Statement before the Committee on Health, Education, Labor and Pensions (HELP)
On Reauthorization of the Higher Education Act:
Exploring Institutional Risk-sharing

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Andrew P. Kelly

Director, Center on Higher Education Reform

American Enterprise Institute

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Introduction

Good morning, Chairman Alexander, Ranking Member Murray, and distinguished Members of the Committee, and thank you for giving me the opportunity to share my views on the concept of risk-sharing in higher education.

My name is Andrew Kelly and I am the director of the Center on Higher Education Reform at the American Enterprise Institute, a non-profit, non-partisan public policy research organization based here in Washington, DC. My comments today are my own and do not necessarily reflect the views of AEI.

I'm here today to discuss how the federal government can give the colleges and universities it helps to finance a greater stake in student success and college affordability. Specifically, the question before us today is how a risk-sharing policy, where colleges would bear some financial responsibility for a portion of the federal loans that their students do not repay, might better align the incentives of colleges, students, and taxpayers. This idea has received increasing attention from both sides of the aisle of late, and it is an opportune time to discuss it.

Today I will start by briefly outlining the problems with our current approach to determining student aid eligibility, explaining the principles of risk-sharing and why I believe it would represent an improvement over the status quo, and discussing basic policy design principles the Committee could consider. I will conclude with some important caveats that we must keep in mind.

Over the past half-century, federal higher education policy has been focused on ensuring college access for qualified students who would otherwise be unable to attend due to financial constraints. To achieve this goal, the federal government makes available grants and loans to any eligible student pursuing education after high school.

This is an admirable objective. After all, the average return to completing a degree or certificate remains robust, lower-income Americans who earn a degree are more likely to experience upward mobility, and a more-educated population helps grow the economy.[1]

Evidence suggests that federal need-based grants encourage enrollment among low-income students,[2] and the marked increase in college access at all income levels reflects the expansion of the federal student aid system. In 1972, the year the Pell Grant was created, 49 percent of recent high school graduates went on to enroll in postsecondary education; by 2012, 66 percent had done so.[3]

However, federal policy has paid less attention to whether these student aid investments promote student success and encourage colleges to keep their tuition affordable. On each of these measures, the trends are far from encouraging. Research shows that college completion rates have declined over time,[4] and just over half of the students who start a degree or certificate graduate within six years.[5] Completion rates are much lower among disadvantaged students.[6]

Meanwhile, the sticker price of tuition at public four-year colleges has more than tripled since the early 1980s. Though net prices have increased more slowly, family incomes have not kept pace, putting college out of reach for many and forcing others to take on large amounts of debt. In 2013, 70 percent of graduates from public and nonprofit colleges had student loan debt, and the average borrower owed just under $30,000.[7] Those who take on debt but do not graduate often have the most difficulty repaying their loans. The effective delinquency rate on student loans, after excluding students who are not required to make payments, is over 30 percent, about as high as it was on subprime mortgages during the housing crisis.[8]

Borrowing itself is not inherently bad: if a loan enables an individual to pursue a high-quality postsecondary credential that he or she would not otherwise have been able to afford, then the loan is advancing economic opportunity. But when students borrow for programs that are unlikely to deliver a positive return on investment, it is easy for them to find themselves in the worst place of all: saddled with debt but without a credential to advance their career. The ranks of these borrowers are growing.

Faced with these trends, policymakers are now asking how federal student aid policy can encourage colleges to provide a quality education at an affordable price.

Leaders of both parties have acknowledged that these are not entirely, or even mostly, questions about how much we spend, but about how we change the incentives that existing programs create for colleges. There is a growing consensus in states and at the federal level that improving student success and college affordability requires reforms that better align the incentives of institutions and students. A host of initiatives, from outcomes-based funding in the states to President Obama's college ratings to the recent white papers released by this committee, fit under this broad category.

A key question is whether existing federal policies provide colleges with enough of a stake in student success. To be sure, the policymakers who designed the student aid system a half-century ago did not ignore these questions. They set up a three-pronged quality assurance regime—known as the "triad"—to govern eligibility for federal aid programs. Today, institutions must be accredited by a recognized organization, authorized by any state they operate in, and must meet federal standards for financial viability, student loan default rates, and, in the case of for-profit institutions, the proportion of their revenue that comes from non-federal sources (the "90/10 rule").

Above these quality assurance standards, market competition is supposed to discipline providers. Policymakers decided to give aid directly to students as a portable voucher, allowing them to "vote with their feet" and reward schools that offer affordable, high-quality programs. In the aggregate, these choices are supposed to hold eligible colleges and universities accountable for their performance.

These quality assurance mechanisms have failed to protect consumers or taxpayers, however.[9] Low levels of consumer information about costs and quality, coupled with a dearth of clear, comparable data on those dimensions, blunts market accountability.[10] Basic information on out-of-pocket costs, the percentage of students who complete a degree, or the likely return on

investment at different programs is incomplete or unavailable. Programs with high price tags and poor outcomes continue to attract students and taxpayer dollars.

The triad has also proven ineffective in its gate-keeping role. According to the most recent data available from the Integrated Postsecondary Education Data System (IPEDS), over 1,300 aid-eligible two- and four-year colleges graduated less than 30 percent of their first-time, full-time students in 150 percent of the normal time to degree. When it comes to finishing on time, more than 750 four-year colleges had four-year completion rates of 20 percent or lower. Similarly, among those institutions receiving federal loan dollars, nearly 500 schools had three-year Cohort Default Rates (CDR) of 25 percent or higher in 2014.

Each part of the triad has its own shortcomings. Accreditation reviews rely on faculty from other institutions to evaluate their peers, creating a conflict of interest. It is also a binary measure, and the high stakes of revoking a school's accreditation mean it rarely happens. A Government Accountability Office (GAO) analysis found that just 1 percent of accredited institutions lost their accreditation over a four and a half year period.[11] State regulations vary considerably across the country, and few states authorize institutions on the basis of their student outcomes.

At the federal level, the primary mechanism for holding colleges accountable—the Cohort Default Rate—successfully curbed the worst instances of fraud and abuse when first introduced in the 1990s. But the policy is flawed. First, it is easily gamed. So long as students default outside of the three-year window, colleges are held harmless for that failure, creating incentive to get students just over that three-year threshold. Indeed, when the Department of Education shifted from two-year to three-year default rates, loan performance was much worse in the three-year window. The average default rate jumped 4.6 percentage points.

Second, the rule is binary in nature: colleges whose default rates are just below the federal standard (40 percent in a given year or 30 percent over three consecutive years) continue to have full access to federal aid programs. Those institutions that are close to the threshold likely have incentive to improve in order to avoid sanction in the future. But the mass of institutions with default rates that are high but still below the thresholds bear no responsibility for loans that go into default. There is nothing magical about the thresholds, yet policy treats colleges on either side of them completely differently.

Third, the binary element also makes the measure extremely high-stakes; losing access to Title IV aid would essentially be a death sentence for colleges. An entire industry has evolved to help colleges manage their defaults within the three-year window, and institutions have a host of opportunities to challenge and appeal the Department of Education's ruling. And policymakers have been reticent to sanction schools under the policy. Just eight institutions were subject to sanction in 2013.[12] This past year, the Department of Education revised the default rates of a subset of institutions on the basis of concerns about inadequate loan servicing, effectively saving them from sanction.[13]

Thus, existing policies have given rise to a system where colleges that effectively originate student loans bear little of the risk if borrowers are then unable to pay those loans back. This

creates little incentive for poorly performing colleges to keep tuition low, enroll students who are likely to be successful, or change institutional practice so as to maximize student success.

To be clear: student success is a joint product of student effort and institutional practice. And institutions have only limited control over whether students arrive prepared for college, how much students decide to borrow above the cost of tuition, or their behavior during and after college. I discuss these caveats below.

But evidence suggests that colleges do have an effect on student success;[14] that institutions who adopt research-based interventions can improve retention and completion rates;[15] and that it is possible to contain costs without sacrificing quality.[16] The question is how to structure federal policies to encourage colleges to focus effort and resources on these goals.

Risk-sharing

A risk-sharing policy would change these incentives for all colleges. Risk-sharing here refers to a policy that would require all colleges who participate in the federal loan program to retain some portion of the risk that their students will be unable to repay their loans. Specifically, colleges would be on the hook financially to pay back a fraction of the loans that their students fail to repay. In the parlance of other lending markets, colleges would have some "skin in the game" when it comes to student loans.

The intent of such a policy is to give all colleges—not just those with the highest default rates—stronger incentive to consider changes to institutional practice, resource allocation, and tuition pricing that would lower the probability that borrowers experience problems in repaying their loans. Risk-sharing is thus designed to change institutional behavior by holding colleges accountable for student outcomes, not dictating specific changes from Washington. Colleges would maintain the flexibility to figure out how best to accomplish student success goals.

How might such a policy play out in higher education? It is worth noting that the concept of risk-sharing has received significant attention in other lending markets, particularly in the context of home loans. Evidence from the period before and after the financial crisis suggests that the loan portfolios of mortgage lenders who had some skin in the game—as little as three percent of the risk—performed better than those who did not.[17] In a comparative study of loan performance in the Veteran's Affairs (VA) and Federal Housing Administration (FHA) loan programs, researchers at the Urban Institute found that VA loans were less likely to default than FHA loans. The researchers hypothesize that the fact that lenders in the VA program have skin in the game likely explains some of the difference in performance (though they caution that they establish a correlation, not causation).[18]

Because similar variation is not present in federal student loans, it is more difficult to project how this policy would play out in American higher education. But a recent paper by Temple University economist Douglas Webber attempted to simulate how different types of institutions might respond to a risk-sharing system, namely whether they would price risk-sharing into their tuition costs. Webber's simulation suggests that a risk-sharing system where colleges had to pay back 20 percent or 50 percent of defaulted loans would "bring about a sizable reduction in

student loan debt," though at the cost of "modestly higher tuition rates."[19] Webber shows that if colleges were able to reduce their default rates even 10 percent, the reduction in loan debt would be even larger.

Webber's simulation of a 10 percent reduction in default rates is likely a conservative estimate of the extent to which proactive institutions could improve loan repayment rates. Indeed, there are a number of strategies colleges could pursue in this regard.

First, broad-access colleges could raise entrance standards and be more careful about enrolling students who have little chance of success. This would be an improvement in consumer protection; students should not enroll at an institution that cannot serve them effectively. But such a response also has consequences for access that I discuss below.

Second, some colleges will likely change their pricing and enrollment policies to minimize the number of students that wind up with debt but no degree. One approach is to implement a free or low-cost "trial period" that allows students to test the waters before they take on any debt. For instance, in the aftermath of the Obama Administration's effort to regulate for-profit colleges, Kaplan University introduced a free, three-week trial.[20] Another option is to have students start taking courses with a lower-cost provider before transferring those credits to the home institution. Western Governors University has partnered with online course provider StraighterLine to provide this kind of low-risk onramp for prospective students.[21]

Third, and most importantly, colleges will have incentive to restructure the student experience in ways that maximize student success. The most effective way to help students avoid repayment problems is to help them complete a credential with labor market value.[22] A series of rigorous, randomized evaluations has provided evidence that different interventions can raise retention and completion rates—personalized coaching, performance-based grant aid, full-time enrollment in a "structured pathway."[23] A comprehensive intervention that combined many of these strategies doubled graduation rates among remedial students at the City University of New York.[24] Improvements are possible, provided colleges have an incentive to adopt evidence-based strategies. Having skin in the game could provide that incentive.

Design Principles

There are a number of design principles and caveats that the Committee could consider when thinking about the structure of a risk-sharing policy. I start with four design principles and conclude with two important caveats.

First, leaders might consider moving away from cohort default rates as the key measure. On the one hand, putting institutions on the hook for a fraction of defaulted dollars is transparent, simple, and clearly pegged to a defined outcome. But default rates are highly imperfect measures of institutional quality and loan performance.[25] Options like forbearance, deferment, and income-based repayment help students avoid defaulting even if they are not making progress in paying back their loans. As an alternative, policymakers could use a measure of repayment progress, such as cohort's loan balance that remains unpaid after the standard ten-year repayment period.

Second, in terms of the structure of penalties, the simplest approach would be to charge institutions a flat percentage of non-performing loans, perhaps excluding institutions whose repayment rates are above a certain threshold. For example, institutions might pay a flat percentage of a cohort's loan balance that remains at the end of the standard 10-year repayment window. Alternatively, a sliding scale of penalties that increased as repayment rates worsened would punish poor-performing institutions more severely, but policymakers would want to avoid a system that ratchets up penalties at particular thresholds in a way that creates large discontinuities.

Third, while it is difficult to forecast in advance, it is my opinion that risk-sharing penalties need not be particularly large to get the attention of schools. One study of the mortgage market found marked differences in loan performance with risk retention as low as 3 percent.[26] In higher education, the system should be designed to provide schools with an incentive to focus on student success, but penalties should not be so large as to summarily put schools out of business simply because they have cash flow issues.

Fourth, it would be ideal to create a system that is simpler, more transparent, and that applies equally across all institutions regardless of tax status or other factors such as borrowing rates. We should have high expectations for all institutions, and a risk-sharing system can help achieve that goal so long as it is not riddled with provisions that exempt particular types of institutions.

Fifth, there are clearly many factors outside an institution's control—such as economic recessions. Tying the risk-sharing formula to the national unemployment rate, for instance, and exempting a fraction of non-performing loans from an institution's calculation based on that index, would help account for this risk.

Caveats

Now for the caveats. The most obvious criticism is that risk-sharing will reduce access for low-income students. This is a likely outcome at some schools, and must be taken seriously. But it's important to note that, in many cases, encouraging institutions to think twice about enrolling students that are unlikely to be successful is not necessarily a bad thing. For years, colleges have knowingly enrolled such students in order to capture additional student aid money, a practice that members of this committee criticized during prior hearings on for-profit colleges.[27] It is also important to note that these students would still have access to institutions where they are more likely to be successful. Federal policy should encourage students to enroll in institutions that are prepared to serve them.

But it is true that increased selectivity could keep out students that would benefit from schooling on the basis of their characteristics. Therefore, policymakers should consider offering institutions a bonus for every Pell Grant recipient they graduate. Such a reward would help balance the potential risk of enrolling low-income students.

Colleges also have justifiable concerns that risk-sharing would hold them accountable for behaviors they have no control over. For instance, colleges cannot limit how much students are allowed to borrow over the cost of tuition, meaning a poorly-designed risk-sharing system would

put them on the hook for loans that were not used to pay tuition. In light of this, a risk-sharing policy should only hold colleges responsible for a portion of the total sum of unpaid loan dollars. The penalty formula could multiply that sum by the ratio between tuition and living costs for that cohort. Similarly, colleges should not be punished for ineffective loan servicing.

Alternatively, the Committee might consider giving schools the power to limit student borrowing under certain circumstances. For guidance on this issue, policymakers could look to the Department of Education's current experimental sites project that empowers selected colleges to limit borrowing.[28]

I appreciate the opportunity to provide feedback. I am enthusiastic about the Committee's focus on this topic and believe a well-designed risk-sharing system can help to better align the incentives of institutions and their students.

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