Distinct Income Share Oversight Could Reform Student Debt

By Alissa Gardenswartz and Tony Arias (May 19, 2020)


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Student loan debt continues to be a growing and seemingly unsolvable problem in the U.S. As the costs of higher education show no signs of slowing, students are forced to take on more public and private loans.

Currently, one out of four student borrowers is either delinquent or has defaulted on his or her student debt, and those numbers are poised to increase given the significant economic downturn occasioned by the coronavirus pandemic. Higher education and specialized technical skills, however, continue to be the path to financial security for many.

Consequently, the status quo of education finance cannot continue. Absent significant legislative reforms and lower tuition costs, there is a need for financial innovation to help students achieve their potential while ensuring that they're not saddled with unmanageable debt.

In this environment, income share agreements, or ISAs, which allow students to obtain financial assistance in exchange for agreeing to pay a percentage of their future income as long as it meets or exceeds a certain level, are gaining popularity as an alternative to traditional student loans.

And, where COVID-19 has resulted in staggering unemployment rates that are likely to continue for the foreseeable future, the need for streamlined income-contingent education financing has been brought into stark relief.

According to a discussion paper from the Federal Reserve Bank of Philadelphia's Consumer Finance Institute, as of December 2019 over 40 "colleges and universities, as well as numerous alternative educational, vocational, recredentialing, and workplace development programs, have offered ISAs as an option for financing educational expenses."[1] Although ISAs are too new to track long-term outcomes, educational institutions are reporting positive experiences with them.[2]

Part of the reason ISAs are growing in popularity is that they protect students who do not reach their projected income, or who suffer a job loss or a wage decrease. ISAs also provide a financing resource to students who otherwise would be ineligible for traditional student loans — e.g., because they reached loan caps or because they are ineligible for Title IV financial aid.

Colorado Mountain College, for example, implemented an ISA program to help young immigrants who are otherwise unable to secure public or private funding for higher education because of their immigration status.[3] Other institutions, such as Purdue University and The University of Utah have incorporated ISAs into their financial aid offerings for students who may also qualify for Title IV loans.

The past few years have also seen increased efforts at regulating ISAs at both the federal and state levels. Some regulators have attempted to design a regulatory framework specific to ISAs, recognizing that they do not function as typical loans, and differ significantly from loans in their risk allocation between students, schools and funders.

Other regulators view ISAs as a type of loan that should be subject to regulatory oversight similar to traditional loans. Proposed state and federal legislation would require the use of loan terminology to explain ISAs to students, seeking a hybrid approach.

Sweeping ISAs into a regulatory regime designed for loans, however, will lead to consumer confusion rather than consumer protection, will result in unintentional consequences that undermine the features that make ISAs a viable alternative to traditional student loans, and may discourage much-needed innovation in education finance.

Moreover, attempting to regulate ISAs under regulatory regimes intended for loans adds no additional benefit that cannot be obtained simply by inserting similar requirements into ISA-specific regulation, after carefully adapting those requirements to the unique aspects of ISAs.

Background

ISAs are contracts where universities, colleges, philanthropic organizations or private investors cover all or a portion of a student's educational costs in exchange for a percentage of a student's future income for a set period of time or number of payments.[4] ISA payment obligations typically start three to six months after graduation, and are triggered only if the graduate's income meets or exceeds a minimum income threshold as specified in the ISA.

ISAs establish a maximum payment cap, ranging from an amount equal to the amount advanced (a so-called 1x payment cap), to a more typical amount of around 1.4x, with a few payment cap multiples going up to 2.5x the amount advanced.

Students satisfy their ISA obligations upon the earliest of: (1) making a predetermined number of monthly payments; (2) reaching the end of the ISA payment period; or (3) reaching the fixed maximum payment cap for the the total of their payments. There is no outstanding balance that a student is paying down, and there is no interest to capitalize during nonpayment.

The downside protection for lower earners via the minimum income threshold and the upside protections for higher earners via the maximum payment cap are unique features of ISAs. In essence, therefore, ISAs provide students a multifaceted safety net that traditional loans do not.

Attempts at ISA Regulatory Oversight

As with any new product that enters the finance market, ISAs are increasingly attracting the attention of regulators and legislators. With the growing popularity of ISAs, regulation is certainly necessary to protect students from any abusive practices that could arise in the ISA context.

Regulation is also necessary to provide a clear road map for ISA providers on regulatory compliance. In fact, over the last few years key players in the ISA space have been advocating for ISA-specific regulation, recognizing the importance of regulation in ensuring the long-term viability of ISAs in education finance.[5]

So far there have been four bills proposed at the federal level specific to regulating ISAs. In 2017, Sen. Marco Rubio, R-Fla., introduced a bill known as the Investing in Student Success Act, which ultimately died in the U.S. Senate.[6]

The bill explicitly authorized the use of ISAs for financing post-secondary education and provided various requirements to qualify as a valid educational ISA. The proposed bill would have required, for example:

- That ISAs expressly state the percentage of future income that a student will be obligated to pay;
- That ISAs expressly provide that students will not be obligated to pay if their income is equal to or below 200% of the federal poverty line for a single person;
- That the percentage of income in an ISA does not exceed the equivalent of what would be required to be paid during a 12-month period "under a comparable loan that bears interest at a fixed annual rate of 20%;" and
- That students do not enter into multiple ISAs where the total percentage of income the student agrees to pay at any given time exceeds 15% of the student's future income.

Rep. Allen Lucas Messer, R-Ind., also introduced a bill in 2017, which was called the Investing in Student Achievement Act and contained similar requirements to Rubio's bill.[7] Messer's bill would also have required, among other things, that ISA providers disclose a comparison between the ISA and other comparable loans, "including a loan at an interest rate determined by the Director of the Bureau of Consumer Financial Protection to be an approximation of the interest rate available to student loan borrowers in the private marketplace and, where applicable, a Federal Stafford loan."

U.S. senators and members of the U.S. House of Representatives introduced two other bills in 2019. The Kids to College Act was introduced in the House in March 2019, and it also contains disclosure requirements, limits on ISA payment terms, and applicability of federal consumer protection statutes for ISAs, such as the Truth in Lending Act and the Fair Debt Collection Practices Act.[8]

In July 2019, a comprehensive bipartisan bill, the ISA Student Protection Act, was introduced in the Senate.[9] The proposed bill is specifically tailored to qualified ISAs, which are expressly defined as neither loans nor credit, and requires many of the same disclosure requirements, limits on ISA payment terms, and consumer protection laws as the prior bills.

Both of the 2019 federal proposals would preempt state laws related to usury, credit, loans, or credit or installment sales unless they expressly state that they are intended to apply to qualified ISAs. The proposals would also preempt existing state credit laws, such as those related to licensing and ability-to-repay requirements.

Several states, including California and Washington, have also proposed ISA legislation, but to date, only Illinois has passed a law that simply enables the state treasurer to invest in ISAs.[10] Of note, the legislation defines ISAs separately from loans.

In February 2020, Rep. Emanuel Chris Welch, D-Ill., introduced a bill titled the Income Share Agreement Consumer Protection Act.[11] Under the proposed legislation, ISAs constitute loans and debts within the meaning of the Illinois Consumer Installment Loan Act.

The proposed law requires more than 30 different disclosures, including a requirement to disclose the student's effective annual percentage rate, or APR, under three hypothetical scenarios, using the best information available to the ISA provider: the borrower's income stays the same for the payment term; the borrower's income is 50% less than expected for the term; and the borrower's income is 50% more for the term.

The proposal also (1) prohibits ISA providers from contracting for more than 5% of a student's income; (2) sets a limit on ISA terms from exceeding 60 months; (3) sets a limit of 1.10 times the amount of the amount funded with the ISA to be paid toward the ISA; (4) sets a minimum income threshold of at least 250% of the federal poverty line, based on the family size of the borrower; and (5) requires that ISA providers comply with the Fair Credit Reporting Act. The Illinois bill has been sent to committee. It is unclear if it will advance further.

Concerns in Regulating ISAs as Loans

While legislators and regulators may be tempted to follow in the footsteps of the proposed Illinois legislation to categorize ISAs as loans and regulate them accordingly, doing so would undermine the consumer protections that they are seeking to secure. In contrast, creating a specific regulatory framework for ISAs would allow flexibility to account for the unique nature of ISAs without harm, as any consumer protection applicable to loans could simply be adapted for ISAs in the ISA-specific regulatory framework.

For example, requiring an ISA provider to articulate an APR equivalent where a student makes 50% less than her anticipated salary, as is required by the proposed Illinois law, could result in disclosing a negative interest rate, which is more likely to confuse than inform. While students should receive upfront disclosures about ISA cost, and it makes sense to express those costs in terms of projected income levels, it is far more useful to describe those costs in terms of monthly or annual payment amounts rather than APR.

Expressing the cost of an ISA in terms of APR gives students a false sense of precision, and does not allow the consumer to fully appreciate the other features of an ISA that differentiate ISAs from loans, e.g., different protections for under- or unemployment.

Second, the classification of ISAs as a loan or credit can lead to other uncertainties or unanticipated consequences that could harm students. For example, student loans generally are not dischargeable in bankruptcy.

If ISAs are characterized as student loans, they could also be considered nondischargeable. The proposed Illinois legislation attempts to deal with this concern by providing that ISAs should not be considered nondischargeable education loans for bankruptcy purposes, but it is questionable whether a federal bankruptcy court would accept Illinois' position that ISAs are loans for all other purposes except for bankruptcy.

Also, if an ISA participant ultimately pays less over the term of her ISA than the original amount advanced, and an ISA is classified as a borrowed debt, the unpaid amount would have to be reported as income under IRS guidance and a much broader swath of students would suffer tax consequences from earning less than their peers.[12]

That is, the ISA participants who are least able to afford it could be stuck with large tax obligations. Having the difference between the original amount financed and the amount paid characterized as a "forgiven balance" that qualifies as income may also impact a student's ability to qualify for income-driven repayment plans for federal student loans or other means-based benefits (e.g., the earned income tax credit), or other student loans.

The Purpose of Regulation — Consumer Protection — Is Better Served by Regulating ISAs on Their Own

ISAs should be regulated, and loan-specific regulations should provide useful guidance for certain aspects of any proposed regulatory framework for ISAs. For example, ISAs should be required to have clear, comprehensive disclosures such that students understand the obligations they are undertaking when signing onto an ISA.

Students also should not be subject to intentional or unintentional discrimination through the use of ISAs. These are necessary ingredients to a viable ISA marketplace and for strong consumer protections. Many ISA providers in fact already voluntarily conduct compliance testing along the lines of existing consumer finance regulations.[13]

Of course, ISAs are already regulated. They are subject to various consumer protection laws, such as the Federal Trade Commission Act, state laws barring unfair, deceptive and abusive acts or practices, and the like.

Additionally, schools offering ISAs are already subject to extensive state and federal oversight. However, regulations specifically tailored to address the features of ISAs are also needed to ensure consumers are able to make fully informed financial decisions and to deter the particular ways that ISAs could be used in a predatory manner.

The aforementioned ISA Student Protection Act, for example, imposes robust disclosure requirements on ISA providers such that the student understands all material terms of the ISA, including that the student may end up paying more or less than the original ISA amount depending upon income levels achieved.

The act also imposes limits on the share percentage an ISA program can require, a maximum payment cap, a minimum income threshold that must be at least 200% of the poverty line for a single person, and parameters around the duration of an ISA, as well as other standards such that ISAs must be offered in a manner that protects consumers.

The act additionally amends other federal consumer protection statutes to clarify how their protections apply to ISAs. While providing all these protections for consumers, the act also clarifies that ISAs do not constitute a loan or credit, and additionally addresses the questions raised above regarding how unpaid ISA amounts should be treated for tax purposes and in applications for federal student aid.

This approach, which bakes in protections for consumers while taking into account the unique features of the ISA, will more effectively delineate the rules of the road for ISAs such that bad actors can be deterred or removed from the ISA landscape.

Moreover, the creation of a federal regulatory benchmark allows for consistent expectations around ISA features and protections. Importantly, while the bill preempts existing state laws, it does not preempt future consumer protection laws that are targeted at ISAs, thereby still allowing states to use their consumer protection authority to address ISA abuses within their jurisdictions.

Additionally, if postsecondary institutions want to offer ISAs as an alternative or supplement to traditional student loans, separate regulation allows students to better distinguish ISAs as a different product entirely. Again, students should be afforded the opportunity to understand how an ISA operates differently than a loan so they can decide overall what works for them without the primary focus of such a comparison being limited to the overall cost.

For certain students, and in the current economic environment, the risk of paying more than they would under a traditional loan if they find themselves exceeding their income expectations may be worth securing the safety of having to pay less or not make payments at all if they become unemployed or underemployed. Others may want the predictability of a traditional loan payment.

Understanding that the products carry different risk profiles, but are regulated according to their particular features, allows for better informed decision-making and consumer protection than trying to fit ISAs within a regulatory framework designed for loans.

Finally, forcing regulation of ISAs as loans may discourage the expansion of funding sources available to students, and innovation in education finance more generally. The ISA structure, which allows for higher earners to make higher payments and subsidizes graduates that secure lower incomes, arguably achieves a similar result to income-driven loan repayment programs, but in a more streamlined fashion.

Labeling the ISA structure and the potential for higher payments as exceeding acceptable loan APRs consequently dismisses out of hand a progressive income-based approach to education finance that may prove more attractive to students and investors alike. Likewise, nonuniform state-specific requirements add complexity without much added benefit, and may even discourage ISA providers from offering ISAs in certain jurisdictions.

Education finance is an area requiring innovation, as student debt sits at $1.6 trillion with no signs of abating soon, and with the vast majority of students reporting that their financial circumstances play an important role in their decision whether to attend college at all.[14]

Certainly ISAs should be regulated, but in a way that accounts for their particular qualities such that students understand how an ISA differs from a loan, and how it could be a better funding alternative for their particular circumstance. Informed decision-making is a hallmark of consumer protection regulation, and that should be the guiding principle in regulating ISAs, not labeling them as loans and risking consumer confusion.

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[1] Dubravka Ritter & Douglas Webber, Modern Income-Share Agreements in Postsecondary Education: Features, Theory, Applications, Fed. Reserve Bank of Philadelphia, at 2 (December 2019).

[2] See id. at 18. (stating that educational programs that have implemented ISAs "broadly describe positive experiences after introducing ISAs.").

[3] Colorado Mountain College, Colorado Mountain College Launches Student Access Initiative to Help DREAMers Pay for College (Sept. 19, 2018), https://enews.coloradomtn.edu/2018/09/19/colorado-mountain-college-launches-student-success-initiative-to-help-dreamers-pay-for-college/.

[4] ISAs may also be used as an alternative to general consumer loans. This article focuses only on their use in education finance.

[5] https://www.christenseninstitute.org/blog/a-joint-letter-to-congress-unlocking-innovation-in-the-income-share-agreement-market/.

[6] See https://www.govtrack.us/congress/bills/115/s268/text.

[7] See https://www.congress.gov/bill/115th-congress/house-bill/3145/text#toc-H29CFED6A4FFD40CAB82CAD4A7AA972E7.

[8] See https://www.govtrack.us/congress/bills/116/hr1810/text.

[9] See https://www.govtrack.us/congress/bills/116/s2114/text.

[10] See http://www.ilga.gov/legislation/fulltext.asp?DocName=&SessionId=108&GA=101&DocTypeId=HB&DocNum=2685&GAID=15&LegID=118880&SpecSess=&Session=.

[11] See http://ilga.gov/legislation/fulltext.asp?DocName=&SessionId=108&GA=101&DocTypeId=HB&DocNum=5524&GAID=15&LegID=126191&SpecSess=&Session=.

[12] https://www.irs.gov/taxtopics/tc431.

[13] Dubravka Ritter & Douglas Webber, Modern Income-Share Agreements in Postsecondary Education: Features, Theory, Applications, Fed. Reserve Bank of Philadelphia, at 25 (December 2019).

[14] https://iop.harvard.edu/student-debt-viewed-major-problem-financial-considerations-important-factor-most-millennials-when.