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# THE EMERGENCE OF INCOME SHARE AGREEMENTS

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Even as the college premium for the average graduate remains robust, the downside risk of attending college—that is, the risk of not completing or failing to realize a higher income after graduation—has also increased over time. Groups of students most significantly affected by this risk are low-income/low-wealth and nontraditional college students, often people of color, who attend educational institutions (particularly for-profit institutions and under-resourced community colleges) that sometimes fail to produce good job outcomes for their students. As student loan repayment burdens have grown, so have policy efforts to provide assistance to struggling borrowers, particularly those with federal student loans. The most notable policy solutions include income-driven loan repayment (payments tied to income) and various loan forgiveness programs. Meanwhile, apprenticeships, skills-based training programs, and other lower-cost alternatives to traditional college enrollment are becoming more popular relative to costly college degrees. This is no doubt attributable to many factors, including the rising price and debt burden of traditional programs and an increased focus on recredentialing and lifelong learning (more often found outside of traditional higher education settings).

Even as outcomes for many students have worsened, the federal government accountability framework has been insufficient to protect the interests of both students and taxpayers, in part due to decades-old performance thresholds for educational institutions to maintain eligibility for federal financial aid and a changing student loan landscape.[1] While most institutions are likely attempting to make decisions in the best interests of the student, there exists a striking lack of connection between the monetary incentives of schools and the financial outcomes of students.[2] The recent direction of reform has not been encouraging for reducing poor outcomes for students (e.g.,

[1] For a comprehensive analysis of the entire college and student loan accountability landscape, see Robert Kelchen, *Higher Education Accountability* (Baltimore: Johns Hopkins University Press, 2018).

[2] As we discuss later in this chapter, maximizing labor market outcomes is not and should not be the sole objective of students or institutions in higher education. That being said, education funding is repaid in dollars, so financial outcomes of students do and should matter.

the dilution of certain guidelines meant to restrict lending for institutions that do not produce reasonable labor market outcomes for their students).[3]

This landscape of rising college costs, loan repayment challenges, and poor alignment of incentives between educational institutions and students/taxpayers has catalyzed a small but rapidly expanding market for alternative approaches to finance all or part of both traditional college degrees and nondegree postsecondary programs. Income share agreements (ISAs) are one such vehicle that follows Pay for Success principles of financing: Students pay a fixed share of their future income toward the ISA only if they make more than the contractual minimum income threshold and up to a maximum total amount. At the same time, education providers receive the full amount of funding from investors only if students are successful. ISAs thus may offer a mechanism to directly align the incentives of colleges with their students' objectives and outcomes, although, as we discuss later in this chapter, designing a sustainable and student-friendly ISA is quite challenging. ISAs can also push institutions to signal the value of their degrees through increased transparency around student outcomes in a market where consumers struggle to assess the value of educational programs.

By 2020, several dozen colleges and universities, as well as numerous alternative educational, vocational, recredentialing, and workforce development programs, were offering ISAs as an option for financing all or part of students' educational expenses. ISAs are offered by some institutions as an alternative to student loans, though students are typically advised to exhaust the more favorably

[3] For an analysis of employment and earnings outcomes of students within the context of the recently repealed Gainful Employment rule, see Stephanie Riegg Cellini and Nicholas Turner, "Gainfully Employed? Assessing the Employment and Earnings of For-Profit College Students Using Administrative Data" (Working Paper #22287, National Bureau of Economic Research, Cambridge, MA, 2018), www.nber.org/papers/w22287.



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priced federal loan options before turning to ISAs. At other institutions and training programs, ISAs are one type of education financing for students who are ineligible for federal student lending or whose programs of study do not participate in the federal loan program. Yet other education providers see ISAs as a way to extend limited institutional resources by recovering at least some of the funding provided to ISA participants to fund future cohorts of students. And some institutions arrive at ISAs for several of the above reasons and others. A few ISA providers market direct-to-consumer, without partnering with a specific educational institution, though the majority of outstanding ISAs in the space today are linked to a school-based or training provider-based ISA program.

## WHAT IS AN ISA?

In its simplest incarnation, an ISA is a contract that obligates students to pay a certain percentage of their future incomes (income share), up to a set number of payments, over a set period of time (payment window) in exchange for funding of educational expenses in the present.[4] The income share varies widely across institutions and sometimes can vary across majors; theoretically, the share could vary with the characteristics of the institution (for direct-to-consumer

[4] In addition to the other excellent chapters in this book, please see our 2019 discussion paper for a longer and more thorough examination of theoretical and practical issues facing modern ISAs: Dubravka Ritter and Douglas Webber, "Modern Income-Share Agreements in Postsecondary Education: Features, Theory, Applications" (Federal Reserve Bank of Philadelphia, December 2019), www.philadelphiafed.org/consumer-finance/education-finance/modern-income-share-agreements-in-postsecondary-education-features-theory-applications.

ISAs) or the personal characteristics of the student. Income shares are typically expressed per the dollar value (say, $10,000) of the funding amount, ranging from as low as 1% to as high as 20% or more per $10,000 in the market today. All ISAs of which we are aware have fixed income shares, but the income share theoretically could take other forms including progressive, variable, or termed as a premium over an index.

Typically, participants begin to make payments once their incomes rise above a certain floor (minimum income threshold) set by the terms of the ISA and will never pay more than a set multiplier of the original funding amount (maximum cap, e.g., 1.5x). An ISA is designed such that payments are limited by the income share at all levels of income. The payment amount scales with income, with no payments due for borrowers earning less than the minimum income threshold or due to certain life events (e.g., enrollment in a course of study).

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To be sustainable, an ISA must be designed with a maximum cap low enough to attract students who expect to have higher incomes post-graduation but high enough to make up for the cost of providing downside protection to students who earn little. That said, some programs have successfully used philanthropic or institutional resources to provide the downside income protection without necessitating a maximum cap higher than the principal plus interest on a typical parent or private loan. In select cases, students never pay more than the funding amount (i.e., the maximum cap is up to 1x for Colorado Mountain College's Fund Sueños ISA).

There are three ways to satisfy an ISA obligation:

1. Reach the payment maximum cap,
2. Make the required number of monthly payments at the required income share (with payments due in periods in which income exceeds the minimum income threshold and not otherwise deferred), or
3. Reach the end of the payment window. Payment timelines usually combine a certain maximum length of time, expressed in months or years, with a certain maximum number of payments (e.g., a minimum of 48 payments over a maximum of 96 months).

Within an existing ISA program, parameters such as income share can vary across cohorts, rather than being fixed, and can be pegged to a given rate of return for investors. For example, the income share for future cohorts could increase if investors are consistently receiving a negative return or decrease if returns are consistently higher than anticipated. Across cohorts, institutions will sometimes also update the terms of new ISAs based on new information on how prior students are performing in the labor market. This can encompass more precise information about student outcomes or simply a change in market conditions because of unanticipated economic conditions (e.g., a pandemic).

## INVESTOR CAPITAL IN THE ISA SPACE

There are various sources of funding for educational expenses, including the educational programs themselves, private investors (purely for-profit, social impact, and/or philanthropic), employers, or rarely, government entities. As

awareness of ISAs has increased, there has been substantial interest in these financial contracts from a wide variety of funders. Any investor capital used to fund the ISA is typically provided to the institution in part upfront (e.g., 50% or 75% of the ISA amount), then payments from students are passed to the investor until a certain threshold is reached (e.g., 10% return for the investor). The institution then receives any remaining payments after this point or at significant junctures (e.g., at student graduation, placement, or after a certain job retention).

Funding for ISAs can be divided into three broad categories:

1. **Yield-based funds**, where a profit-seeking investor seeks a return on capital and expects a return of 7% to 20% (with payment multipliers in the range of 2x to 2.5x);

2. **Evergreen funds**, which generally rely on a combination of institutional funds, philanthropic contributions, and investor capital, with returns just high enough to replenish the fund for future generations (with payment multipliers in the 1.5x to 1.8x range); and

3. **Deferred tuition models**, which seek to recover only a share of the initial investment in the student's education—rarely the full amount—thus "stretching" grant funding by receiving future payments in exchange for education funding from participants who do well in the job market (with payment multipliers in the 1x to 1.2x range).

We can think of these incarnations as progressively more student-friendly and more challenging to scale as we move from yield-based funds to deferred tuition models.

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## THEORETICAL UNDERPINNINGS AND HISTORICAL CONTEXT FOR ISAs

Throughout history, society has injected public funds into higher education systems, where private markets are likely to underinvest due to risk of repayment challenges. Early public sector solutions to the market failure in higher education in the decades after World War II involved federal loan guarantees for educational expenses and featured mortgage-style fixed payments over a set period of time. Robert Shireman in 2017 detailed how income-contingent loan repayment and participation shares in future incomes cropped up in discussions of higher education funding again and again in the 1960s and 1970s at the federal, state, and institutional levels.[5] In fact, several prominent universities—Duke, Harvard, and Yale—attempted their own versions of income-contingent payments in exchange for educational funding, none of which proved workable.

Various administrations and higher education players have revisited income-contingent repayment over the years, with a formal Income-Contingent Repayment Plan introduced for loans funded directly by the federal government (i.e., in the Direct Loan program) during the first Clinton administration. Several additional plans in the same spirit, now called income-based repayment plans, were introduced in 2007 and until as recently as 2015. All that to say: The modern-day notion

[5] Robert Shireman, "Learn Now, Pay Later: A History of Income-Contingent Student Loans in the United States," *Annals of the American Academy of Political and Social Science* 671, no. 1 (2017): 184–201.

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of financing investments in higher education via a share of future income is hardly new. Indeed, roughly 30% of current borrowers in the federal Direct Loan program are enrolled in one of the available income-based repayment plans for student loans. Nor are income-contingent loans purely a U.S. phenomenon; many countries have successfully designed and implemented forms of income-contingent repayment of government-provided student loans, and the most well-known program is likely Australia's.

## THE RISE OF MODERN-DAY ISAs

The more recent surge in interest in, and the availability of, ISAs likely stems from the combination of at least five main factors:

1. The rapid rise in the government's student loan portfolio (both because of the increase in the number of borrowers and in their average balances), principally during and immediately after the Great Recession;

2. The increase in the student's downside risk of investing in postsecondary education because of increased prices, a rapidly changing and uncertain economy, and more unequal returns to college education (particularly for disadvantaged students);

3. The rise in income-driven repayment for government student loans and increased consumer comfort with the notion of payments based on the ex-post realizations of income;

4. The recognition of some of the unintended consequences of extended repayment terms in the federal loan portfolio, which have led to delays in life events (e.g., home ownership) for some young people; and

5. The increased political and public focus on tying the investment in postsecondary education more directly to future job prospects and income.

Altogether, the current financial aid landscape and its heavy reliance on student debt helped create an environment in which some educational programs, students, and philanthropic or profit-seeking investors saw ISAs as an intriguing alternative.

The past 10 to 15 years have seen more attempts at socializing ISAs, including by Lumni, an ISA provider that has been active in Latin America and sought to replicate its success in the U.S. A high-profile early mover in the recent burst of ISA programs was Purdue University, with its Back a Boiler ISA program launched in fall 2016. Back a Boiler garnered significant attention from industry participants, policy circles, and the general public. It was crucial in setting the stage for postsecondary educational programs to offer ISAs more widely as a vehicle for financing higher education. However, while Purdue is perhaps the most well-known provider of ISAs, the Back a Boiler program is not necessarily representative of the ISA market as a whole. For a thorough look at Purdue's program, see the chapter "Back a Boiler" of this book.

## ISA USE CASES

There is considerable diversity of models and implementations in the ISA space today; no two ISAs are alike. The typical ISA program is offered not at a 150-year-old, prestigious, public university known for its scholarly research but rather at a

smaller college or university or at a short-term, accelerated, vocational, or skills-based learning program, ranging from coding academies to HVAC repair courses.

ISAs administered by four-year colleges, such as Purdue University or the University of Utah, tend to have longer payment windows, and they tend to require smaller income shares from students. Funds at these schools are more likely to be evergreen or have deferred tuition than in other settings and are more geared toward gap financing than access at the admissions level (with the exception of Colorado Mountain College's Fund Sueños for noncitizen students ineligible for federal financial aid). In other words, students generally exhaust grant, scholarship, and subsidized government-loan financial aid before considering an ISA for the remaining cost of attendance. There also tends to be more diversity in contract structure, often based on different degrees and programs of study within these schools. For example, Purdue offers different income shares and payment terms based on the student's year in school (sophomore, junior, senior), level of study (undergraduate, graduate) and projected earning profile of the relevant field/major. On the other hand, the University of Utah offers the same income share to all students, but different payment terms based on field of study. Other schools offer the same contract to all students who share certain common characteristics (e.g., GPA cutoff, qualifying majors) or to all students.

***As funding for workforce development programs in the U.S. has fallen dramatically over the past decades, organizations engaged in this field have turned to ISAs to inject capital into public and private workforce development efforts.***

ISAs provided by vocational and skills-based training programs, such as data science programs and coding academies, tend to be shorter and have a tight link to relatively immediate labor market outcomes. The payment term is commensurately short—as little as three to six months for some programs—and the income shares required tend to be higher than those at colleges and universities. At these institutions, the impetus for offering ISAs revolves around expanding access. Many, if not most, do not participate in the Title IV student loan program, meaning students are either paying out of pocket or securing private loans. For some programs, offering an ISA has become a necessary tool for competing for students. Access to ISAs at many programs is not necessarily universal, as plan providers can employ certain knockout criteria (e.g., not offering contracts to individuals with recent bankruptcies or significant defaults) or require that individuals who take on an ISA obligation pass rigorous educational testing. Such policies reduce the risk for ISA providers and investors, but they also reduce the population of disadvantaged or credit-constrained individuals eligible to benefit from ISAs.

As funding for workforce development programs in the U.S. has fallen dramatically over the past decades, organizations engaged in this field have turned to ISAs to inject capital into public and private workforce development efforts. Because of the short-term, often vocational nature of these educational and training programs, many of the typical ISA features discussed previously for accelerated, nondegree programs apply in the workforce development space as well. An increasing number of workforce boards concentrate on outcome-focused approaches to support sustainable workforce development programs through an evergreen fund, as discussed in the chapter "Unlocking Education and Economic Mobility with Income Share Agreements" of this book. ISAs as part of workforce development programs

have proved particularly popular among participants who are ineligible for federal financial aid and are drawn to the "learn now, pay later" aspect of ISAs.

## PROMISES OF ISAs

Given that the market for modern ISAs is both young and relatively small, there is little to no causal evidence on the benefits and risks/costs associated with ISAs for consumers, educational programs, or investors engaged in the market. On a theoretical level, education providers are incentivized to offer education that leads to gainful post-graduation employment for students. Educational programs that provide students with few high quality job prospects theoretically would be forced to either reform their curricula and placement services or else be purged from the market because of a lack of profitability. This incentive is effectively a result of the risk sharing created by some ISA structures in which the burden of financing a student's education is shared by the institution. But since ISAs are a relatively new product and one of many financing methods for students, in reality, institutions have other options, including abandoning the ISA, changing its terms, or becoming more selective about the type of student they admit. Alternatively, in a market typically characterized more by noise than certainty, ISAs could offer a useful signal to students that their education is likely to lead to successful job outcomes—particularly when the ISA program has performed well for several years.

Compared to loans with income-driven repayment (including the possibility of balance forgiveness), both payments scaled by income and the cancellation of the debt obligation are inherent in an ISA contract and available to all participants without special eligibility rules or administrative processes. For comparison, the private student loan market, typically used by families who have exhausted federal financial aid, offers no protections against negative income shocks.[6] ISAs could also relax credit constraints and power an investment in valuable human capital for students who have exhausted their federal loan eligibility and do not have family members willing or able to participate in either the Parent PLUS or private loan markets.

## CHALLENGES AND RISKS OF ISAs

The primary area of concern for critics of ISAs thus far has been contract terms that are unfavorable to students, particularly as they relate to potentially deceptive marketing, high implied annual percentage rates in the event of high realized incomes, potentially insufficient protections in the event of disruptive life events or low incomes, and potentially burdensome aggregate income shares for individuals who take on multiple ISAs or combine ISAs with loans. ISAs are intentionally designed to cross-subsidize low-earning participants by charging high-earning participants more, so the balance between downside protections and upside protections can be difficult to strike. To protect students, ISAs need robust consumer protections that are comparable to those available to student loan borrowers. Thus far, both case law and regulatory enforcement have been nonexistent or inconsistent—partly because the market is so new and partly because many laws applicable to student loans, as written, are not necessarily conducive to being applied to a complex contract such as an ISA without additional regulatory guidance.

As ISA providers must project the income distribution of a cohort of students, program managers need far more than outcomes for the "average" student. Most educational programs unfortunately do not collect (and are often unable

[6] We understand some lenders have considered offering optional "insurance" in the case of low incomes for private student loan borrowers at a price of 2 to 3 percentage points relative to the no-insurance loan rate.

to collect) high quality earnings data on former students, and new programs have no data to inform these projections. Even with perfect retrospective data, individuals who have lower earnings potential or are more risk-averse may be more likely to select an ISA than an alternative form of financing. As a result, the earnings distribution of would-be enrollees can be somewhat different from the overall distribution; this concern is known as adverse selection. Once participants have taken out an ISA, they may have an incentive to earn less or nothing at all and avoid their ISA obligation; this concern is known as moral hazard. At a minimum, these and other issues inherent in designing financial products complicate the task of setting ISA terms that are both profitable (break-even for nonprofit entities) and attractive to would-be participants. Longer-term, ISAs may require more significant ongoing analytics and recalibration of terms for viability. Moreover, the absence of adverse selection or moral hazard in early ISA markets when the product is relatively niche does not necessarily imply that they are not concerns in a future with widespread ISA adoption. This is an endemic issue in consumer finance and one to which ISAs are certainly not immune.

And while an ISA may resonate in the abstract, many families struggle to evaluate the quality of higher education programs because of the diversity of programs and the purposeful obfuscation of quality metrics (for example, at certain for-profit colleges). In other words, some of the value of higher education is often opaque to families; if that were not the case, there would be no need to worry about aligning the incentives of education providers with student outcomes in the first place. The students least equipped to evaluate quality are often the most vulnerable—first-generation college, under-represented demographics, and those facing obstacles or discrimination in the labor market—who are of particular concern to lawmakers,

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regulators, and society at large. In other words, in the case of new programs without a proven track record or those with a very low marginal cost (e.g., many online programs), the signal of offering an ISA may not be correlated with quality. This is less of a concern with traditional colleges, where the cost of education is very high, and the institutions incur the costs well before they are fully reimbursed by student payments. With online and other low marginal cost programs, however, a provider can offer generous ISA terms that might appear to suggest quality when they may actually be a way of creating a claim to be exercised via collections. The source of financing (institution, philanthropy, investors) can have a strong influence on these dynamics. These and other issues underscore the importance of and necessity for clear and strong consumer protections in the market for ISAs, particularly as ISAs promulgate and the possibility of "bad actors" increases.

ISAs, like many novel financial products, have garnered both ardent supporters and fierce critics over the years. A nuanced view recognizes the potential of ISAs to address a number of market failures of the current system but urges legislators and regulators to build important guardrails that can help prevent harmful outcomes for students and institutions. Generally speaking, we find that ISAs hold promise, but some have overstated this since ISAs often share some of the same challenges as other forms of income-contingent payment, including (well-designed) income-driven student loan repayment programs. On the other hand, critics

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highlight important consumer protection questions but tend to understate the promising mechanisms of ISAs around value alignment between educational provider and student and in drawing institutional focus more directly toward measurable student outcomes (financial and otherwise). Ultimately, ISAs are neither a panacea nor a peril, and the devil is in the details.

One key challenge for lawmakers and regulators is that, with so many contract terms at an institution's and investor's disposal, writing regulations that both 1) envision most reasonably predictable means of abuse but also 2) continue to encourage innovation and investment in the sector will be a tough needle to thread. Regardless of what the future holds for financing higher education, we must learn from the many programs (successful and not) that have led to the current challenges around postsecondary education and funding. We recognize the myriad ISAs that educational programs have designed in thoughtful ways to achieve important access, retention, and completion goals for their learner populations, and we anticipate seeing interesting ISA variants in the near future. But we also recognize that the relative success of some ISAs may in part be the result of better data collection processes and increased contact between students and financial aid offices (which can lead to higher rates of Free Application for Federal Student Aid [FAFSA] completion, financial counseling, academic counseling, career development services, and connection with support programs[7]). Implementation of these and other policy changes (e.g., automatic enrollment in income-driven repayment) in the federal loan system—and the accompanying investment in both pre-loan and post-loan servicing—may produce comparable program improvements for student loans. We encourage and look forward to robust program evaluations that can formally assess the ability of ISAs to remain sustainable—and provide value to students and the institutions those students attend.

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[7] Some ISA providers and program managers, such as Better Future Forward, explicitly set a goal of funding these wraparound services—delivered internally or with external partners—as part of the ISA program.