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A Risk-Sharing Proposal for Student Loans

Tiffany Chou, Adam Looney, and Tara Watson
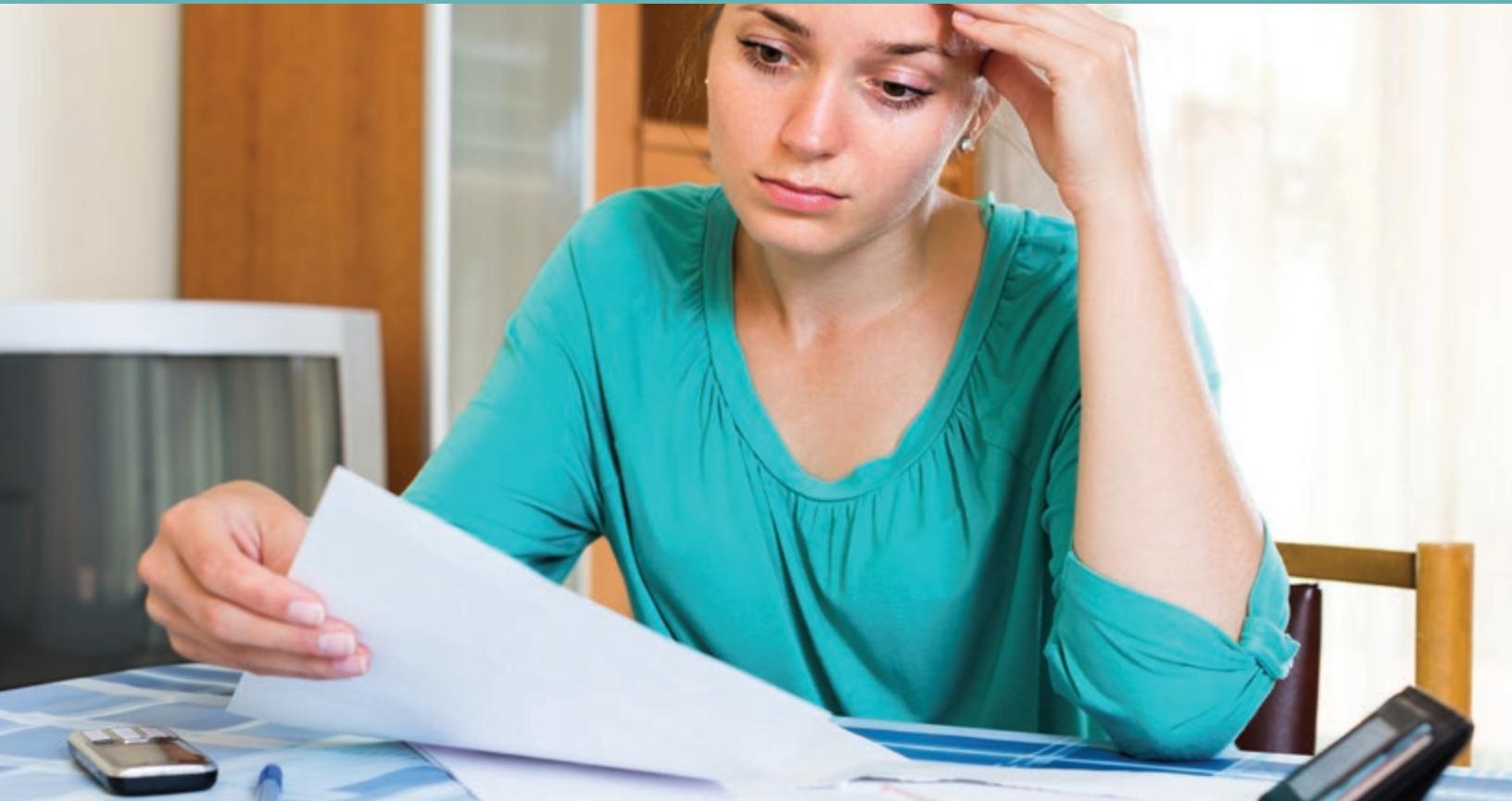
MISSION STATEMENT

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth.

We believe that today's increasingly competitive global economy demands public policy ideas commensurate with the challenges of the 21st Century. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by fostering economic growth and broad participation in that growth, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments.

Our strategy calls for combining public investment, a secure social safety net, and fiscal discipline. In that framework, the Project puts forward innovative proposals from leading economic thinkers — based on credible evidence and experience, not ideology or doctrine — to introduce new and effective policy options into the national debate.

The Project is named after Alexander Hamilton, the nation's first Treasury Secretary, who laid the foundation for the modern American economy. Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces. The guiding principles of the Project remain consistent with these views.

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Abstract

Many borrowers have difficulty repaying their federal student loans, particularly at certain institutions. This paper proposes an institutional accountability system that is intended to help align incentives of institutions with their student loan borrowers and taxpayers. Under the risk-sharing proposal, institutions with poor loan performance reimburse the federal loan program for a fraction of unrepaid loan dollars. In particular, the proposal uses a robust and hard-to-manipulate repayment rate—the amount each institution's students have repaid after five years—to set minimum thresholds below which institutions would have to contribute. Recovered funds could be used to provide support to institutions that serve low-income students well.

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Chapter 1. Introduction

Though there has been a significant increase in the cost of college attendance over the past decade, a high-quality college degree remains one of the best economic investments a young person can make. Workers with a bachelor's degree and no graduate degree typically earn 68 percent more than those with only a high school diploma, and have a lower unemployment rate as well (Bureau of Labor Statistics [BLS] 2015). Increased educational attainment confers broad social benefits including better health, lower crime rates, less dependence on public programs, and a more informed electorate, among others. Access to college is also a key way to promote economic opportunity. Children from the bottom fifth of the income distribution have a 41 percent chance of reaching the top two quintiles if they earn a college degree, but only a 14 percent chance if they do not (Haskins 2008).

Despite these significant benefits, many students struggle with the high cost of 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 as of 2011 (Federal Student Aid 2016).[1] Among the $628 billion in federal Direct Loans that were in repayment in the third quarter of 2015, nearly 17.6 percent were delinquent or defaulted. By comparison, during the peak of the housing downturn in the recent financial crisis, only about 10 percent of mortgage holders were in default on their loans.

Such poor outcomes are concentrated among students at low-repayment institutions, who are less likely to complete a degree and—even if they do—are less likely to have earnings sufficient to repay their loans. The evidence suggests that factors associated with institutional repayment matter for economic success: students from lower-income families who attend high-repayment schools do nearly as well as their higher-income peers, suggesting that the characteristics of the institution affect loan outcomes above and beyond what would be predicted based on the backgrounds of their students (Goodman, Hurwitz, and Smith 2015; Hoxby 2015). This is the case even at high-repayment nonselective institutions.

This paper outlines a proposal to address the challenge of poor repayment outcomes in the federal student loan program. Under the proposal, institutions whose students are systematically unable to repay their loans will reimburse the federal government for a share of their students' unpaid balances. Because institutions would share in the risks that students and taxpayers face from poor outcomes, the proposal gives institutions a stronger incentive to maximize the long-term financial outcomes of their students.

Specifically, the proposal compares an institution's five-year cohort repayment rate—the share of the institution's aggregate loan balances that students have repaid five years after they were required to start repayment—to a minimum threshold. To the extent that the balance repaid is too low, the institution would be required to reimburse the federal government for part of the shortfall. In our proposal, the minimum threshold is set at a five-year cohort repayment rate of 20 percent; about half of schools exceeded that threshold for loans that started repayment in 2009. Institutions would reimburse a portion of unpaid balances below the threshold, with the marginal rate per unpaid dollar reaching 100 percent at especially low repayment levels. For schools that would owe a risk-sharing payment under the proposal, the effective average rate is 3 to 9 percent of loan dollars. Funds generated by the risk-sharing program would be used to provide grant support to institutions with high value-added for low-income students, regardless of whether those institutions have high loan repayment rates.

Chapter 2. The Challenge

Some institutions exhibit consistently poor loan outcomes for federal student loans. At 255 educational institutions, students who had started repaying loans in 2009 owed just as much or more, on average, after five years of repayment than they initially borrowed. By contrast, under a standard 10-year plan, roughly 40 percent repayment would be expected after five years. At many institutions, poor loan repayment is a common and predictable outcome.

MISALIGNED INCENTIVES

These poor outcomes and the growth of low-repayment, high-cost programs is partially the result of incentive misalignment between schools on the one hand, and students and taxpayers on the other. In many cases, schools have better information than students do about the likely economic return to a particular program for a given student, and control the quality of advising, instruction, and job placement services, which help students obtain good jobs. Schools must weigh their desire to wisely advise the student about enrollment and borrowing against their financial incentive to encourage students to enroll even when their expected returns are low. This asymmetry of information and misaligned incentives can lead to students making poor choices, especially when institutions put greater weight on their own financial considerations than on student well-being.

The issues arising from asymmetric information and misaligned incentives are exacerbated by weak institutional accountability standards in the federal loan system. The federal student loan program plays a central role in financing higher education, especially for low- and middle-income families. There are currently $1.2 trillion of federal student debt outstanding, up from $0.5 trillion in 2007. In fiscal year 2009—the year for which we conduct our analysis below—approximately 3.8 million students entered repayment with $57.4 billion in aggregate initial loan balances, amounting to $15,100 per borrower. 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 are able to make both wise and unwise enrollment choices.

For students, an unwise 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 garnishment of tax refunds and Social Security payments. Even for borrowers who do not default, outstanding loan balances might cause other financial hardships or make it difficult to reach their economic goals.

Loan repayment problems are exacerbated by the fact that low-income students 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 when their institutions fail to deliver an adequate education. Disadvantaged students consequently face the most significant hardships as a result of borrowing to attend institutions with poor repayment rates. A significant number of institutions rely on the federal loan program to serve disadvantaged students, but many of these institutions consistently ask students to take on more debt than they are likely to be able to repay, harming both students and taxpayers. The current accountability system does little to ensure that federal loan dollars flow to institutions that serve disadvantaged students well and leave their students in sound financial position after graduating or leaving the institution.

LITTLE PROTECTION FOR TAXPAYER INVESTMENTS

The current accountability system provides little protection for taxpayer investment in higher education. Because a substantial fraction of loaned funds at low-repayment rate institutions will never return to federal coffers, the student loan program represents a sizeable taxpayer-funded transfer to these institutions. These subsidies are desirable in the case of low-repayment institutions that provide high value-added to low-income students, but undesirable when the institutions provide little or no educational value to their students. Responsible stewardship of federal dollars requires that subsidies be targeted to institutions that do well by their students.

About half of all institutions currently fail to meet our proposal's cohort repayment target of 20 percent after five years. There are low repayment institutions in the public, private nonprofit, and for-profit sectors. However, more than 90 percent of for-profits, both undergraduate and graduate, fail to meet the 20 percent repayment threshold. In other words, much of the implicit subsidy stemming from nonrepayment

of federal loans benefits for-profit institutions, a sector where policymakers have historically been concerned about low educational quality.[2] Since there are some institutions in all sectors with poor repayment, institutional accountability rules that apply only to particular sectors address only part of the problem.

CURRENT ACCOUNTABILITY MEASURES ARE INADEQUATE

Student loan policy has taken a two-pronged approach in addressing the problem of poor repayment and high default. The first approach is to provide more flexibility for borrowers to repay their loans over a longer period of time—with interest—to minimize defaults arising from temporary hardships, like unemployment. For example, borrowers might go into deferment or forbearance on their loans, both of which halt loan payments temporarily.

In addition, income-driven repayment (IDR) programs, which allow monthly payments to fluctuate according to student earnings, can help reduce student financial hardship and student loan default. Borrowers in these programs pay a fixed percent of discretionary earnings, capped at the 10-year standard payment, and the remaining loan balance is forgiven after a certain number of years.[3] The Obama administration took significant steps to raise availability, awareness, and enrollment in IDR programs, and 24 percent of borrowers and 40 percent of outstanding Direct Loans are now enrolled in IDR.[4] With the expansion of IDR programs, students are increasingly protected against the downside risk of a poor investment in education. Though total interest payments are higher under these longer repayment terms, IDR plans offer repayment flexibility that benefits students who face labor market shocks, helping them avoid the negative consequences of loan default.

Insuring students against temporarily or unexpectedly low earnings is desirable, but may yield unintended consequences if students and educational institutions can take advantage of the system. For example, students who anticipate receiving IDR loan forgiveness face roughly zero cost of borrowing the marginal dollar. This weakens their incentive to borrow prudently and diminishes their sensitivity to the level of tuition charged by institutions.[5] Much as health insurance can lead to excess consumption of health care and high prices, asymmetric information between students and schools combined with the zero marginal cost framework of IDR may lead to over-borrowing, higher tuition, and enrollment in low-return programs. Indeed, even schools motivated only by the best interests of their students might encourage them to participate in a postsecondary program of low but positive value, knowing that the loan will be forgiven.

The second approach used to address poor student loan outcomes is to strengthen the accountability systems that govern the institutions and borrowers participating in the federal loan program. For instance, after the high default rates of the late 1980s, Congress enacted new rules limiting institutions' reliance on federal dollars (the so-called 85/15 rule), imposed eligibility limitations on institutions with high student default rates, and required mandatory garnishment of the wages of defaulted student loan borrowers.

These accountability measures have eroded over time, both as the result of direct legislative changes and because of economic forces and incentives. For instance, the original 85/15 rule, which required that at least 15 percent of an institution's financing come from outside the federal aid system, was revised to 90/10. The recent Gainful Employment rules address poor earnings outcomes of students in certain types of programs, but these rules primarily apply to for-profit schools and impose all-or-nothing sanctions on schools that have extremely poor outcomes, affecting only a small portion of total postsecondary enrollment.

Similarly, the cohort default rate rules have become less effective over time. Specifically, an institution's cohort default rate is defined as the share of borrowers who default within three years of entering repayment. Institutions with a cohort default rate over 30 percent for three consecutive years (or over 40 percent in a single year) risk losing eligibility for Direct Loans and/or Pell Grants (U.S. Government Publishing Office 2014). Many institutions have therefore become adept at helping students enroll in deferment or forbearance during the three-year monitoring period, delaying but not necessarily reducing the incidence of poor outcomes.

In addition, "default" is not a particularly meaningful indicator of loan repayment in the presence of IDR, so cohort default rate rules will lose their usefulness as IDR expands. As more borrowers enroll in IDR plans, default rates will fall regardless of whether a school is offering economic opportunity to its students or whether those students will repay their loan obligations. Though IDR provides useful protection against default for students, a default-based accountability metric will no longer be an appropriate tool for ensuring institutional quality as IDR becomes the norm. Thus, there is a strong justification for an alternative accountability system using institution-based repayment metrics rather than cohort default rates.

In addition to loan accountability, there have been state and federal efforts to hold institutions accountable for educational quality. The results of these efforts have been mixed at best. For example, Washington state community colleges produce more certificates as the result of financial rewards for completion, but it is not clear that these certificates reflect genuine educational value (Hillman, Tandberg, and Fryar 2015). It is possible that, rather than yielding large outcome improvements at any given institution, the benefits of loan accountability policy will arise mainly by nudging students toward institutions that better serve them.

Chapter 3. Background

The proposal introduces a new accountability metric: the cohort repayment rate. Here we describe this repayment rate in some detail; further information can be found in Chou, Looney, and Watson (2017).

To assess the degree to which students from an institution succeed in repaying their loans, we consider a cohort of student loans—incurred at a given institution—that enter repayment in a given year. Our definition is analogous to the definition of cohort used in the existing cohort default rate rules. However, instead of focusing on the share of loans that default in a fixed time period, the cohort repayment rate measures the principal remaining after five years of repayment, relative to the amount of principal owed at the start of repayment. We separate undergraduate and graduate loans into distinct cohorts for reasons discussed below. The cohort repayment rate for a given school and year is calculated by identifying a cohort of loans—incurred by students at a particular school—that entered repayment in a given fiscal year. For each school, we take the total principal remaining for all loans after five years and divide by the total principal at the beginning of repayment. One minus that ratio is deemed the cohort repayment rate. Intuitively, this

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BOX 1.

Debt Repayment Schedules under 10-, 15-, and 20-year Plans

Figure 1 shows the amount of principal that would remain at the end of each repayment year, assuming a fixed 6.8 percent annual interest rate and a fixed loan term. For a standard 10-year repayment plan, at Year 5 $0.60 would still be owed for each dollar of principal originally borrowed. In other words, 40 percent of principal would be repaid by Year 5. If the term were instead 20 years, the Year 5 repayment rate would be around 15 percent. The amortization curves also allow us to proceed in the opposite direction, linking a repayment rate at Year 5 with a particular loan term. For example, a cohort repayment rate of 15 percent implies that the cohort is unlikely to completely repay before 20 years. The 20-year timeline is relevant because for many IDR borrowers any remaining balance is forgiven after 20 years and absorbed as a loss by taxpayers.[6] For concreteness, this proposal uses a repayment target of 20 percent, which is consistent with repayment over roughly 15 years.

FIGURE 1.

Typical Amortization Curve
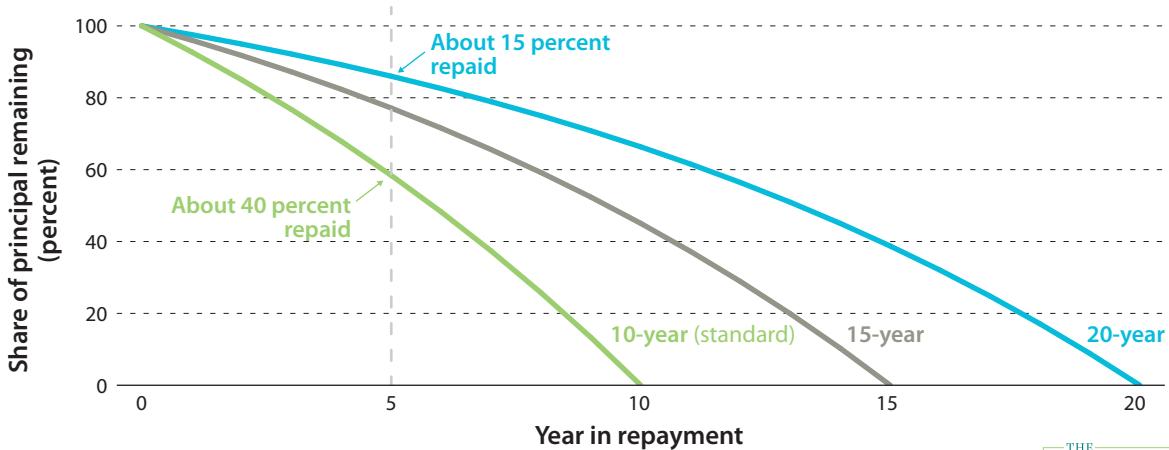
Source: Chou, Looney, and Watson 2017.

Note: Assumes a fixed annual rate of 6.8 percent and fixed monthly payments.

metric describes a school's share of student debt that is paid down five years after having entered repayment.

Note that repayment rates can be negative, indicating that the principal owed after five years of repayment exceeds the original sum. This can happen if payments are not large enough to cover interest, and that unpaid interest is added to the principal.

We define the cohort repayment rate in this way because it allows us to use standard loan amortization formulas to gauge whether the cohort is, as a whole, on track to repay on a given schedule (see box 1). The choice of measuring repayment at Year 5, as opposed to Year 3 as is currently stipulated in the cohort default rate rules, renders the metric more accurate as an assessment of school performance.

Though the repayment rate is straightforward in concept and calculation, there are some subtleties specific to federal student loans we need to address before turning to policy implementation. Here we take the approach of accounting for all loans in the repayment cohort, including those that are in deferment, forbearance, or default; considering only the principal balance; and assuming a 20 percent repayment target after five years. Adjustments to this approach might be reasonable.

DISTRIBUTION OF REPAYMENT RATES

In this section we document the distribution of cohort repayment rates across types of institutions. These data were provided to us by Federal Student Aid and cover all loans entering repayment—whether due to graduation or departure without a degree—in fiscal year 2009. Loans are attributed to the school and academic degree level (i.e., undergraduate or graduate) for which they were originated, and parent borrowers

are excluded. Technical details and additional discussion of the cohort repayment rate are included in Chou, Looney, and Watson (2017).

We focus on the 2009 cohort entering repayment for data availability reasons. Though 2009 was a particularly challenging year to leave school given the extremely weak labor market, preliminary evidence suggests that more-recent cohorts are performing similarly: the median three-year repayment rate for the 2009 undergraduate cohort was 21.7, compared to the three-year repayment rate for the 2011 undergraduate cohort of 22.7. Therefore, the characteristics and distributions of cohort repayment rates presented next are probably not driven by adverse macroeconomic factors unique to 2009.

Undergraduate Repayment

Figure 2 shows the distribution of institutional repayment rates for undergraduate loans entering repayment in 2009. The typical institution has a cohort repayment rate of 22 percent, meaning that undergraduates in aggregate have repaid 22 percent of the initial principal after five years. This repayment rate corresponds to a typical student smoothly amortizing over 15 years, though of course in reality some students are paying more and some students are paying less.

The bars of the figure 2 histogram are colored to reflect the repayment term associated with that five-year repayment rate. 5 percent of institutions have cohort repayment rates below zero—signified by light purple—meaning that the cohort in aggregate owes more after five years than it did when leaving school. These bars combine with those in dark purple to show the 32 percent of institutions that have repayment rates below 15 percent, meaning their borrowers are paying down less in

FIGURE 2.

## Distribution of Cohort Repayment Rate across Institutions
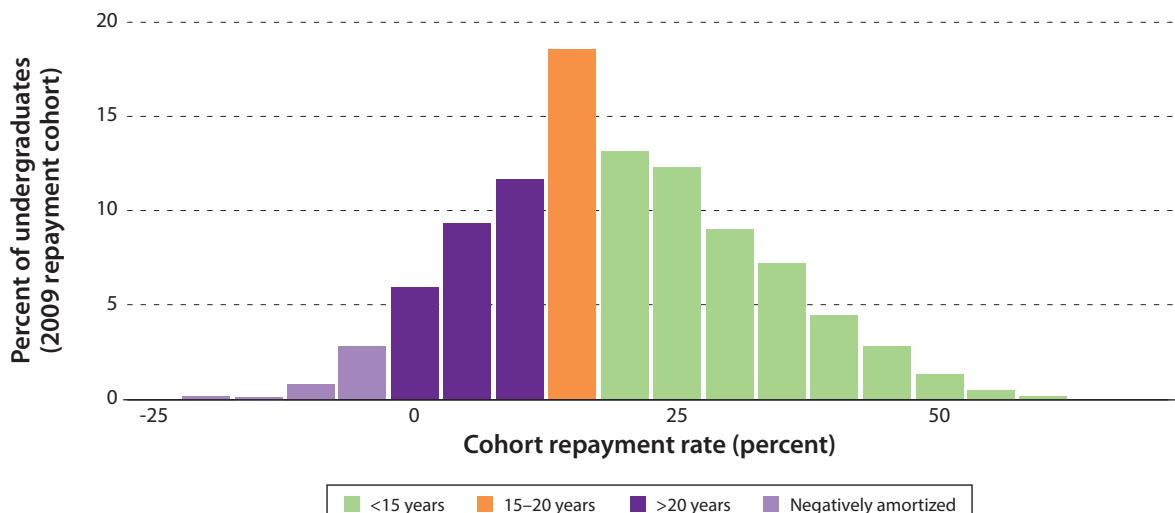
Source: Chou, Looney, and Watson 2017.

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

FIGURE 3.

Cohort Repayment Rate, Four-year Schools
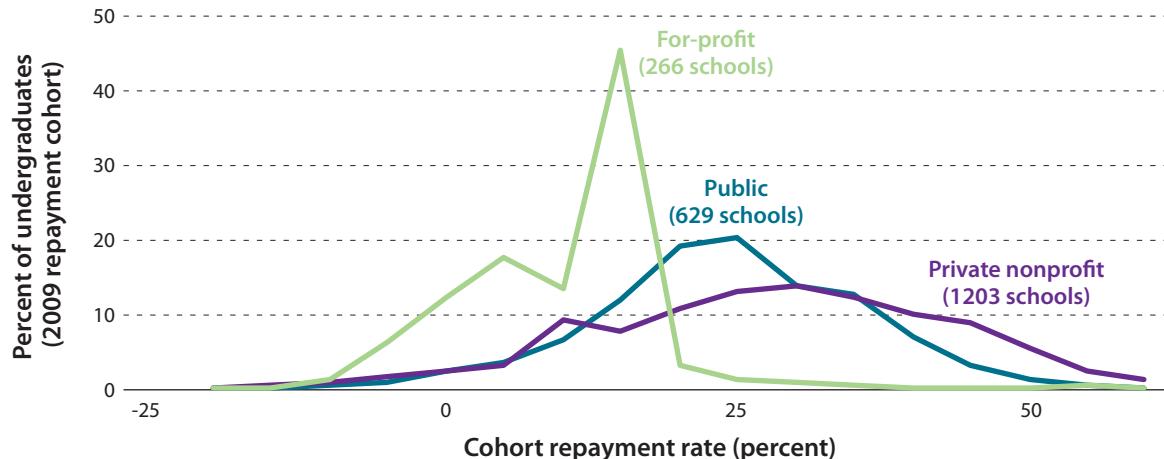
For-profit
(266 schools)

Public
(629 schools)

Private nonprofit
(1203 schools)

Percent of undergraduates
(2009 repayment cohort)

Cohort repayment rate (percent)

Source: Chou, Looney, and Watson 2017.

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

aggregate than would be expected on a 20-year repayment plan. Half of the figure is green, implying that these institutions have repayment rates of 20 percent or higher, which would be consistent with a repayment term of 15 years or less.

Repayment by Sector and Level

Figure 3 shows the distribution of cohort repayment rate by institutional sector among four-year schools. At bachelor's degree–granting institutions, public and private nonprofit schools both tend to have relatively good repayment rates. Both sectors have a small share of students attending schools with low repayment, but, in general, their students are making progress

toward repaying their loans. Among for-profit schools, there are almost no schools with repayment rates above 20 percent, though many students attend for-profit schools with repayment rates in the 15 to 20 percent range. Many for-profit borrowers attend schools with low, and even negative, repayment rates.

Figure 4 depicts the sectoral decomposition for each decile of cohort repayment rate, showing the contribution of each sector to the overall repayment picture. A few patterns are evident. First, all six sectors appear to have some poor performers. In the lowest three deciles of repayment, the distribution is about evenly divided between less-than-four-

FIGURE 4.

Sectoral Composition of Repayment Rates

Percent of undergraduates
(2009 repayment cohort)

Decile of undergraduate cohort repayment rate

For-profit 4-year Private nonprofit 4-year Public 4-year
For-profit <4-year Private nonprofit <4-year Public <4-year
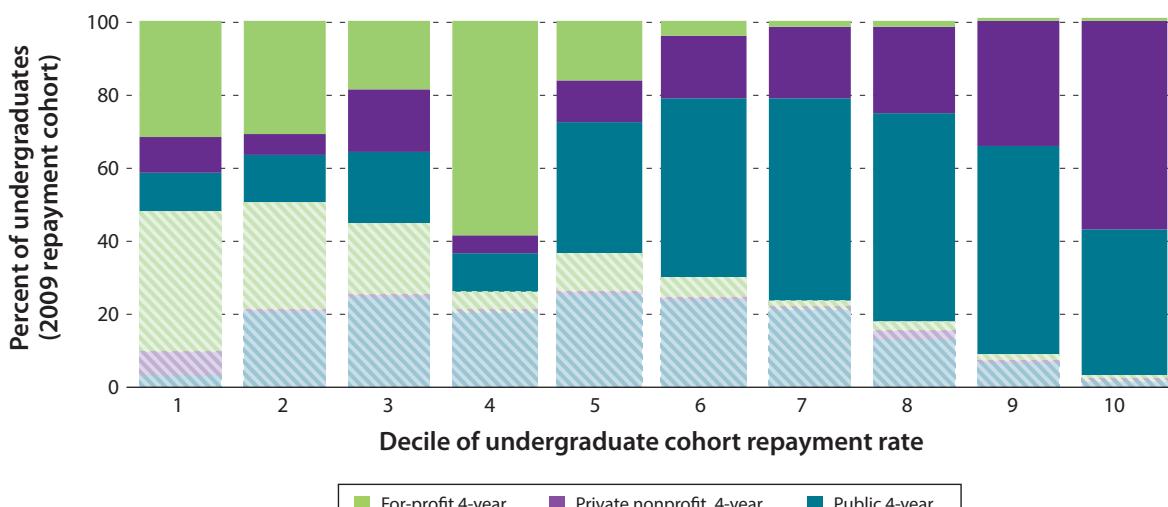
Source: Chou, Looney, and Watson 2017.

Note: Repayment rate deciles are weighted by the school's undergraduate borrower count. Decile 1 is the lowest repayment rate.

year (shown in the lighter hatched pattern) and four-year schools (in solid pattern), and skewed toward for-profit schools (in green). Though low repayment tends to be more of an issue at for-profit and two-year schools, all sectors have some low repayment institutions—the problem is not exclusive to any particular sector.

Second, the middle of the repayment rate distribution has substantial numbers of borrowers from both two- and four-year programs. This suggests that borrowers at low-repayment schools might be able to shift to better-repayment schools without having to switch to four-year programs.

Finally, the top three deciles in terms of repayment are dominated by public four-year institutions and private nonprofit four-year institutions. These schools are more selective than schools in the rest of the distribution, and

repayment is a function of both the school quality and the types of borrowers that attend. There are few two-year schools and almost no for-profit schools among institutions with very high repayment rates.

At the graduate level, institutions tend to have better repayment, but some institutions have systematically low repayment rates for this group as well (see box 2). Risk-sharing plans should treat graduate and undergraduate students separately in determining repayment cohorts.

RELATION OF THE COHORT REPAYMENT RATE TO OTHER INSTITUTIONAL OUTCOMES

Cohort Default Rate

The primary accountability metric for federal student loans is the cohort default rate. As is evident from Figure 6, very


BOX. 2.

Graduate Repayment

We have focused on the repayment outcomes of undergraduate loans at each institution; this is where policy interest in borrowing, repayment, and access tends to be focused. However, an institutional accountability program would also have to consider how to address graduate borrowing. Figure 5 shows the distribution of repayment rates among graduate loans (including Graduate PLUS loans) for those schools with graduate borrowers. Overall, graduate repayment is somewhat higher than undergraduate repayment, particularly at the low end of the distribution—only 21 percent of graduate borrowers went to schools with poor repayment rates (in purple), compared to 32 percent of undergraduate borrowers. However, the repayment rates are not dramatically different—the typical graduate repayment rate is about 24 percent, compared to 22 percent for a typical undergraduate loan.

FIGURE 5.

Cohort Repayment Rate, Graduate Loans
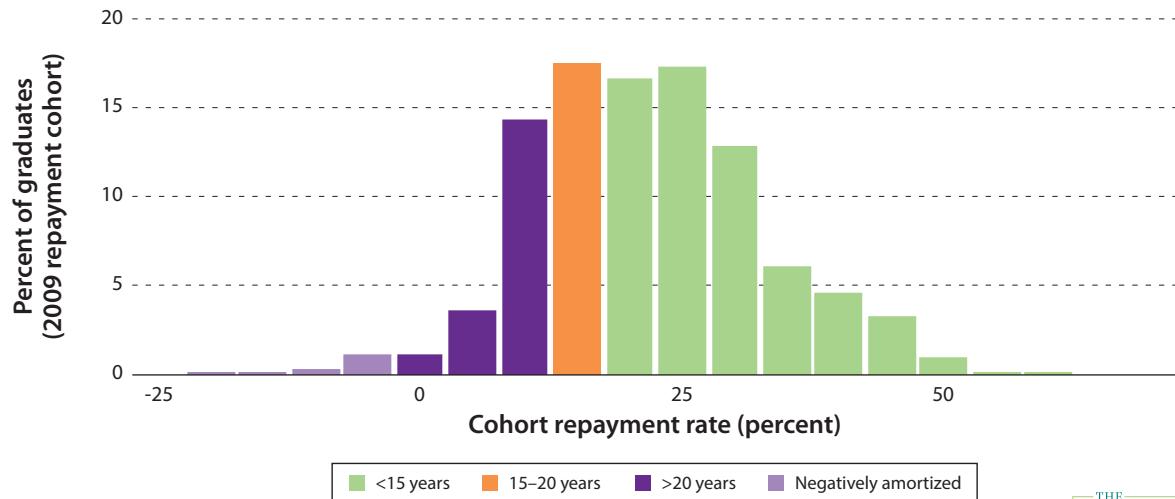
Source: Chou, Looney, and Watson 2017.

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

Although graduate loans are repaid more quickly than undergraduate loans on average, graduate borrowers tend to have lower repayment rates than undergraduates at schools with both types of students. This would matter for the design of an institutional accountability program that pooled undergraduate and graduate loans in a single repayment cohort. As discussed later, we propose to treat undergraduates separately from graduates for accountability purposes.

few institutions exceed a cohort default rate of 40 percent—the level that would put their federal loan eligibility at risk if breached in a single year. Somewhat more exceed 30 percent—the level that risks eligibility if exceeded for three consecutive years—and most of these institutions have below-average repayment rates.[7] In addition, it is clear from Figure 6 that even many institutions with moderate default rates have low repayment levels, suggesting their students are struggling to repay their loans even if they are not defaulting. For example, around 130 schools have cohort default rates of 20 percent,

Cohort Repayment Rate vs. Cohort Default Rate
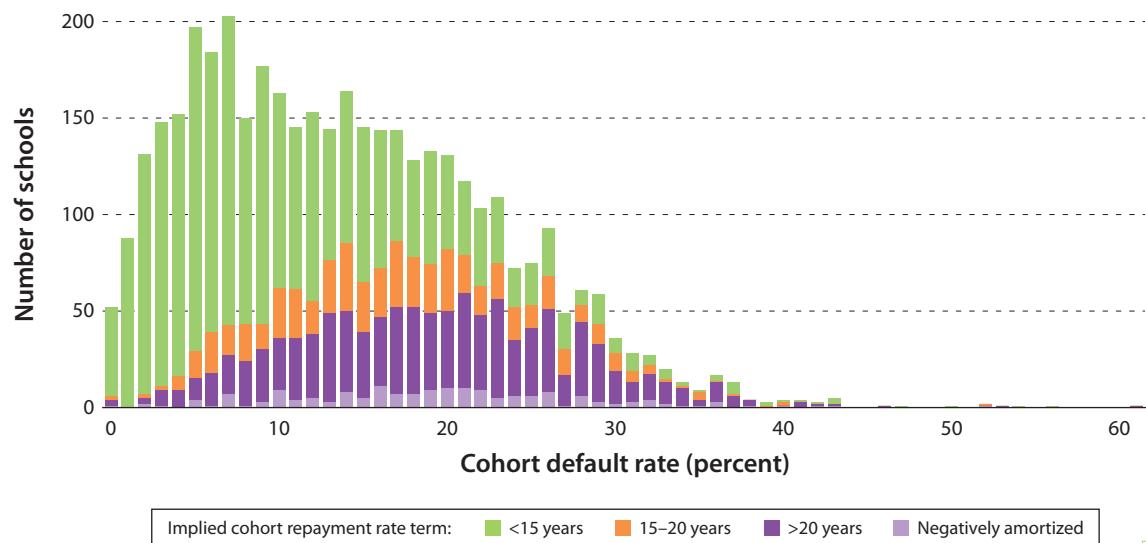
Source: Chou, Looney, and Watson 2017.

Note: Three-year cohort default rates are for 2010. The cohort repayment rate is for 2009.

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Debt and Earnings by Cohort Repayment Rate
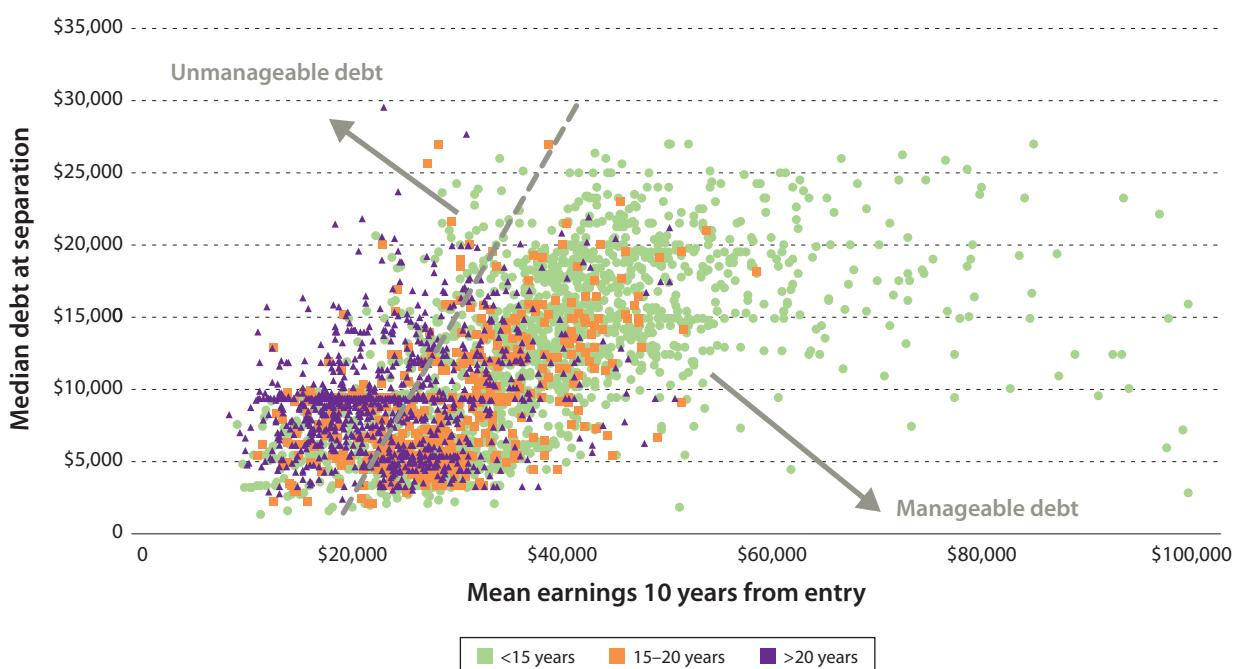
Source: Chou, Looney, and Watson 2017.

Note: Dashed line denotes debt level for which a 20-year repayment is equal to 10 percent of discretionary income, so that a borrower might reasonably be expected to repay her loan over 20 years. Nonemployed included in calculation of mean earnings.

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but about 50 of these schools have low cohort repayment rates consistent with amortization over more than 20 years.

As noted above, the cohort default rate will become an increasingly ineffective tool to monitor institutional student loan performance as IDR becomes more prevalent. More-flexible repayment plans that protect borrowers from defaulting in the case of earnings shocks or systematically low earnings require a new approach for holding schools accountable.

Debt vs. Earnings

The manageability of student debt depends on students' likely earnings. Taking on a high amount of debt to attend an expensive school is often a smart financial decision if that institution is likely to provide substantial economic opportunity. Similarly, borrowing to attend a program that typically leads to modest earnings could be a worthwhile investment if the debt incurred is also modest.

Figure 7 shows the relationship between median debt incurred by borrowers at an institution and mean earnings 10 years after starting school. The dashed line represents the amount of debt that would be affordable, where affordability is defined by a 20-year payment schedule taking up less than 10 percent of mean discretionary earnings.[8] Institutions to the left of the dashed line produce graduates with earnings so low that it would not be reasonable to expect a typical student to repay their debt without financial hardship. To the right of the line, borrowers tend to make enough that even high debt amounts are affordable. It is clear that given any particular level of expected future earnings, institutions ask their students to take on very different levels of debt.

The figure also shows that students struggle to repay their loans at schools with high levels of debt relative to earnings. The purple dots represent schools where cohort repayment rates are low—below 15 percent—with most of these schools to the left of the line that indicates an affordable loan burden. Although there are some institutions that have poor repayment despite reasonable debt-to-earnings ratios, high levels of debt relative to earnings are generally associated with students struggling to repay.

Institutional Opportunity for Low-Income Students

Repayment rates are also related to the degree of economic opportunity offered by schools. Both low- and high-income students at schools with higher cohort repayment rates achieve better post-college outcomes. For instance, students from families earning less than $30,000 have about a 58 percent chance of earning at least $25,000 if they attend a middle-tier repayment rate school, compared to a 45 percent chance at a low-tier school. These differences are similarly apparent in loan performance: at low-tier repayment rate schools, low-income students are very likely to default and struggle to repay their loans on time.

Low-income students are disproportionately served by institutions with low cohort repayment rates (see Figure 8). Among undergraduate borrowers who started repayment in 2004–09, there are about 3.2 students from families earning more than $30,000 for each student from a family earning under $30,000. At low-repayment schools, this ratio is much lower, implying that a disproportionate share of low-income students are enrolled at these institutions. Schools with higher repayment tend to have higher ratios, meaning they enroll a disproportionate share of higher-income students.

FIGURE 8.

Low-Income Students Disproportionately Attend Low-Repayment Schools
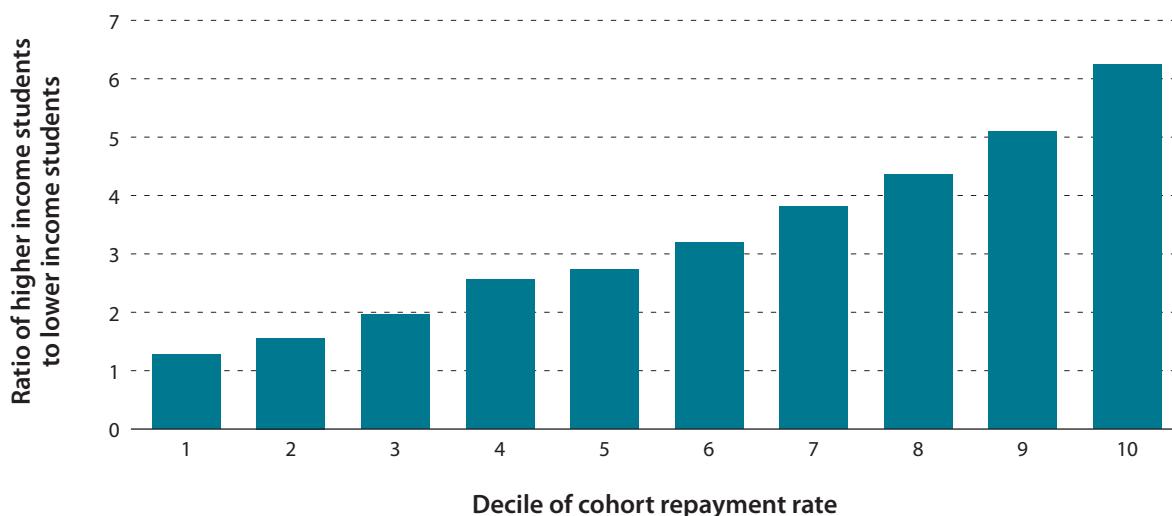
Source: Chou, Looney, and Watson 2017.

Note: Limited to dependent undergraduates with loans that entered repayment in 2004–09 who are not currently enrolled. Ratio defined as number of students from families with incomes above $30,000 over number of students from families with incomes below $30,000.

Chapter 4. The Proposal

We propose a risk-sharing program to give schools "skin in the game"—a small financial incentive to improve the loan outcomes of their students. This will encourage institutions to improve student loan outcomes by improving matching between students and programs, enhancing program quality, promoting graduation, strengthening loan counseling, and keeping institutions connected with students after leaving school. However, it is important to design the program to minimize unintended consequences. These include reduced access to education for low-income students, pass-through tuition increases, gaming of accountability metrics, and negative distributional consequences for institutions serving low-income and minority populations.

Our proposal is based on a performance standard defined by repayment rates. The design improves on existing accountability measures by focusing on repayment rather than default, by applying to a broader set of schools (where the scope is defined by loan outcomes rather than predetermined school characteristics), and by having a continuum of penalties for poor performance. In addition, we use revenue from the risk-sharing program to fund a mobility bonus system that would reward institutions that serve low-income students well.

An institutional cohort repayment rate—defined as the fraction of a cohort's initial principal that is repaid within five years after leaving school—is an appropriate student loan accountability metric. As has been shown, it is highly correlated with student earnings outcomes, institutional quality, and the return on federal loan dollars. The cohort repayment rate also has other benefits: it is difficult to game or manipulate, it is straightforward to measure, and it directly corresponds to the federal investment in the loan.

Our proposal requires institutions to reimburse taxpayers for a portion of the amount by which their students fail to achieve a minimum threshold for cohort loan repayment. We propose minimal five-year repayment thresholds that are consistent with loans amortizing over a 15-year period. Based on the repayment performance of the cohort entering repayment in 2009, about half of institutions would incur a penalty. Penalties would be modest for most affected institutions, serving as a nudge for schools to improve their students' loan outcomes. But for schools with very low repayment rates, penalties could be significant. Because the proposal would raise revenue, those budget savings could be used to finance bonus payments to institutions that serve low-income recipients well.

The risk-sharing proposal includes four key elements: (1) the outcome measure (i.e., cohort repayment rate), (2) the performance target, (3) the reimbursement underperforming schools pay (i.e., the risk-sharing payment), and (4) any nuisance exemptions or discounts on the risk-sharing fee that institutions would otherwise be charged. We discuss each of these elements in turn and provide an illustrative example. We then discuss additional implementation considerations and sketch a system of bonus payments that would be targeted to institutions that serve low-income students well. The proposal we put forth here balances the need for meaningful risk-sharing with the goal of maintaining access to good educational investments.

There are several compelling reasons to use a five-year cohort repayment rate for loan accountability purposes:

- **It is not based on student loan defaults, which are an increasingly unreliable measure of institutional success.** The cohort default rate is currently used as the primary loan accountability metric. Defaults are an indicator of student distress, but the growth of IDR plans has masked systematic loan repayment problems. In coming years, the cohort default rate metric will be an increasingly unreliable indicator of whether an institution is providing economic opportunity to its students and reliable stewardship of federal loan dollars.

- **It is more difficult to manipulate than simpler binary measures.** Since the introduction of the College Scorecard in 2015, students can easily access information about institutional quality and cost, including loan repayment information (College Scorecard n.d.). The Scorecard's repayment rate metric—distinct from what we propose—is the fraction of students that pay down at least one dollar of total balance within three years. Because this binary metric relies on a discrete threshold, it is easier to manipulate and less well-suited for a broad-based accountability system. By contrast, to manipulate our cohort repayment rate target of 20 percent, schools would have to provide funds to pay down accrued interest and $0.20 of principal for every dollar borrowed.

- **It considers loan outcomes after a five-year window, which is sufficient to predict long-run loan outcomes.** Analysis using borrower-level data suggests that early-stage outcomes of loans predict long-run outcomes. Loan status after five years is a strong indicator of where the loan will stand after 15 years: nearly 90 percent of loans that are performing five years after entering repayment will still be performing at Year 15 (Chou, Looney, and Watson 2017). . Similarly, loans that fail to perform early on are very likely to remain nonperforming at Year 15.

- **It directly incentivizes the repayment of student debt.** The cohort repayment rate is a direct indication of whether student debt is repaid in a timely manner by students who borrow to attend an institution. Unlike other measures, it accurately captures taxpayer risk, appropriately emphasizing large-dollar loans within an institution. Timely repayment is fundamentally of interest to both students and taxpayers.

- **It is closely correlated with institutional outcomes of interest.** As previously discussed, the cohort repayment rate is correlated with important institutional outcomes, including the Scorecard debt-to-earnings ratios and economic opportunity.

LOAN OUTCOMES AND SETTING A PERFORMANCE TARGET

Any loan that is on a fixed amortization schedule will have a predictable remaining balance, given the interest rate and loan term (see box 1). For example, at Year 5 of repayment and assuming an interest rate of 6.8 percent, we would see the following:[9]

- A 10-year loan would have 58.4 percent of origination principal remaining, or 41.6 percent of principal repaid.

- A 15-year loan would have 77.1 percent of origination principal remaining, or 22.9 percent of prinicipal repaid.

- A 20-year loan would have 86.0 percent of origination principal remaining, or 14.0 percent of principal repaid.

Although the 10-year term is the standard plan for borrowers, many life events can interrupt repayment, so targeting the 10-year amortization curve in a broad-based institutional accountability program is too aggressive. Instead, we propose a five-year target of 20 percent of the initial principal repaid; this target is consistent with a cohort repaying its loan after 15 years. However, the proposed reimbursement rate is low for institutions that are close to the target. Incremental penalties become much more significant for institutions below a 15 percent repayment target, which roughly corresponds to a 20-year repayment term.

About one third of schools have cohort repayment rates for undergraduates below 15 percent. About one half of schools have repayment rates below 20 percent, and only the very best performers (in the top 10 percent) have repayment rates close to 40 percent (see Table 1).

TABLE 1:
Distribution of Cohort Repayment Rates at Year 5

Loans included	Number of schools	Mean	10th	25th	50th	75th	90th
Undergraduate and graduate	4,722	21.5%	6.2%	14.0%	20.8%	29.4%	36.9%
Undergraduate only	4,578	21.6%	5.3%	12.7%	20.2%	30.1%	39.5%
Graduate only	1,478	24.2%	11.8%	16.6%	23.6%	31.1%	38.9%
Undergraduate only:							
Public	1,533	24.2%	11.1%	16.9%	24.1%	30.9%	38.2%
Private nonprofit	1,358	29.0%	9.3%	18.7%	30.2%	40.1%	47.7%
For-profit	1,687	11.1%	0.2%	5.5%	11.7%	15.7%	18.8%
Graduate only:							
Public	500	24.1%	12.5%	18.7%	24.7%	30.0%	38.0%
Private nonprofit	896	26.8%	13.6%	19.4%	26.3%	33.8%	41.0%
For-profit	82	13.6%	9.2%	11.8%	11.8%	19.1%	19.4%

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

Note: Calculations are weighted by the relevant borrower count. 10th, 25th, 50th, 75th, and 90th refer to the respective percentiles of cohort repayment rates.

Holding schools to a target based on a fixed amortization curve might be questionable in a world with IDR; a school's borrowers could pay little in the first five years but eventually manage to repay in full. Arguably, such a school should not be penalized in a risk-sharing proposal if its borrowers do not receive loan forgiveness. However, such a scenario requires that cohort earnings rise with age more steeply than our analysis suggests is likely.[10] In addition, since we are setting a target for an entire cohort of borrowers, there is scope for some students to repay more slowly than prescribed by a 15-year amortization schedule while others repay more quickly.

A final detail of the proposal is that undergraduate and graduate loans are to be assessed separately. At schools with both types of loans, graduate repayment rates tend to be below the undergraduate rates; if higher education subsidies are intended to be more generous for undergraduates than for graduates, it would be undesirable for relatively strong undergraduate repayment rates to mask the poor repayment outcomes of graduate students. The proposal therefore separately assesses graduate and undergraduate loans at each school. Consideration of Parent PLUS loans is also omitted.

RISK-SHARING PAYMENT

Schools that fail to meet the repayment target are required to reimburse a fraction of loan dollars according to their distance from the target and the aggregate initial loan balance for the cohort. Specifically, the revenue base on which the risk-sharing payment is assessed equals loan originations multiplied by the difference between the school's cohort repayment rate and the 20 percent repayment target.

For example, a school's cohort might have $1 million in initial loan balances. If the repayment target is 20 percent and the cohort overall had repaid 17 percent, the revenue base will be 0.03 * $1 million, or $30,000. That revenue base will then be multiplied by a rate (at 25 percent for repayment rates between 15 and 20 percent, and at 100 percent for rates below 15 percent) to determine the risk-sharing payment. This structure means that missing the target by just a few percentage points is penalized only moderately, but missing the target by additional percentage points will entail a higher rate, akin to a progressive tax schedule. Our proposal has three brackets: a 0 percent bracket, a 25 percent bracket, and a 100 percent bracket. Institutions with moderate repayment rates will experience a slight financial nudge to improve, and those with very low repayment rates will face more substantial fees.

Note that these are *marginal* rates, so every school is charged the low assessment rate on the first 5 percentage points below the repayment target and only the worst performers are charged on the excess missed repayment in the next bracket. This differs from the *effective* rate faced by a school, which is the total risk-sharing fee relative to the origination volume. Effective rates are of interest for schools because they reflect how much of the original principal a school might have to return to the government if its loans fail to perform. Nevertheless, it is the marginal rates that determine the degree to which a school is nudged toward devoting resources to improvement of repayment outcomes.

NUISANCE EXEMPTIONS

Providing a nuisance exemption from the risk-sharing program for some schools is desirable. This would minimize the extent to which institutions with little student borrowing entirely opt out of the federal loan program due to the administrative burden and uncertainty associated with risk-sharing payments.

The proposal therefore provides a nuisance exemption to schools where less than a quarter of students borrow. For schools where one quarter to one half of undergraduates borrow, we build in a linear dial-down of the assessment rate. This means that a school with 30 percent of undergraduates borrowing would pay one fifth of the undergraduate fee of a school with 50 percent of undergraduates borrowing, even if both schools have the same cohort repayment rate and loan volume. A gradual dial-down rather than a binary cutoff avoids large, sudden changes in the risk-sharing penalty associated with making one additional loan.

ILLUSTRATIVE EXAMPLE AND ANALYSIS

Given the proposed 20 percent repayment target, those institutions with cohort repayment rates at or above 20 percent would face no penalty. At institutions with repayment rates above 15 and below 20 percent repayment, a fee equal to 25 percent of the base would be assessed. At institutions below 15 percent, an additional 100 percent assessment on the marginal base would be assessed. Box 3 provides an illustrative example.

To better understand how institutions would be affected, we perform an analysis using the 2009 cohort entering repayment for 4,722 institutions representing 3.9 million borrowers. As shown in Tables 2 and 3, we find the following for the risk-sharing proposal outlined above:

1. With no change in school behavior, expected annual revenues from this risk-sharing proposal are roughly $1.09 billion.

2. 2,171 schools are required to pay some reimbursement to the loan program, representing roughly half of the institutions in our data.

3. The average reimbursement per borrower is $665 at affected institutions.

4. The average public school with a reimbursement liability has an effective rate below 3 percentage points, meaning it

An Example of Payments Assessed under the Risk-Sharing Standard

Suppose that a school with a high rate of borrowing has a 13 percent cohort repayment rate. The repayment is 7 percentage points away from the target of 20 percent. Moreover, initial loan balances are equal to $10 million. The payment would be

$$(0.25 \times 0.05 \times \$10 \text{ million}) + (1 \times 0.02 \times \$10 \text{ million}) = \$325,000$$

The institution is charged only the 25 percent rate on the first 5 percentage points missed, and then the full 100 percent rate on the additional 2 percentage points from the target.

is required to reimburse less than 3 percent of originated loan dollars.

5. Effective rates are significantly higher for the other sectors: 5 percentage points for private four-year nonprofits and 7–9 percentage points for private nonprofits at other levels and at for-profits of any level.

ADDITIONAL IMPLEMENTATION DETAILS

Timing

In order to give institutions time to respond to the new incentives, we propose to delay fee collection by seven academic years from the date of policy implementation, so if implemented in fiscal year 2018, the fiscal year 2020 repayment cohort would be the first one for which institutions would be

TABLE 2.

Distribution of Risk-Sharing Outcomes

	Mean	25th	50th	75th
Total fee charged to the school	$502,800	$14,700	$71,900	$344,800
Fee per borrower	$665	$69	$329	$938
Effective rate	6.4%	0.7%	3.9%	10.5%

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. 25th, 50th, and 75th refer to risk-sharing outcomes for schools at those percentiles of the cohort repayment rate. Total fee charged to the school is rounded to the nearest one hundred dollars.

TABLE 3.

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.

subject to risk-sharing payments, and the first payments would be calculated in fiscal year 2025. This would provide time for institutions to improve outcomes for currently enrolled students and would avoid penalizing them for historical loan outcomes. Information on historical cohort repayment rates would be provided immediately and on an ongoing basis so institutions would be able to gauge their level of success to date and consider appropriate changes.

Special Circumstances

Student repayment rates are often affected by life events like death, disability, and military service. The cohort defined for accountability purposes should exclude students affected by these factors. In principle, the cohort could also exclude students who have registered their intention to pursue the Public Sector Loan Forgiveness Program, but under current rules students are not required to register prior to forgiveness (which occurs after 10 years of public service).

Importantly, the risk-sharing measure would not exempt IDR recipients; IDR is a safety net program for students but should not serve as a way for institutions to avoid accountability. Excluding IDR would render the accountability system more easily manipulated, allowing schools to avoid penalties by encouraging their students to use IDR.

Target Adjustment

The choice of a 20 percent repayment rate target reflects long-term amortization, but sudden macroeconomic shocks or other unforeseen circumstances could systematically reduce five-year repayment rates. Under the proposal, the Secretary of Education would have the discretion to reduce the repayment target for a given cohort if that cohort was exposed to a recession—as defined by the National Bureau of Economic Research—during the five-year period.

MOBILITY BONUS PAYMENTS

The expected revenue from the proposed risk-sharing system will be allocated to support institutions that serve disadvantaged students well. Some institutions provide a high level of social value, including post-enrollment earnings that are higher than what the student would have earned without the educational opportunity, but still have low repayment rates. This is particularly the case for institutions that serve highly disadvantaged students; these students often have modest post-enrollment incomes, minimal family wealth, and other financial obligations that make repayment difficult.

We propose that institutions receive 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. Bonuses would be given to the institution for each low-income borrower—defined as those receiving a Pell Grant—who earns above $25,000 (roughly the median earnings of a high school graduate) five years after entering repayment. To account for the fact that many community college students do not borrow, additional bonuses could be given for non-borrowing Pell Grant recipients meeting the same threshold six years after enrollment. The data needed to calculate such a bonus are not currently available at the institutional level, but could be generated from the same sources used to produce the College Scorecard.

Once data are available, we propose setting the per student mobility bonus such that the total expected cost is around $1 billion per year. This approximates the expected revenue from the risk-sharing plan we propose, assuming no response on the part of institutions. Of course, to the extent that risk-sharing incentives are successful, risk-sharing payments would decline as institutions improved their repayment outcomes. Mobility bonus payments would continue at the baseline rate even in that case, providing continued encouragement to institutions that enroll and enhance the earnings of low-income students.

Chapter 5. Questions and Concerns

1. Will the proposal have an 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. Our hope is 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 under-resourced schools before they are expected to come into compliance, we do not include such an exemption here.[11] The mobility bonus system or a similar plan 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 your proposal encourage a shift from student loans to parent loans?

Parent PLUS loans are not included in our proposal, making it important to minimize the degree to which risk-sharing causes substitution away from student loans toward parent loans, which have inferior loan terms from the perspective of the borrower. One possibility would be to require that families take advantage of all federal student loan options before becoming eligible for the Parent PLUS program. Risk-sharing could also be expanded to include PLUS loans.

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

Some of the cost of risk-sharing—roughly 3 to 9 percent of loan dollars—might be passed through to students in the form of tuition increases. We 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. It is our hope that the mobility bonus system will offset some of the resource constraints at under-resourced schools that serve low-income students well, and that these schools will not need to increase tuition as the result of the program.

5. Doesn't IDR already address many of the same goals as risk-sharing?

It is true that IDR protects students from the serious consequences of default, and it is an important safety net. However, IDR does not address institutional quality issues, and indeed might make it easier for low-quality institutions to ask their students to borrow excessively. An optimal policy will preserve IDR while limiting the ability of low-quality institutions to ask their students to borrow funds they will never be able to repay.

Chapter 6. Conclusion

Institutional accountability in the federal student loan program has been weak and is becoming increasingly obsolete as income-driven repayment policies become more popular. In addition, current accountability rules are limited in scope, either targeting extreme cases or applying only to particular sectors. This proposal reinforces accountability with a risk-sharing scheme based on a cohort repayment rate metric. Revenues from risk-sharing would be used to provide mobility bonus payments to schools that serve low-income students well.

We see many advantages to using a repayment-based metric for a loan accountability program. However, there are some schools that provide valuable, high-quality education without commensurate high earnings in the labor market. For example, some institutions serve highly disadvantaged students who upon entering the workforce earn more than they would have without college education but whose income is inadequate to repay their loans. Our proposed mobility payments would address this concern by supporting high-quality education for low-income students, who are disproportionately harmed by current institutional accountability rules that leave them with unmanageable debt burdens.

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Acknowledgments

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Endnotes

1. The cohort default rate excludes Parent Loan for Undergraduate Students (PLUS) loans.
2. For example, the original 85-15 rule targeting for-profit schools was included in the 1952 Korean GI Bill. A 1984 report by the Government Accountability Office also noted that practices at for-profit schools were "not in the best interests of the students and do not comply with [Pell Grant] program requirements." (GAO 1984)
3. Borrowers on Income-Based Repayment (IBR) pay 15 percent for 25 years; borrowers on Pay As You Earn (PAYE) pay 10 percent for 20 years; and borrowers on Revised Pay As Your Earn (REPAYE) pay 10 percent for 20 years, but their monthly payment is not capped at the 10-year standard payment. Discretionary income is defined as gross income minus 150 percent of the federal poverty guideline. The poverty guideline varies by family size, and is higher for residents of Alaska and Hawaii.
4. Refers only to Direct Loan borrowers in income-contingent, income-based, PAYE, or REPAYE (Federal Student Aid n.d.a, 2016 Q3).
5. In addition, if a school can ex ante identify these borrowers, it can capture the additional forgiven dollars (by raising tuition) at little cost to itself or the student. Note that tuition setting is a prerequisite for this strategy, so only certain types of programs are likely to be able to capture loan forgiveness in this way.
6. The "correct" term length for a student loan is subject to debate. Some argue that because human capital pays off over an entire working life, the term should be the borrower's remaining working life, which could be much longer than 20 years. Others argue that borrowers should not be expected to still be repaying student loans well into adulthood because they will probably have additional economic goals to meet (e.g., children's education, buying a house, and saving for retirement).
7. Perhaps surprisingly, some schools with very high default rates also appear to have favorable repayment rates. This relationship generally arises for one of two reasons. First, some institutions, such as community colleges, have very polarized outcomes in which borrowers either repay relatively small balances quickly or quickly default. Second, recovery rates on smaller, defaulted loans are often high because the law requires wage garnishment and the offset of tax refunds, including Earned Income Tax Credit and Child Tax Credit refunds. Hence, a borrower who quickly defaults might appear to have a high repayment rate because these collections have reduced the balance or paid it off entirely.
8. This construction is very similar to the definition of "partial financial hardship" used in IDR plans, except with a 20-year payment instead of a 10-year payment. In both cases, "discretionary earnings" refers to earnings above 1.5 times the federal poverty level, assuming that households consist of single persons.
9. Amortization curves do depend on the interest rate, but there is not much movement in the Year 5 amounts when the interest rate changes. If the interest rate were 8 percent instead, the remaining balance at Year 5 of a 20-year plan would be 87.5 percent, or 12.5 percent principal repaid.
10. Our calculations using data from the National Longitudinal Survey of Youth 1979 suggest historical earnings trajectories are not steep enough to generate this profile at the cohort level (BLS n.d.). In other words, cohorts who are behind at Year 5 are highly likely to have significant balances forgiven after 20 years of IDR. Individuals do experience large shocks that lead to disproportionate repayment in later years, but these average out when aggregated to the cohort level.
11. Title IIIA, IIIB, and V schools receive some direct federal funding because they enroll a large share of Pell students, are historically black colleges or universities, or are Hispanic-serving institutions.

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THE HAMILTON PROJECT

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.