBR repayment, which include a 15 percent discretionary income cap over a term of 25 years. To qualify for either plan, the payment amount under the percent-of-income calculation must not exceed the cost of payments under the standard 10-year repayment plan (total loan cost including fees and interest divided into 120 payments). Current interest rates on undergraduate loans are 4.29 percent; however, since 2006, those rates have varied from 3.4 to 6.8 percent, depending on when the loan was disbursed. Students who do not qualify for IBR may qualify for another income-*driven* repayment plan, or may be required to use standard repayment.

IBR and ISA Comparison: Below, we compare the old and new federal IBR plans and three different ISA plans (under the regulatory framework of Sen. Rubio's plan, as described on page one) in terms of monthly and total payments owed. For both IBR scenarios, we assume the student took out a direct subsidized undergraduate loan at the current interest rate of 4.29 percent. Our analysis assumes a starting post-graduation Adjusted Gross Income (AGI) of $35,000 with average pay increases of 5 percent per year. For consistency, we have set the upfront cost paid by the ISA investor and the loan balance under IBR at $40,000 – roughly the cost of four years of tuition a public university in the United States.

Table 1. Comparison of Total Cost for Private ISAs, Federal Loans

		Private Income Share Agreements*			Federal Loan with IBR**	
		Scenario 1	**Scenario 2**	**Scenario 3**	**Before July 1, 2014**	**After July 1, 2014**
Variables	**Value/Loan Balance**	$40,000	$40,000	$40,000	$40,000	$40,000
	Income Owed	15%	10%	5%	15% of discretionary	10% of discretionary
	Years to Repayment	10 yrs	15 yrs	30 yrs	13 yrs, 9 mo***	18 yrs, 11 mo***
	Interest Rate	n/a	n/a	n/a	4.29%	4.29%
Payments	**Monthly - Average**	$425	$336	$281	$333	$278
	Monthly - Range	$313-$554	$208-$494	$104-$559	$217-$411	$145-$411
	Total (approximate)	$51,000	$60,500	$101,000	$55,000	$63,000

All scenarios: $35,000 Adjusted Gross Income with 5 percent annual increases
*Percent rates are applied to total income minus $10,000 forgiven (minimum under Sen. Rubio's plan)
**For the sake of comparison, current interest rates and a tax filing status of "Single" are used in both IBR scenarios.
***Approximate time to payoff with minimum payments

The overall cost of ISA Scenario 1 is relatively comparable to that of the old IBR plan, and the overall cost of ISA Scenario 2 is relatively comparable to that of the current IBR plan; however, **both ISAs are slightly lower in *total* cost and slightly higher in *monthly* cost compared to their IBR counterparts.** This is largely due to the slightly shorter repayment periods under these ISA scenarios. High-percentage, short-term ISAs (like Scenario 1) would require high initial payments that would rise rapidly over the short term, whereas low-percentage, long-term ISAs (like Scenario 3) would require low-initial payments that, contingent on income growth, could drastically increase toward the end of the payment term.

Since investors would be seeking to make a profit, ISA plans would likely end up being more expensive than federal IBR options, especially considering monthly payment amounts. Further, some affordability programs that are available to certain federal loan borrowers, such as Public Service Loan Forgiveness (PSLF), can make federal loans an even more viable option. In addition, federal loan borrowers have the option to pay off their loans before the maximum payment term, which can significantly lower the amount of interest paid and would not be an option with an ISA. However, a

[1] Discretionary income is defined as Adjusted Gross Income (AGI) minus 150 percent of the federal poverty level. For a single person in 2015, that would be their AGI minus $17,655.
[2] For graduates who qualify for Public Service Loan Forgiveness (PSLF), loan forgiveness could occur after 10 years.

benefit unique to ISAs is that a graduate with no income would simply pay nothing. In this respect, some students may prefer ISAs over federal loans, which cannot be discharged in bankruptcy and can be sent to collections.

To calculate repayment for federal student loans, visit the U.S. Department of Education's Federal Student Aid website. Download our ISA calculator to estimate the total cost of an ISA by income, percentage owed, and term.

Remaining Questions and Concerns Regarding ISAs

ISAs are a relatively new idea. Below are a few questions and concerns that would need to be reconciled before ISAs can be considered a viable option for funding postsecondary education:

- If lenders are allowed to base rates off of family income – a powerful indicator for future income – would ISAs discriminate against students from low-income backgrounds?
- If lenders would be more inclined to offer ISAs to students from middle- or high-income backgrounds or to those with high credit scores, federal loan programs could be left with borrowers with higher risk profiles which could in turn lead to higher default rates and jeopardize the solvency of federal loan programs.
- If ISA lenders are allowed to adjust their repayment terms (or not offer funds at all) based on a student's academic discipline, some students could end up making academic and career decisions based on ISA lenders' preferences, rather than on their own skills and interest.
- What if a student changes schools, majors, or doesn't graduate?
- What would be the effect on the price of tuition? Would some colleges raise prices knowing that businesses would be responsible for paying (possibly reducing access to the loans for those in low-future-income degrees)?
- Could the emergence of ISAs as a funding option hurt private and corporate donations to student scholarship programs? Would some donors switch from funding scholarships to investing in ISAs?
- Complicated interactions between federal loans and state and institutional financial aid programs have already been ironed out; it is unclear how ISAs would fit in and interact with those programs.

Alternatives to ISAs

While ISAs could be a promising tool in the effort to make college more accessible, thoughtful regulations will be needed before ISAs can be considered a viable option in the United States. One alternative to ISAs would be expansion of IBR programs, which could provide most of the benefits of ISA programs without having to create an additional scheme in an already complicated financial aid landscape. This was attempted, in part, by the Obama Administration's expansion of the Pay As You Earn (PAYE) income-driven repayment plan for new borrowers, which, similar to ISAs, mandated payments at 10 percent of income instead of a higher cap. Several types of federal loans are not eligible for income-driven repayment plans, which could potentially be expanded. While the new IBR plan caps payments at 10 percent of income for 20 years, other income-driven plans, such as Income-Contingent Repayment (ICR) have much higher caps and longer repayment periods. Lastly, the federal government could provide a simplified repayment environment, perhaps through payroll deduction, allowing students to pay a low rate initially but increase their rate to shorten payment terms. These alternatives could ease some of the burden for loan repayment, decrease default rates, and provide some clarity to make plan choice less complicated.

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