# CONSUMER PROTECTIONS FOR INCOME SHARE AGREEMENTS

/ SHEILA BAIR + PRESTON COOPER /

Over the past decade, income share agreements (ISAs) have enjoyed a spectacular surge in popularity. Several traditional universities such as Purdue have adopted them as an alternative to high-interest private and Parent PLUS student loans, and they have become the funding tool of choice for startup educational providers like General Assembly (both of which are discussed in this book). But as the product has become more prominent, so too have consumer protection concerns. ISAs are a promising financial innovation, but innovations present risks.

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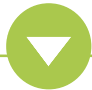
This chapter will delve into the consumer protection issues surrounding ISAs and the best ways to address them. However, it is important to remember that ISAs are intended to disrupt a status quo that is rife with consumer protection failures. The current student loan landscape is a nightmare for borrowers.

## BENEFITS OF ISAs VERSUS LOANS

With a traditional student loan, the debt burden is fixed. Students who borrow the same amount will be responsible for paying the same amount, regardless of whether they succeed in the labor market. Federal student borrowers have the option to reduce their payments if they have low income, but the outstanding balance will negatively amortize if these reduced payments do not cover interest. If students default on their loans, the federal government is empowered to garnish their wages, seize their tax refunds and Social Security benefits, report the default to credit bureaus, and charge fees of up to 25% of the outstanding balance. In most cases, the loans are not dischargeable in bankruptcy.

The federal student loan program regularly perpetrates abuses that regulators would never tolerate from a private lender. Critiques of ISAs on consumer protection grounds must keep this in mind: There are no perfect financial products, but ISAs can be a major improvement over the status quo.

ISAs avoid many of the problems with traditional student loans. There is no interest and no principal, which means no negative amortization. Payments are tied to income and automatically adjust if students face economic headwinds, which means no wave of defaults when recessions strike. If the federal government adopted the model as a replacement for student loans, ISA payments could be collected through the tax system, further simplifying life for recipients.



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For providers of education, ISAs fundamentally change the financial incentives. Since payments depend on a student's earnings after graduation, providers are encouraged to maximize their students' potential to find a well-paying job. The ISA program operated by the San Diego Workforce Partnership, also highlighted in this book, pairs classroom instruction with mentorship and career consulting. Those extra supports maximize the student's earnings potential after completion.

Many student protections are built into the very structure of an ISA, such as adjustable payments and a lack of negative amortization. When designed right, the model also aligns the incentives of the student and the provider, ensuring that the school has a direct financial stake in its students' future success. The remaining question is how regulators can design consumer protections to ensure the model lives up to its full promise.



## CONSUMER PROTECTIONS TO MAXIMIZE THE BENEFITS OF ISAs

Consumer protections are vital because ISAs carry the potential for abuse, like any financial instrument. Many existing consumer protection rules, such as usury laws, are not appropriate for ISAs because they are not traditional loans. Moreover, private investors and philanthropists may be reluctant to back ISA programs so long as consumer protection issues remain unresolved. Establishing clear consumer protection rules is in everyone's interest.

Fortunately, at the time of publication of this book, a bipartisan proposal exists to do exactly that. The ISA Student Protection Act of 2019, introduced by U.S. Sens. Todd Young (R-IN), Mark Warner (D-VA), Marco Rubio (R-FL), and Chris Coons (D-DE), would set down many of the consumer protections in law. While many of the specific rules would be enshrined in statute, the bill also delegates authority to the Consumer Financial Protection Bureau (CFPB) to design disclosure forms and ensure that ISAs comply with consumer finance laws. Unlike traditional student loans, the act would make ISAs dischargeable in bankruptcy.

Some progressives push back on the legislative effort, worrying that a formal consumer framework will give ISAs legitimacy. Many recoil at the involvement of private investors in existing ISA programs. But this reticence stems from a fundamental misunderstanding of the issues on the table.

First, ISAs are not a purely private phenomenon; public universities such as Purdue have embraced the model, as discussed earlier. And for our part, we would be delighted if the federal government would also consider ISAs as an alternative to its student loan program. ISAs are far superior to loans in financing higher education: Properly designed, they better align the incentives of education providers while giving student borrowers considerably better downside

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protection against the risk of future financial hardship because of a recession, illness, or other unforeseen circumstance.

Second, there is already a well-established private student loan market, which ISAs are poised to disrupt alongside federal loans. If the federal government makes it harder to offer ISAs, more students will turn to private loans, which will be higher-cost and impose future payment obligations that do not fluctuate with income capacity and are not dischargeable in bankruptcy.

ISAs are here to stay and likely to expand as their advantages over traditional loans become apparent. Advocates of consumer welfare should embrace legislative efforts to get ahead of potential problems by establishing protections today.

## ESSENTIAL ISSUES

Efforts to establish consumer protections for ISAs should focus on several core aspects. Unlike loans, where the primary variable term is the interest rate, ISAs have multiple parameters that determine how much students will pay and what risks they will assume. Strong disclosure rules are necessary so that students understand the contracts they are entering into. The proposed ISA Student Protection Act would go one step further and set legal restrictions on how ISA contracts may be designed.

Lawmakers should be wary of directly regulating the parameters of an ISA program, since they may inadvertently give an implicit government blessing to programs with disadvantageous terms. We argue that the most important role for regulators in this space is ensuring robust disclosure rules. In addition, allowing ISAs to be discharged in bankruptcy—a prerogative not allowed for student loan borrowers—should provide powerful incentives against ISA contracts with onerous, unaffordable terms.

**Disclosure.** Perhaps the most critical issue with any new financial product is disclosure: Consumers must know what their obligations are and what risks are involved. Consistent disclosure rules are also necessary to allow students to comparison-shop among ISA providers.

Notably, a lack of strong disclosure rules is one of the central problems bedeviling the federal student loan program. Traditional colleges and universities send financial aid letters to students that often do not clarify that the students will be taking on loans, associating them with other forms of funding such as scholarships, grants, and work study programs that do not require repayment. According to a survey of award letters by New America, these letters rarely include reasonable estimates of monthly payments as is required of private lenders.[1] Traditional colleges also have no "skin in the game" on loan repayment. The more students borrow, the bigger are colleges' revenues. Thus, the current federal loan program provides perverse incentives for colleges to push loans onto students without considering ability to repay. Weak disclosure rules facilitate this. ISAs, on the other hand, impose discipline on education providers where they provide some portion of the financing. If the

[1] Stephen Burd, et al., *Decoding the Cost of College: The Case for Transparent Financial Aid Award Letters* (uAspire, June 2018), www.newamerica.org/education-policy/policy-papers/decoding-cost-college.

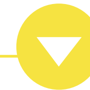
student does not succeed, those providers will not achieve a return on their contribution.

To their credit, many ISA providers are taking disclosure seriously, though issues have risen underscoring the imperative for government standards to ensure transparency around this new financing innovation.[2] Purdue even requires students participating in its ISA program to pass a quiz to help ensure they understand their obligations. But, as ISAs become more mainstream, there is the potential for unscrupulous providers to enter the market. Disclosure rules will help avoid a repeat of the transparency problems plaguing traditional loans and provide meaningful opportunities for students to compare the terms of different ISA offerings.

**Minimum income threshold.** ISAs typically set a minimum income threshold. When a student's income dips below this amount, payments are set to $0 until income climbs back above the threshold again. The proposed ISA Student Protection Act sets this minimum threshold at 200% of the federal poverty line ($25,520 in 2020). The idea is to relieve financial pressure on students who may be unemployed or have low income, since making any payment may be burdensome for students in that situation.

However, most ISA programs voluntarily set a minimum income threshold considerably higher than the parameters set in the bill. For instance, the program at General Assembly sets a threshold of $40,000, and other coding boot camps have gone as high as $60,000. ISA providers find that voluntarily setting a minimum income threshold increases student confidence in the education on offer: If

[2] National Consumer Law Center, "Advocates File Complaint with FTC; Urge Enforcement Action Against Vemo Education for Its Deceptive Marketing of Income-Share Agreements to Students," June 1, 2020, www.nclc.org/media-center/advocates-file-complaint-with-ftc-urge-enforcement-action-against-vemo-education-for-its-deceptive-marketing-of-income-share-agreements-to-students.html.



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the student's earnings don't exceed a certain amount, the school doesn't get paid.

Lawmakers should think carefully about prescribing limits considerably different from those currently offered in the market. The lowest minimum income threshold permitted by law could become a market norm if Congress gives it a stamp of approval, even if lawmakers themselves intend for minimum income thresholds that low to be outliers. Government-set limits could become a rationale for much more onerous terms, since they have the seal of government permissibility.

Clear disclosure requirements around terms, combined with the ability of students to discharge ISA obligations in bankruptcy, will promote competition and have a powerful disciplining effect on ISA providers that try to impose overly burdensome terms. It may not be necessary for lawmakers to prescribe a minimum income threshold, and it could be counterproductive if ISA providers were to migrate to government-mandated limits instead of letting market competition drive terms that will likely be much better for students.

**Percentage of income required.** Another component of ISAs is the percentage of income students are required to repay if their earnings exceed the minimum threshold.

The proposed ISA Student Protection Act cap of 20% is considerably higher than the current norm in the ISA market. Notably, it applies to all income, not just amounts above the 200% federal poverty line threshold, and could lead to unaffordable payment burdens, particularly for graduates in high-expense areas.

Take a graduate living in Baltimore, where living expenses for a single household are around $30,000, with taxes adding another $9,000. A student earning the average starting salary for a college graduate of about $49,000 would have around $10,000 left over for discretionary expenses. Yet a 20% payment of the student's total income would consume all of that discretionary spending money and then some. Government approval of charging an onerous 20% of total income could give unscrupulous ISA financiers "cover" for abusive terms.

At the same time, participants with higher incomes could manage a larger share of income, and providers may wish to exploit this fact to cross-subsidize lower-earning participants. Thus, leaving some flexibility in law for high percentages may be warranted. Alternatively, lawmakers could create a safe harbor for payment terms that are closer to market norms. ISAs with terms within the safe harbor range would generally not be subject to enforcement actions. ISAs with terms outside the safe harbor range would not be banned, but the CFPB would have authority to bring enforcement cases against those providers if their ISA terms are unfair, deceptive, or abusive. This is similar to the approach used by the CFPB in mortgage credit. Innovation outside the safe harbor parameters is permitted but subject to the CFPB's ability to bring enforcement actions against egregious practices.

**Overall cap and time limit.** Generally, ISA participants will no longer be required to make payments after their cumulative payments have reached a certain multiple of the original amount received. General Assembly, for instance, caps total payments at 1.5 times the amount of tuition. If a participant does not reach this overall cap, the ISA obligation eventually expires after a specified period of time. Regardless of how much they have paid, the student is completely freed from their obligation after this point.

The proposed ISA Student Protection Act does not set a maximum overall cap, but it does set a maximum time limit of 30 years. If an ISA requires a high percentage of income, the maximum time limit is less than 30 years. Most current ISA programs specify much shorter time limits. General Assembly has a limit of four years, and Purdue has a limit of 10.

If ISAs ever expand to very expensive educational programs, such as medical schools, the 30-year limit might seem more reasonable. But as with other ISA parameters, lawmakers should be wary of giving an implicit stamp of approval to ISAs with 30-year time horizons, as not all are justifiable. Notably, even our troubled federal student loan program offers repayment options discharging payment obligations after 20 years (10 years for those with careers in public service).

If policymakers must regulate parameters, an alternative solution would be to set a maximum overall cap on payments as a multiple of tuition. This would be more akin to state usury laws that apply to traditional loans. But the best disinfectant is sunlight: Robust disclosure requirements and bankruptcy protections will do more to shield students than direct regulation of parameters will. Nongovernment organizations can also play an important role in defining emerging best practices, such as Social Finance's "Student Bill of Rights."[3]

[3] "Student Bill of Rights," Social Finance, accessed February 12, 2021, www.socialfinance.org/student-bill-of-rights.

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ISAs hold a great deal of promise, especially compared to traditional loans. But any financial product can be abused, as we learned during the 2008 mortgage meltdown, and we continue to learn from the many problems with traditional student loans. A federal framework for consumer protection will ensure students are not harmed by unscrupulous providers. It will also give colleges and funders the regulatory certainty they need to invest in the model.

However, government should exercise care in setting parameters that could end up being far more burdensome to students than the practices that currently prevail in the market. It is better to impose robust disclosure obligations and guarantee the ability to discharge ISAs in bankruptcy, possibly combined with an overall cap on a student's repayment obligation as a multiple of the original amount borrowed. This would allow for more innovation and customization of ISA funding arrangements, without the appearance of creating government templates that may encourage less advantageous terms than the market would provide.

As traditional colleges and educational startups across the nation continue to prove, ISAs can help students escape the burdens of traditional student loans and enable new forms of education entirely. If designed correctly, smart consumer protections will help the model expand. Congress should do its job to help this promising new area of education finance grow.

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This chapter came from the book *Workforce Realigned: How New Partnerships are Advancing Economic Mobility.*

Learn more at workforcerealigned.org