



POLICY PRIMER:

Federal Risk-sharing Proposals for Student Financial Aid

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INTRODUCTION

A cumulative national student loan debt surpassing \$1.4 trillion and alarming headlines over a potential student loan default crisis have led some policymakers, think tanks and scholars to call for colleges and universities to have “skin in the game” by sharing in nonrepayment costs of federal student loans originating from their institutions. Variants of this “risk-sharing” construct are intended to incentivize institutions to hold the line on excessive borrowing, to help students succeed in college and to offer programs of compelling financial value that enable borrowers to repay their loans in a timely manner.

While a subset of losses on federal student loans can be categorized as intentional policy choices to ensure broad access to higher education, nonrepayment due to defaults or long-term debt-to-income disparities are viewed as examples of unintended and undesirable outcomes for which institutions are increasingly believed to be responsible. According to this narrative, either due to corruption or out of benign self-interest and indifference about the effects on students and taxpayers, institutions can gain financial advantages by promoting or allowing inappropriate borrowing with impunity.

Institutional nonparticipation in federal and borrower losses in the student loan system is a key driver of risk-sharing proposals, along with recognition of the considerable shortcomings of the existing federal accountability regime for higher education. As it is configured today, student loan credit risk—the risk of nonrepayment—is not evenly distributed among borrowers, taxpayers and higher education institutions. Students taking out student loans have a responsibility to pay off the loans or risk the consequences associated with default. Taxpayers, meanwhile, absorb losses stemming from nonrepayment and loan forgiveness. Colleges and universities originating loans, however, do not face similar levels of risk. While there are some federal accountability measures for institutions participating in Title IV financial aid, they are widely viewed as an ineffective patchwork of policies that do not match the challenges posed by the nation’s growing student loan portfolio.

The concept of skin in the game, however, is fraught with complications. Risk-sharing is not a bilateral purchase transition; there are multiple actors and dynamics at play. Institutions admit and educate students; students must put in the work to succeed in college and the workforce; and external factors, such as the economy’s health and institutional funding, can influence the success of both institutions and students. If a student defaults on his or her loan, how much responsibility is attributable to the institution, the student and to external factors? The answer remains both complicated and subjective.

In this paper, we review risk-sharing’s appeal to a diverse array of policymakers, along with skepticism of this concept among some higher education associations. We then review events leading up to proposals for risk-sharing and similarities to the 2008 financial crisis. The paper also examines the current federal accountability framework for colleges and universities participating in federal

financial aid programs and the challenges to developing an equitable risk-sharing policy. It concludes with a summary of risk-sharing proposals currently on Capitol Hill.



RISK-SHARING: BROAD SUPPORT FROM POLICYMAKERS, BUT FAIR TO INSTITUTIONS?

Risk-sharing has attracted interest from both the political left and right, with speculation that a risk-sharing policy will be a prominent feature of the next reauthorization of the Higher Education Act (HEA) or be enacted in the near future as a rider (or perhaps as a budgetary offset) to another piece of legislation. President Trump’s FY2019 budget request called for implementing a federal risk-sharing program and expressed the administration’s interest in working with Congress to develop such a policy. Sen. Lamar Alexander (R-TN), chair of the Senate Committee on Health, Education, Labor and Pensions (HELP), distributed a whitepaper in 2015 on risk-sharing concepts and proposals,¹ and held a hearing on the topic.² Senate Democrats, meanwhile, have introduced their own risk-sharing measures—including a bipartisan bill—over the last several years. The Republican-led House Committee on Education and the Workforce has a variant of risk-sharing in its HEA reauthorization bill—called the Promoting Real

Opportunity, Success, and Prosperity through Education Reform (PROSPER) Act—which awaits action on the House floor. Beyond this, there have also been a number of risk-sharing proposals by policy analysts and academics.³

Despite support from a diverse group of policymakers, risk-sharing has vocal skeptics, including several major higher education associations.⁴ They contend that risk-sharing could encourage institutions to minimize risk by refusing to admit students who would be most likely to fail to repay their loans, which would disproportionately affect students from low-income backgrounds. Beyond undermining access, they argue risk-sharing could compromise the financial stability of some institutions, while also passing along additional costs to students and possible reductions in campus services. It could also incentivize some colleges and universities to leave Title IV financial aid and originate private-label loans with fewer borrower protections.⁵ There are numerous other concerns, such as the limited ability of institutions to restrict borrowing and student responsibility to find and keep a job. The challenge of creating a risk-sharing program, therefore, is to fairly identify adverse outcomes attributable to institutions in a way that leads to improvements in institutional practices rather than cuts to college access, affordability and quality.

PRELUDE TO RISK-SHARING PROPOSALS: THE SUBPRIME MORTGAGE CRISIS AND DODD-FRANK

In the aftermath of the 2008 financial crisis, escalating student loan debt and growing concerns over student loan defaults led some policy observers to worry about a “student debt bubble” akin to the subprime mortgage phenomenon that triggered the Great Recession. While the scale and specifics of the two credit markets are different, they share a few similarities that have resonated with policymakers. These include rapid volume growth, the rise of delinquencies and defaults, the systemic lack of meaningful financial consequences for originators, and allegations that key industry oversight bodies have failed to crack down on low-performing or fraudulent actors.

In the case of mortgage loans, the post-crisis consensus is that the advent of securitization enabled banks to make risky loans and immediately sell them off to investors by issuing securities that rating agencies represented as less risky than they proved to be. As the portfolios backing these securities began to generate losses, it was the investors who suffered losses, not the originating banks who had greater knowledge of their true value based on home prices and borrowers’ ability to pay.

The analogy often drawn to higher education portrays colleges and universities—which both select and educate the borrowers—as originating student loans, immediately paying themselves with the proceeds, and handing the loan paper and credit risk to the federal government. The credit risk arises from borrower default, payment reduction options such as income-based repayment, or other contingencies such as borrower death or disability.

Beyond institutions, this analogy also extends to accrediting bodies. Accreditors, whose seal of approval many view as the only substantive gatekeeping mechanism for Title IV aid, are alleged to have played a role analogous to the one played by rating agencies regarding securities. They have allegedly accredited corrupt and low-performing institutions and allowed them to participate in the federal program, like the ratings agencies that provided strong ratings to subpar mortgage-backed securities.

In the immediate aftermath of the financial crisis, the Wall Street Reform and Consumer Protection Act, better known as Dodd-Frank

after its lead authors, called for several agencies of the federal government to develop regulations to ensure sponsors of asset-backed securities retain a significant component of the credit risk. This was done to ensure the economic interests of parties issuing such securities would align with interests of other participants involved in the transaction. The notion of “skin in the game” quickly migrated to higher education, with policymakers and observers suggesting retention of some of the credit risk on student loans would similarly align institutional interests with the interests of students and taxpayers.



AN INADEQUATE FEDERAL ACCOUNTABILITY FRAMEWORK

Beyond its parallels with the financial crisis, risk-sharing must also be viewed in the context of the existing federal accountability framework. Several federal policies seek to hold Title IV-participating institutions accountable for outcomes. These include the 90/10 rule directed at for-profit institutions; gainful employment regulations applying to for-profit colleges and non-degree programs at private, nonprofit colleges and public universities; the cohort default rate thresholds; and the program integrity triad consisting of states, accrediting bodies and the federal government. These are not the only accountability mechanisms that institutions must meet—states have their own accountability frameworks—but are main federal accountability mechanisms governing colleges and universities.

However, these measures and their enforcement are often considered inadequate because they may only apply to select segments of higher education, or the threshold for punitive measures are so high that few institutions will ever be seriously threatened with sanctions. Some of the accountability measures, such as gainful employment, are targeted for elimination by the current administration and lawmakers on Capitol Hill. Others, such as the cohort default rate, can be manipulated by institutions so they do not breach the thresholds.⁶



CAUSALITY AND ACCESS: CHALLENGES TO DEVELOPING AN EQUITABLE RISK-SHARING POLICY

A prudent credit risk-sharing policy should attempt to impose liabilities only on that subset of adverse outcomes that can be attributed with high statistical probability to underlying causalities over which institutions exert significant control. While it would be difficult to blame institutions for individual cases of poor outcomes, patterns of poor outcomes—such as institutions that leave large shares of their students with debt that students are unable to repay—clearly implicate such institutions and suggest some measure of responsibility on their part.

In addition, balancing broad access to higher education with institutional accountability is challenging because these policy goals can conflict with each other. In the current policy environment, the government prioritizes access above other considerations. The simplest variations of risk retention—for example, a flat percentage co-pay requirement for any losses—would swing the pendulum to the other extreme, in which educational loans would be treated as a standard consumer credit transaction, an outcome that would have a predictably negative effect on college access. An effective risk-sharing regime would provide significant new incentives for institutions to make investments and reforms to help students succeed in college, and would avoid incentives that reward institutions that game the system by excluding at-risk populations. Beyond this, lawmakers must devise a policy that institutions and the public can understand, while also shielding it from manipulation.

FEDERAL RISK-SHARING LEGISLATION

There have been three major pieces of federal legislation pertaining to risk-sharing on federal student loans in recent years. Beyond these three pieces of legislation, the Trump administration has demonstrated interest in risk-sharing in its budget request, but has not advocated for a specific proposal. In addition to these proposals, there have been several other models for risk-sharing proposed by advocacy organizations and think tanks.⁷

Protect Student Borrowers Act:

The Protect Student Borrowers Act, first introduced in 2013, is authored by Sen. Jack Reed (D-RI) and cosponsored by Sens. Dick Durbin (D-IL), Elizabeth Warren (D-MA) and Chris Murphy (D-CT).⁸ The bill would determine risk-sharing payments on a sliding scale with four categories. For example, institutions with cohort default rates of 30 percent or higher pay 20 percent of the total amount of defaulted loans, while institutions with cohort default rates lower than 30 percent—but not lower than 25 percent—would pay 15 percent of the total amount, and the following tiers would pay 10 percent and 5 percent, respectively. These penalties would be reduced for institutions participating in a loan management program. The money generated from the penalties

would be applied toward delinquency and default prevention and boosting the maximum Pell Grant for institutions that serve large shares of Pell Grant students but do not have high levels of default rates. The legislation prohibits institutions from denying admission to students if they are perceived to be a higher risk of student loan default.

This bill would pertain only to institutions that have at least a third of their students participating in the federal student loan program, exempting institutions with low borrowing rates.⁹ While Sen. Alexander, who chairs the Senate HELP committee, welcomed this bill into the discussion on risk-sharing, he has stated that any risk-sharing program should apply to all institutions.¹⁰ The bill is currently in committee.

Student Protection and Success Act: This legislation, co-authored by Sens. Jeanne Shaheen (D-NH) and Orrin Hatch (R-UT) and first introduced in 2015, includes a risk-sharing provision.¹¹ It would create a program where institutions would be responsible for paying 5 percent of the cohort nonrepayment balance—loans that had not paid down at least \$1 of principal in three years. The legislation factors in the national unemployment rate and includes a list of exceptions for loans in deferment and mandatory forbearance. The bill is currently in committee.

PROSPER Act: Another risk-sharing provision can be found in the PROSPER Act, which is the HEA reauthorization bill authored by House Education and Workforce Chair Virginia Foxx (R-NC). The legislation would make changes to provisions related to institutional refunds if a student withdraws from college. The percentage of student aid earned would be based on a quarterly review of the payment period. For example, if the student withdrawal date is 0 to 24 percent of a payment period, the aid percentage earned would be zero; if the withdrawal date is between 25 to 49 percent of the payment period, the percentage of aid earned would be 25 percent. This continues up to 100 percent, when students finally earn all of the aid. The bill allows institutions to charge students up to 10 percent of the money owed.¹² The PROSPER Act has passed the Education and Workforce committee and currently awaits action on the House floor.

CONCLUSION

Risk-sharing is a concept in higher education financing that attracted interest from leading policymakers in the post-recession era, as many believe the current federal accountability measures on student loans do not apply to enough institutions, can be easily gamed, or have failed to make a meaningful difference in holding institutions accountable for poor outcomes. However, higher education associations have responded to risk-sharing proposals by arguing that implementing a risk-sharing framework could lead to cuts in college access, affordability and quality. Further, they argue that many of the factors that contribute to loan default are beyond the reach of institutions.

There is precedent for the risk-sharing concept in federal law stemming from the Dodd-Frank financial reforms. However, creating a policy that is politically viable, understandable to all parties and

difficult to manipulate that encourages institutional investments and reforms without sacrificing college access, affordability and quality remains difficult. There have been several risk-sharing models from think tanks and legislation proposed on Capitol Hill, but policymakers and others in the higher education community have not coalesced on risk-sharing policy structure.

Discussions on risk-sharing, however, will continue as the HEA reauthorization process moves forward. Risk-sharing could also be included in other pieces of legislation on Capitol Hill instead of the HEA. Due to its wide-ranging implications for college access and higher education financing, higher education

advocates should be aware of risk-sharing proposals, share their perspective with policymakers and contribute to the conversation throughout the policy process.



ENDNOTES

- ¹ U.S. Senate Committee on Health, Education, Labor and Pensions. *Risk-Sharing/Skin-in-the-Game Concepts and Proposals*. 2015. Accessed April 30, 2018. <https://www.help.senate.gov/chair/newsroom/press/alexander-seeks-input-from-higher-ed-community-on-accreditation-risk-sharing-and-consumer-information>.
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- ³ Miller, Ben and Beth Akers. *Designing Higher Education Risk-Sharing Proposals: Evaluating Choices and Tradeoffs*. Center for American Progress, 2017. Accessed April 30, 2018. <https://www.americanprogress.org/issues/education-postsecondary/reports/2017/05/22/432654/designing-higher-education-risk-sharing-proposals/>.
- ⁴ Broad, Molly Corbett. "Risk-Sharing and Skin-in-the-Game Proposals." Letter to Senator Lamar Alexander. April 28, 2015. American Council on Education, Washington, D.C. Accessed April 29, 2018. <http://www.acenet.edu/news-room/Documents/Comments-Alexander-Risk-Sharing.pdf>.
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- ⁶ Kreighbaum, Andrew. "GAO: Colleges, Consultants Game Rules to Lower Default Rates." *Inside Higher Ed*, April 27, 2018. Accessed April 29, 2018. <https://www.insidehighered.com/news/2018/04/27/gao-finds-colleges-manipulating-loan-default-rates-keep-access-federal-aid>.
- ⁷ Miller and Akers, 2017.
- ⁸ U.S. Congress. Senate. *Protect Student Borrowers Act of 2018*, S.2028. 115th Congress, 1st sess., 2017. Accessed May 15, 2018. <https://www.congress.gov/bill/115th-congress/senate-bill/2028/text>.
- ⁹ Ibid.
- ¹⁰ Stratford, Michael. "Risk Sharing, Yes. But How?" *Inside Higher Ed*, May 21, 2015. Accessed May 15, 2018. <https://www.insidehighered.com/news/2015/05/21/bipartisan-agreement-risk-sharing-concept-only>.
- ¹¹ U.S. Congress. Senate. *Student Protection and Success Act*, S. 2231. 115th Congress, 1st sess., 2017. Accessed May 15, 2018. <https://www.congress.gov/bill/115th-congress/senate-bill/2231/text>.
- ¹² U.S. Congress. House. *PROSPER Act*, H.R. 4508. 115th Congress, 1st sess., 2017. Accessed May 15, 2018. <https://www.congress.gov/bill/115th-congress/house-bill/4508/actions>.