

Promoting Genuine Competition in Private Financing for Higher Education

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As policymakers and the public fret over the price of college and increasing debt loads, the federal student loan program has come under ever-increasing scrutiny. With \$1.3 trillion in federal student loans outstanding to 42.4 million borrowers, policymakers must ask whether the current loan system is helping achieve our broader goals of access and success in higher education while maintaining fiscal responsibility. In the past few years, objections to student loans have gained traction, with the idea that students should be able to attend college without owing any debt upon graduation or without paying any tuition garnering considerable support. Proposals for lower interest rates on existing loans and more forgiveness options have also gained wide acceptance. Unfortunately, these proposals suffer from several issues, including the cost to federal and state governments, as well as being an inefficient use of funds. And, most troubling, these policies solve a problem defined by a media narrative that is not supported by facts.

The current loan system has issues, though different ones than the media typically report. For borrowers who complete a degree, federal loans have been a great deal for many. A 2014 Brookings Institution study by Beth Akers and Matthew Chingos found that the average increase in earnings for households with college degrees far outpaced the increase in debt over the last 20 years. They also found that “the monthly payment burden faced by student loan borrowers has stayed about the same or even lessened over the past two decades” (Akers and Chingos 2014, 2). Student loans help a lot of people, with the added benefit that those borrowers pay back the loans to the government.

But beneath those averages lurk disturbing trends. To the extent that a student loan crisis exists, it is a crisis because 49 percent of borrowers who ought to be repaying their loans are not—they are either in default or in forbearance or delinquency.¹ And it is not because none of these borrowers can afford to make payments, because a variety of options allow borrowers to pay based on an affordable percentage of their income. Rather, borrowers face a complex repayment system that at times nearly encourages them not to pay (Delisle and Holt 2015). Another Brookings study showed that of borrowers who entered repayment in 2012, 57 percent had not paid a dollar toward their principal after two years of repayment, compared with 9 percent in 1986 and 34 percent in 2000 (Looney and Yannelis 2015). That number is both a result of borrowers failing to make payments that are due and of repayment plans that allow balances to grow even when borrowers are in good standing.

Some conservative reformers see private financing as an answer to these woes. These reformers argue that private financing propels the American economy. Because financiers must earn their money back to stay in business, they have a strong incentive to identify the most profitable and cost-effective

products. In financing students to attend higher education, the financier only earns a profit if the student succeeds—the student needs to earn an income to be able to repay. Therefore, financiers should help steer students toward the programs in which they are likely to pay back their loans because they earn a higher income afterward, the cost of the school was low, or a combination of both. That, in turn, forces schools to compete on cost and quality and improve the system for students.

Unfortunately, that is not how it works, and it is not just because existing federal programs crowd out private dollars. Although private financing could play an important, and much larger, role in higher education, it is not the silver-bullet solution some market reformers suggest.

That is because of characteristics of the higher education marketplace. At first glance, one would assume the US student loan market should be a hotbed of private financing. College is a lucrative investment for students on average. Lenders should be eager to lend money to students who attend quality programs, as the increase in earnings that results from the education those students receive should more than cover the cost of the loan over time.

But private lenders have never been willing to finance undergraduate students because the bet on each student is so uncertain. Although the averages work out for undergraduates who complete degrees, it is hard for a lender to know who will succeed.

Perhaps if lenders could better predict a student's success, this would be less of a problem. But lenders are accustomed to assessing whether to lend by looking backward at a borrower's historic decisions (often reflected in his or her credit score). An 18-year-old with great potential has no credit history, and it is difficult to predict which borrowers will succeed. A report from the American Enterprise Institute showed that most private student lenders use this type of "backwards-looking underwriting" (Kelly and James 2016).

Adding even more risk to the lender, the 18-year-old seeking a college degree has no collateral—no house to seize, as is the case with a mortgage. Over 90 percent of new private undergraduate student loans require a cosigner, usually a parent with a credit score (Kelly and James 2016). Most private student loans are, therefore, personal loans to the cosigner dependent on the cosigner's ability to repay. Thus, if the market consisted only of private loans, many promising students would be priced out of college because of their lack of credit history or their family's subpar credit history. Private lenders tend to offer loans with lower interest rates to students from families with high credit scores and high and more consistent sources of income. Even with a cosigner, low-income families may not be offered a loan. This is inconsistent with the federal government's goal of helping students with limited resources, especially those from low-income families, go to college.

This is a market failure, an underprovision of credit to students who would otherwise, on average, succeed and pay back their loans. As long as Americans want to maximize opportunity for their fellow citizens and the capabilities of the American workforce, the federal government must have a role in providing credit for prospective undergraduates.

Nevertheless, there is still potential for the private market to play a greater role in higher education financing. One problem with the current system of federal aid is that it does not reward schools for keeping costs to the student down and preparing students for the workforce. Whether students go on to high or low earnings, whether the school costs a lot or a little, enrolled students have access to the same federal funding. Where appropriate, private financing can benefit both consumers and the overall economy by revealing value, rewarding cost-effective and efficient educational providers, and punishing costly, bloated, and fraudulent actors. This memo will explore how to create space for productive private financing in higher education, but first explains why a popular proposed solution is not really private financing, but, in fact, corporate welfare.

What Not to Do: Corporate Welfare for Banks

From the inception of the federal student loan program up to 2010, most federal student loans were issued by private lenders but guaranteed by the federal government. In the 1960s, there was some logic to this. Although Congress did not want to become a lender, banks did not want to lend to students, so the government subsidized lenders to subsidize students. But student demand for loans exceeded the supply of lenders. Thus, Congress needed to increase subsidies. By 1980, the government was giving generous subsidies to lenders while assuming nearly all default and credit risk, paying banks a hefty sum to be a pass-through. This state of affairs continued, with slight modifications, until 2010 (Delisle 2017). In return, the lenders were given strict rules on what interest rates to charge and who should get loans, eliminating competition in underwriting standards. It was a win-win (and a windfall) for the banks. If the borrowers repaid their loans, the banks earned a profit. If the borrowers defaulted, the banks still earned a profit from the government (Delisle 2017). And, as can be expected from any corporate welfare program, it was fraught with fraud and abuse, with many scandals costing the government even more money.²

By the time Congress eliminated bank-based lending for federal student loans, there were no private-market forces in the guaranteed loan system. It was a large, expensive transfer of dollars from the government to the banks, with the government retaining all the risk and the banks retaining all the profits. When Congress switched to the direct-lending program (where the government originates the loans and uses contractors to service them), they saved \$62 billion, money that Democrats used to fund the Affordable Care Act.³ It would be a mistake to bring back this expensive corporate welfare program.

What to Do: Promote Genuine Competition in Higher Education Financing

Rejecting bank-based lending does not mean abandoning private-market solutions, but instead embracing policies that promote genuine competition and reward value in the higher education marketplace. These policies include eliminating federal loans to parents of students, capping the amount of federal loans offered to graduate students, and creating a transparent and favorable regulatory environment for new financing options.

Eliminate Parent PLUS Loans

Although there is a clear market failure in undergraduate student lending and an economic justification for federal intervention, no such justification exists in the loan market for parents of students. It makes sense for the government to lend to students because the student will benefit from the education and should be able to pay off the loan. Not so with parents. Parents of college students have had ample time to build a credit history and can expect no earnings boost from their children graduating from college. And yet, the federal government offers federal loans, with little underwriting, to any parent of a college student. Worse still, there is no cap on the amount the parents can borrow. After subtracting other aid, parents can borrow the total amount charged for tuition, room and board, and other living expenses.

A robust private market provides credit to parents with sufficiently good credit history to borrow money to pay for their children's education. Of course, that means that some parents with bad credit would not be able to get loans in a purely private market. That is a good thing.

By issuing unlimited amounts of debt, with few questions asked, to parents with limited ability to repay, the federal government has become one of the largest subprime lenders in the country. Of dependent students in 2012 whose parents' income was less than \$30,000 a year, just under 10 percent had Parent PLUS loans.⁴ These parents, with nowhere else to turn, are offered Parent PLUS loans, sometimes as part of an award letter issued by the school, with no other loan option available. (The award letter also includes Pell grants, federal student loans, and other federal, state, and institutional aid.) If any private lender did this, the Consumer Financial Protection Bureau would have them in court.

But Parent PLUS loans also hurt students in less obvious ways. By making it so easy for parents to take out an unlimited amount of debt, PLUS loans reduce the incentive for schools to keep tuition low. They also make alternative providers outside the federal student aid system even less attractive. The loans obscure value.

The biggest barrier to eliminating Parent PLUS is that, unlike the federal *student* loan program, the parent loans make money for the government. That is because there is a large contingent of creditworthy borrowers who pay high interest rates, often higher than they would in the private market. They pay the higher rate because of the ease of the process, the monopoly the government has in the award letter (because schools issuing the letter are strongly discouraged from displaying a private loan), and the brand value of a federal government loan.

Parent PLUS should be eliminated, allowing billions in new private financing to enter the market to offer lower rates to creditworthy parents while protecting low-income parents from loans they may not be able to repay.⁵ Some low-income students would struggle to pay for certain types of schools if this program were eliminated. After the US Department of Education instituted stricter credit standards for Parent PLUS loans in 2011, enrollment at Historically Black Colleges and Universities declined 3.4 percent, a phenomenon at least partially explained by the restricted access to PLUS loans. A study by the Department of Education showed that schools across the country saw decreases in enrollment of low-income students because of the change.⁶

But offering parents loans they cannot pay back is no way to support Historically Black Colleges and Universities or low-income students. To address potential issues of access, dependent undergraduate students should be able to borrow more federal loans in their own name. Independent students can already borrow \$9,500 for their first year, compared with \$5,500 for dependent students whose parents qualify for PLUS loans. But this discrepancy does not make sense for low-income families. All undergraduate students should have the same loan limits, regardless of dependency status. Schools where increasing loan access to undergraduate students by \$4,000 is not enough might lose some students to less expensive institutions. The purpose of loan limits is to protect students and impose price discipline on schools.

Eliminate Graduate PLUS Loans

There are two main federal loan programs available to graduate students. The Stafford Loan Program, started in its modern form in 1994, allows graduate students to borrow up to \$20,500 a year.⁷ Since 2006, graduate students have been able to supplement those loans with PLUS loans, which allow them to borrow an unlimited amount up to the cost of attendance (tuition plus living expenses) (Baum et al. 2016). As with loans to parents, there is no clear evidence in practice or in theory that there is a market failure in the private loan market to graduate students. This is true for two reasons.

First, graduate students have bachelor's degrees, so they are likely to have high, stable earnings when they finish their education. They have also shown an ability to persevere in higher education. They have had time to build a credit history, especially because most graduate students do not matriculate directly after earning their bachelor's degrees.⁸

Second, many graduate degrees lead to promotions or new careers with higher earning power. This makes it easier for lenders to bet on students.

Since 2006, graduate students can borrow up to the cost of attendance (tuition plus living expenses) from the federal government, no questions asked. Although this program has been a boon to graduate schools, it has been a drag on taxpayers and the economy. As researchers Sandy Baum and Matt Chingos point out in an accompanying memo on loan repayment, the program is expensive because of generous loan forgiveness provisions. Although eliminating loan forgiveness might help solve the problem of excessive graduate borrowing, there are issues with such a proposal. Most importantly, there are several graduate degrees that lead to high debt burdens and low income after graduation, so even without forgiveness, many borrowers will never repay their loans if they use income-based repayment.

Although there is justification for eliminating all federal graduate loans, such a move would create too many immediate economic shocks.⁹ The private market, having shrunk because of the federal programs, needs time to mature. Although some lenders now incorporate "forward-looking underwriting," many do not. Thus, the government should eliminate the Grad PLUS program, created in 2005, and leave the Graduate Stafford Loan program, which allows for students to borrow up to \$20,500 a year. This would allow private lenders to develop more robust underwriting practices and

servicing capacity while lending on the margin, helping students top off any difference between the federal loans and cost of attendance.

Before Grad PLUS loans, the Stafford program allowed for higher limits for certain fields of study, such as medicine. Because of the long period doctors go through in school and residency programs while earning little, there is justification for such a carve-out, along with exceptions for a handful of other professional degrees. To ensure no graduate borrowers already enrolled suddenly cannot finish their programs, Grad PLUS should be eliminated for new borrowers only.

As with eliminating Parent PLUS loans, lowering federal graduate student loan limits will restrict access to graduate school, at least in the short term. Many K-12 teachers, for instance, earn more if they have a master's degree, and some are required to have one. Yet a study has shown the costs of those programs are rarely covered by increases in earnings for teachers.¹⁰ If it is difficult for low-income teachers to attend graduate degree programs, states and school districts might need to pay higher salaries or change their requirements for master's degrees. After all, there is little evidence to suggest that master's in education programs make better teachers. That some states will not change, and thus some low-income teachers will not have access to expensive master's in education programs, does not justify a massive federal intervention.

Create a More Transparent and Favorable Regulatory Environment for New Private-Market Alternatives

Despite the significant federal role in lending to undergraduate and graduate students and to parents, new innovations in higher education financing are developing. Most visible among them are Income Share Agreements (ISAs), in which a borrower agrees to pay a set share of income for a set period in return for financing for higher education. This approach could distribute risk among financier, school, and student more evenly than traditional loans.

In an example of an Income Share Agreement, a student might agree to pay 5 percent of future income for 10 years in exchange for \$5,000 to finance his or her education. No matter how much or how little that student earns (and thus pays), the obligation ends after 10 years. There is no balance, as the Income Share Agreement functions more like a time-bound equity investment. This differs from federal income-based repayment options, where the borrower owes a balance with interest, and the obligation ends either when the balance is fully paid or when the borrower reaches the forgiveness term.

Income Share Agreements offer students certainty that they can afford the monthly payments, though they will not know the amounts they will have to pay when they take out the ISAs. With private student loans, students know the exact amount they will pay, but not whether they can afford it. For some students, this makes an ISA superior because it offers comfort they will never have unmanageable debt. They have flexibility in career choice because they will not need to earn a high income to pay off their obligations. Income-based repayment options for federal student loans are subsidized by the government, making them more generous than ISAs.

There is a potential issue that if students will repay federal student loans using income-based options *and* have ISAs, they may owe a high share of income. This issue can be addressed with legislation, ensuring no one owes too high a share of his or her income. For instance, borrowers could never be allowed to commit to owing more than 25 percent of their income through income-based mechanisms. So if borrowers have federal loans with a repayment obligation of 10 percent, they would not be able to commit more than an additional 15 percent of income to private lenders (James and Holt 2015).

This form of lending could inject capital into new and innovative nonaccredited short-term programs, such as computer coding boot camps and other providers whose reputation is more directly tied to labor-market outcomes. Several companies already offer such arrangements. There is also a high-profile ISA pilot for bachelor's degree students at Purdue University.¹¹

Although variations of the idea of ISAs have been around since the 1960s, and several attempts have failed, this time seems different. More availability of data and the ability to predict outcomes plus a more receptive policy and regulatory community mean ISAs may become a viable form of alternative financing for higher education at scale.

But part of the problem with getting investors for these new financing vehicles is the lack of regulatory clarity. Bills such as those introduced by Senators Todd Young and Marco Rubio address these issues while providing consumer protections.¹² By including consumer protections, these bills could gain bipartisan support, and their passage would promote this new type of financing.

Other regulatory tweaks might be necessary for forward-looking underwriting of private loans, a concept that would be especially useful for the graduate loan market. Recent research by the American Enterprise Institute suggests that many lenders are afraid of engaging in forward-looking underwriting for fear they may violate the fair lending laws from the Equal Credit Opportunity Act (Kelly and James 2016). This law was enacted to ensure low-income borrowers were given fair access to credit. But, perversely, the law appears to be stopping lenders from considering low-income students with a clear potential to succeed. Policymakers should examine the options for modifying these fair-lending laws to allow for more forward-looking underwriting. Ideally, tweaks to the existing laws would allow lenders to use a combination of characteristics, such as grade point average and the outcomes of the graduate school the student will attend, to underwrite the loan. Although some lenders are experimenting with such approaches, they do so operating in murky legal waters.

Conclusion

More private financing in higher education could reward efficient, low-cost providers and push other institutions to lower prices and improve outcomes. But such financing will be most effective in lending to parents and graduate students. Therefore, the best thing the federal government can do to encourage a more efficient system is to eliminate federal higher education loans to parents and to curtail the no-limit borrowing for graduate school by eliminating the PLUS loan program for graduate

students. This would encourage a more rational market for higher education for both undergraduate and graduate students, saving taxpayers money in the process.

Congress can also make it easier for new forms of private financing to help students pay for school, specifically by clarifying the legal status of Income Share Agreements and allowing for certain types of forward-looking underwriting among lenders.

But any promotion of private higher education financing must be genuinely competitive. There is no justification to return to the bank-based lending system, which was a form of corporate welfare that cost taxpayers dearly. Under no circumstances should policymakers consider a return to that system.

Notes

1. "Federal Student Aid Portfolio," Office of Federal Student Aid, accessed July 31, 2017, <https://studentaid.ed.gov/sa/about/data-center/student/portfolio>.
2. Stephen Burd, "The End of FFEL," *Higher Ed Watch* (blog), New America, March 25, 2010, <https://www.newamerica.org/education-policy/higher-education/higher-ed-watch/the-end-of-ffel/>.
3. Douglass W. Elmedorf, letter to Judd Gregg, March 15, 2010, https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/03-15-student_loan_letter.pdf.
4. Author's calculations from the National Postsecondary Student Aid Survey 2012.
5. There is \$77.5 billion in Parent PLUS loans outstanding with 3.5 million recipients. See "Federal Student Aid Portfolio by Loan Type" at "Federal Student Loan Portfolio," Office of Federal Student Aid, accessed July 31, 2017, <https://studentaid.ed.gov/sa/about/data-center/student/portfolio>.
6. See Johnson, Bruch, and Gill (2015). The credit standards have seen been loosened somewhat.
7. From 1994 to 2007, students could borrow up to \$18,500, and some of the loans allowed for interest to be forgiven during school. Before 1994, the limits were lower. In 2007, the limit changed to \$20,500, and in 2012, the interest forgiveness provision was eliminated. See "Historical Loan Limits," FinAid, accessed July 31, 2017, <http://www.finaid.org/loans/historicallimits.phtml>.
8. Just over half of graduate students were over age 30 in 2007, and those numbers have remained static over the previous 20 years. See Bell (n.d.).
9. Many schools have come to rely on the inflated tuition from their graduate programs to fund other activities. Too sharp a decrease in enrollment could threaten the solvency of many schools. This may be true for Parent PLUS loans as well, particularly at expensive private, nonprofit schools, as well as Historically Black Colleges and Universities, which both rely more heavily on Parent PLUS loans.
10. Matthew M. Chingos, "Who Profits from the Master's Degree Pay Bump for Teachers?" *Chalkboard Series* (blog), Brookings Institution, June 5, 2014, <https://www.brookings.edu/research/who-profits-from-the-masters-degree-pay-bump-for-teachers/>.
11. Terri Williams, "Code Schools Offering Income Share Agreements, Increased Flexibility for Students," GoodCall, April 4, 2016, <https://www.goodcall.com/news/code-schools-offering-income-share-agreements-increased-flexibility-for-students-05560>; and Cynthia Sequin, "Purdue Expands Income Share Agreement Program to Include More Students, Summer Session," Purdue Research Foundation, April 3, 2017, <https://www.purdue.edu/newsroom/releases/2017/Q2/purdue-expands-income-share-agreement-program-to-include-more-students,-summer-session.html>.
12. Investing in Student Success Act of 2017, S.268, 115th Cong. (2017).

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