SENATE COMMITTEE ON HEALTH, EDUCATION, LABOR & PENSIONS

www.help.senate.gov
@GOPHELP

Lamar Alexander of Tennessee - Chairman

Risk-Sharing / Skin-in-the-Game
Concepts and Proposals

Goal: Realign and improve federal incentives so that colleges and universities have a stronger vested interest and more responsibility in reducing excessive student borrowing and prioritizing higher levels of student success and completion.

Strategy: Design market-based accountability policies that require *all* colleges and universities to share in the risk of lending to student borrowers.

Problems That Need to Be Addressed:

In fiscal year 2015, the federal government will provide approximately $138 billion in financial aid, in the form of grants and loans, to help millions of students finance the cost of college.[1] Students face few eligibility hurdles in accessing this federal money. Borrowers must only possess a Social Security number, be a U.S. citizen and either 1) have earned a high school diploma or 2) passed an equivalency exam such as the General Educational Development (GED) test. The U.S. Department of Education does not maintain any underwriting standards for undergraduate loan programs and for the most part, the same amount of loan money is available to students regardless of their program of study or financial need.

This federal investment in access is important and has helped nearly two-thirds of students who rely on federal aid to attend the college or university of their choice.[2] Students can choose from among more than 6,000 diverse accredited colleges and universities that participate in federal student aid programs. Colleges and universities compete for these students and the federal student loans and grants that follow them.

While this system of choice and competition has worked well, and remains a hallmark of the success of our American higher education system, there may be some unintended consequences of coupling universal access with generous, easy-to-obtain government financing. This may have

---

[1] U.S. Department of Education, "Student Aid Overview: FY2016 Budget Request," U.S. Department of Education, 2015: O-7, http://www2.ed.gov/about/overview/budget/budget16/justifications/o-sao.pdf.
[2] David Radwin, Jennifer Wine, Peter Siegel, and Michael Bryan, "2011-12 National Postsecondary Student Aid Study (NPSA: 12): Student Financial Aid Estimates for 2011-12," *National Center for Education Statistics*, August 2013, http://nces.ed.gov/pubs2013/2013165.pdf.

helped create an environment of over-borrowing and pricing that is becoming increasingly disconnected from a student's ability to repay. Current federal incentives reward colleges and universities for volume (number of students enrolled and associated loan and grant monies) yet federal policy has few, if any, consequences for institutions that leave students with mountains of student debt and defaulted loans.

Federal policy should not shift away from a focus on ensuring access, but taxpayers and other federal actors do have a reasonable expectation that institutions of higher education maintain a greater stake in, or are better aligned with, their students' success, debt and ability to repay.

The following may represent some examples of misalignments in incentives among institutions, taxpayers and the federal government, and as a result, are potential issues to be addressed in the upcoming reauthorization of the Higher Education Act:

- **Generous cost of attendance policies can allow for significant student debt unrelated to tuition and fees:** According to a recent audit of eight schools by the Department of Education Inspector General, on average, tuition, fees, and books accounted for just 42 percent of the cost of attendance for full-time students. Nearly 60 percent of the remaining costs consisted of transportation, room and board and miscellaneous personal expenses.[3] In 2011-12, 68 percent of all undergraduate borrowers took out the maximum amount of annual federal loans permitted under law. At the same time, approximately 25 percent of student borrowers took out loans that exceeded annual tuition (after factoring grants) by $2,500 or more.[4]

- **Some institutions have high cohort default rates:** While federal law establishes default rate thresholds for participation in federal student aid programs, some institutions continually have high default rates. The national three-year default rate for all colleges and universities is 13.7 percent. Using the most recent Department of Education data, more than 1,800 colleges have default rates above 15 percent and nearly one out of every three borrowers defaulted on their federal student loans at more than 200 colleges.[5]

- **Taxpayers and students bear the burden and consequences of default:** Approximately 7 million borrowers currently hold $99 billion in defaulted federal student loans.[6] According to analysis from the New America Foundation, the average dollar amount of the defaulted student loan is not an insignificant amount, averaging over

---

[3] U.S. Department of Education Office of Inspector General, "Title IV of the Higher Education Act Programs: Additional Safeguards Are Needed to Help Mitigate the Risks That Are Unique to the Distance Education Environment," February 2014, http://www2.ed.gov/about/offices/list/oig/auditreports/fy2014/a07l0001.pdf.
[4] Josh Mitchell, "Student Loans Entice Borrowers More for Cash Than a Degree," *Wall Street Journal*, March 2, 2014, http://online.wsj.com/articles/SB10001424052702304585004579415022664472930.
[5] U.S. Department of Education, "New Data Shows a Lower Percentage of Students Defaulting on Federal Student Loans," September 24, 2014, http://www.ed.gov/news/press-releases/new-data-shows-lower-percentage-students-defaulting-federal-student-loans.
[6] Clare McCann and Jason Deslisle, "Student Loan Defaulters Aren't Who You Think They Are," New America Foundation, October 23, 2014, http://www.edcentral.org/defaulters/.

$14,000.[7] Borrowers who default on their federal student loan face damaged credit ratings with consequences for purchasing a car or a home, and wage and tax refund garnishment.

- **Some institutions have low student completion rates:** Just over a half of undergraduate students complete any degree or certificate within 6 years.[8] Additionally, many student borrowers who drop out often end up in default. Approximately 70 percent of borrowers who default on their loans withdrew from college before completing their program.[9]

Current Law is Conflicting, Arbitrary and Complex:

Colleges and universities assert that they are responsible for providing a quality education to their students who, as with any customers in a free market, are able to take their money elsewhere if unsatisfied. But federal policy that provides taxpayer-backed grants and loans to all students, and rewards institutions for enrollment, may not account for unintended consequences and negative incentives.

A number of federal policy provisions currently exist to address any negative incentives – including institutional cohort default rates, the 90/10 rule, the gainful employment regulation, and other federal requirements.

However, these policies generally are not well-focused, represent top-down government mandates, and are enormously complex in design and implementation. Some policies only focus on a certain sector of institutions instead of holding all schools to the same standards.

Cohort default rates, the percentage of a college's federal student loan borrowers who default on their loans within three years of entering repayment, ensure that only institutions whose former borrowers are able to repay their loans can continue to participate in the federal student aid programs. Colleges and universities with default rates that exceed 30 percent over three years or 40 percent in one year risk becoming ineligible for continued participation in the federal student aid programs.

This mechanism may not be particularly effective. In the Department of Education's most recent announcement of cohort default rates, using the fiscal year 2011 cohort, only 21 institutions – out of approximately 6,000 institutions – were sanctioned for rates that exceeded federal

[7] New America Foundation, "Background & Analysis: Federal Student Loan Default Rates," October 28, 2014, http://febp.newamerica.net/background-analysis/federal-student-loan-default-rates.

[8] D. Shapiro, A. Dundar, X. Yuan, A. Harrell, and P.K. Wakhungu, "Completing College: A National View of Student Attainment Rates – Fall 2007 Cohort" (Signature Report No. 8), National Student Clearinghouse Research Center, November 2014, http://nscresearchcenter.org/wp-content/uploads/SignatureReport8.pdf.

[9] Mark Walsh, John Pierson, and Cynthia Battle, "Default and Delinquent Management," Information for Financial Aid Professionals (IFAP), U.S. Department of Education, http://ifap.ed.gov/presentations/attachments/5DefaultandDelinquencyManagementV1.pdf.

thresholds.[10] Even then, institutions facing a potential loss of institutional eligibility in Title IV programs are afforded a generous appeals process that results in minimal consequences. The number of institutions actually kicked out of the federal student aid program is shockingly small. According to the Congressional Research Service, just 11 colleges and universities since 1999 have ever been removed from the Title IV student aid programs because of high cohort default rates.

A recent article in *The Economist* argues that the binary outcome of cohort default rate thresholds is particularly ineffective in altering institutional behavior:

"[Universities] already have some incentive to ensure their alumni do not crash and burn: if a university's student-loan default rates rise beyond 25%, then its students no longer have access to federally backed loans. This nuclear threat has been effective against the most egregious offenders, but until colleges approach that threshold, there is little reason for them to steer students in more remunerative directions."[11]

Even more concerning, Department of Education enforcement of cohort default rates is uneven and inconsistent. Recently, officials at the office of Federal Student Aid unilaterally "adjusted" downward the default rates of certain institutions facing loss of Title IV eligibility, thereby keeping them qualified for continued participation in the federal programs.[12] There have been allegations that some institutions may manipulate cohort default rates by pushing students into deferment and forbearance repayments plans that effectively keep borrowers from defaulting during the three-year window of measurement.

Those colleges and universities at which nearly one in three borrowers default on their federal loans escape any serious consequences and are given little incentive to lower tuition, reduce student debt, or increase program performance. These findings raise serious concerns about the efficacy of cohort default rates as currently constructed.

The 90/10 rule, which applies only to for-profit institutions, also does not result in appropriate institutional risk in Title IV programs. The rule requires proprietary institutions to derive at least 10 percent of their institutional revenues from non-federal student aid programs. Some argue that the basic premise of 90/10 is to ensure that taxpayers do not fully subsidize programs that do not have a need for, or cannot attract, private, non-federal financing. Instead, 90/10 actually creates an artificial floor for tuition at these institutions. Because of the increase in Pell Grants and high

---

[10] U.S. Department of Education, "New Data Shows a Lower Percentage of Students Defaulting on Federal Student Loans," September 24, 2014, http://www.ed.gov/news/press-releases/new-data-shows-lower-percentage-students-defaulting-federal-student-loans.

[11] "Making college cost less," *The Economist*, April 5, 2014, http://www.economist.com/news/leaders/21600120-many-american-universities-offer-lousy-value-money-government-can-help-change.

[12] Jeff Baker, "Adjustment of Calculation of Official Three Year Cohort Default Rates for Institutions Subject to Potential Loss of Eligibility," *U.S. Department of Education Information for Financial Aid Professionals (IFAP)*, September 23, 2014, http://www.ifap.ed.gov/eannouncements/092314AdjustmentofCalculationofOfc3YrCDRforInstitutSubtoPotentialLossofElig.html.

federal student loan limits, for-profit institutions argue 90/10 creates a perverse incentive where they must raise their tuition in order to generate revenue that is not counted as federal funds.

The gainful employment regulation additionally falls short of creating an appropriate mechanism for holding colleges accountable. The regulation's stated objective is to ensure that only college and university programs that leave students with "affordable" levels of debt in relation to their earnings, defined at an 8 percent debt-to-income metric, can continue to participate in federal student aid programs.[13] This approach, however, relies on arbitrary and elaborate government definitions of what is a manageable amount of student debt—definitions that fail to take into account the evidence of non-repayment or failure to meet obligations (default).

Many of these and other "accountability" mechanisms have in fact become cost drivers for institutions of higher education. The gainful employment regulation alone will cost institutions untold millions of dollars and require an additional 7 million hours of staff time to comply.[14] Burdensome and conflicting reporting requirements require institutions to hire additional compliance staff to report information that is rarely used by consumers to make decisions about college enrollment.

New Approaches – Risk-Sharing and Skin-in-the-Game:

Instead of blunt government regulations and policies that are complex and conflicting, federal law should provide colleges and universities participating in the federal aid programs with market-oriented systems that enable these institutions to lower student borrowing yet still be held accountable for financial risks to students and taxpayers. This new set of policies may be considered risk-sharing or skin-in-the-game.

Under these proposals, the risk of enrolling a student would be shared among all those who finance a student's education: the student, the federal government, and now, the institution.

This would ensure that colleges and universities have a clear financial stake in their students' success, debt, and ability to repay their taxpayer-subsidized student loans. It would encourage colleges and universities to establish appropriate admissions practices for at-risk or uncommitted students, motivate students to complete more quickly, and graduate students with less debt. Skin-in-the-game policies could also incentivize colleges and universities to be more thoughtful about creating free "trial programs" for at-risk populations needing remediation or seemingly uncommitted students who may benefit from limited borrowing opportunities. It is worth repeating: approximately 70 percent of borrowers who defaulted on their loans withdrew from college before completing their program. Institutions can minimize their risk by deploying more resources into academic or other support services to drive on-time completion, success, and ultimately repayment of loans.

---

[13] U.S. Department of Education, "Fact Sheet on Final Gainful Employment Regulation: Details of the final regulations and its impact," http://www2.ed.gov/policy/highered/reg/hearulemaking/2012/gainful-employment-fact-sheet-10302014.pdf.

[14] U.S. Department of Education, Final Regulations, "Program Integrity: Gainful Employment," Federal Register 79, no. 211 (October 31, 2014): 64889, http://www.gpo.gov/fdsys/pkg/FR-2014-10-31/pdf/2014-25594.pdf.

With 6,000 diverse institutions of higher education, a one-size-fits-all approach to skin-in-the-game would be inappropriate and inflexible. Federal law should be designed to allow institutions to maximize financial accountability that works with their own individual mission, while still ensuring to students and taxpayers that risk is being shared.

Concepts:

Structuring a federal policy mechanism for risk-sharing can take many shapes, sizes and pathways. The following are general concepts that some have proposed as ways to construct a legislative framework:

Repayment of Federal Student Loans: Colleges and universities assume a liability based on some factor related to their former students' repayment of federal student loans.

Current and historical commentary on skin-in-the-game concepts and proposals often revolves around this idea. Former U.S. Secretary of Education Bill Bennett writes in a recent book of skin-in-the-game as a solution through which each college pays "a fee for every one of its students who defaults on a student loan, or have a 10 to 20 percent equity stake in each loan that originates at its school."[15] *The Economist* recently wrote that "If [universities] were made liable for a slice of unpaid student debts—say 10% or 20% of the total—they would have more skin in the game."[16] Support for this type of skin-in-the-game comes from a variety of higher education observers across the political spectrum from the right-of-center American Enterprise Institute and the U.S. Chamber of Commerce to the Institute for Higher Education Policy.

It is also important to note that the Higher Education Act already establishes a skin-in-the-game concept based on repayment of loans. For example, as a condition of institutional eligibility for federal student loans, foreign nursing schools are required to:

"reimburse the Secretary for the cost of any loan defaults for current and former students included in the calculation of the institution's cohort default rate during the previous fiscal year."[17]

Recent legislation sponsored by Senators Reed (D-RI), Durbin (D-IL), and Warren (D-MA) would expand this concept to some U.S. colleges that have high borrowing rates and high student loan default rates.[18]

There are many pathways and options to deliberate when utilizing federal student loan repayment as a framework for skin-in-the-game. Listed below are some organizing principles and choices for consideration:

---

[15] Bill Bennett and David Wilezol, *Is College Worth It?* (Nashville: Thomas Nelson, 2013), 54.
[16] "Making college cost less," *The Economist*, April 5, 2014, http://www.economist.com/news/leaders/21600120-many-american-universities-offer-lousy-value-money-government-can-help-change.
[17] 20 U.S.C § 1002.
[18] Protect Student Borrowers Act, S. 1873, 113th Cong. (2013).

<u>Participation (what colleges and universities would be subject to risk-sharing)</u>:

1) All colleges and universities that participate in federal student aid programs would be subject to risk-sharing;
2) Colleges and universities with borrowing rates above 50 percent would be subject;
3) Colleges and universities with borrower-based default rates above 15 percent would be subject; or
4) Colleges and universities with borrower-based default rates above the national default rate from the previous year, or a similar "norm-referenced" rate would be subject.

<u>Metric (what instrument are colleges held to)</u>:

1) Cohort default rates (percentage of borrowers who defaulted within three years);
2) Dollar-based cohort default rates (percentage of dollars in default); or
3) Loan repayment rate (percentage of borrowers who are current and paying principal balance on their loans).

<u>Threshold/Trigger (what triggers an institution's liability)</u>:

1) Any default by a former student loan borrower;
2) Sliding scale on borrower-based default rate (0-10 percent; 10-15 percent; 15-20 percent; 20-25 percent; 25-30 percent; 30 percent-plus);
3) Borrower-based default rates above the national default rate from the previous year (13.7 percent), or similar "norm-referenced" rate; or
4) Loan repayment rate below 50 percent.

<u>Liability (what is the impact on colleges and universities):</u>

1) Penalty Payment: College and universities would remit a portion of defaulted student loan dollars to the Department of Education:
   a. Sliding scale of payment based on dollar amount of defaulted student loan dollars in a cohort.
   b. Fifty percent of dollar amount of defaulted student loan dollars in a cohort.

2) Institutional Sanction: Colleges and universities would face a Department of Education sanction:
   a. Limit growth on enrollment or the amount of federal student aid awarded based on the previous year's total.
   b. Lose access to a portion of other federal funds.
   c. Other sanctions/restrictions on colleges and universities.

There may be other ways or variations in designing a skin-in-the-game framework:

Loan Guarantees on Completion/Retention: Colleges and universities would guarantee a percentage of the loan amount for current students.

For example, some countries have established loan programs through which the college is responsible for a decreasing share of the loan amount as students progress through their degrees.

To illustrate, colleges could be responsible for 90 percent of the capital plus interest of the loan for a student's first year, up to 70 percent for the second year and 60 percent for the third year and beyond.[19]

Cost Structure: Colleges and universities assume different liabilities based on the loan amount associated with some portion of an institution's cost of attendance.

For example, since a school's primary responsibility is to teach and educate students, the school would assume some responsibility of loan debt accrued from just institutional tuition and fees.

Federal Student Aid Insurance Fund: Colleges and universities would pay a yearly premium into an insurance fund based on a percentage of the institution's previous year's volume of federal financial aid – Pell grants and federal student loans – and other risk factors such as student withdrawals and non-completions. This up-front payment would increase or decrease each year based on a variety of risk factors.

Other colleges and universities are embracing student loan insurance programs, not necessarily for accountability purposes, but to increase admissions yield and strengthen their appeal to prospective students. For example, Adrian College in Michigan recently started a program called AdrianPlus that reimburses a graduate's loan payments if he or she doesn't graduate with a job earning at least $37,000 a year.[20] Programs like AdrianPlus could be restructured and reexamined to see if insurance fund concepts merit an appropriate federal policy for institutional skin-in-the-game.

Other Principles and Questions to Consider:

- Colleges and universities lack authority and tools to manage student debt levels. Federal student aid acts as an entitlement and recipients are entitled to their full amount of federal student aid money, regardless of whether all of the money is needed for educational expenses.

- Accountability provisions or new policies related to skin-in-the-game or risk-sharing cannot be constructed in a vacuum and must be conditioned upon examination of other provisions in current law.

- Unintended consequences must be examined to ensure that institutions do not tighten admission standards in a way that leads to the admission of only students who the institution expects to succeed or are at low risk of default, dropout, or failure. Policy proposals that incent institutions to enroll these at-risk students and provide incentives, whether monetary or regulatory relief, should be considered.

---

[19] D. Bruce Johnstone and Pamela Marcucci, "Financially Sustainable Student Loan Programs: The Management of Risk in the Quest for Private Capital," University at Buffalo Graduate School of Education, 2007, http://gse.buffalo.edu/org/inthigheredfinance/files/publications/student_loans/(2007)_financially_sustainable_student_loan_programs_the_management_of_risk.pdf.

[20] "Loan Payback Assistance," Adrian College, http://adrian.edu/uploads/files/adrianplus_brochure.pdf.

- Skin-in-the-game proposals that utilize repayment of federal student loans may not necessarily take into account challenging labor markets and business cycles that are outside of an institution's control.