



Students' Futures as Investments

The Promise and Challenges of
Income-Share Agreements

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Executive Summary

Income-share agreements (ISAs) are an emerging idea for helping students pay for college. Under an ISA, investors provide upfront sums of money toward students' college tuition and other associated costs in exchange for a fixed percentage of the recipients' earnings after graduation.

An ISA can take different forms. Some are philanthropic, meaning that successive groups of students receive disbursements from—and pay back into—a revolving pool of money. Under another type of ISA, private investors expect returns from their investments in students' educations, gambling that students' post-graduate incomes will generally be high enough to turn a profit. In yet another incarnation, higher education institutions use funds such as university endowments to finance students' educations, in exchange for a return that at minimum covers the fund's operating costs. Purdue University plans to employ this model, making it the biggest player in the United States to try the ISA idea so far.

ISAs have great promise. Unlike many loans, ISAs have been touted as a form of insurance for the risky investment that is higher education, because they do not have to be repaid until and unless a graduate is making money. They may provide an option for people who prefer private versus publicly subsidized financing,

worry about the state of the economy, are averse to borrowing, or go to universities or colleges that do not participate in federal student-loan programs. And they have proved attractive to critics of mounting conventional student-loan debt.

The challenges? Existing ISAs are so new and so small that most lack a track record to attract students and to show investors, without which there is no capital for that track record to be built. There is also a lack of regulatory and tax clarity surrounding ISAs and competition from new income-based repayment options now being made available for many types of federal student loans.

This paper provides an in-depth look at the ISA industry, detailing the potential of ISAs as a new and innovative financial-aid mechanism, exploring the offerings of emerging providers, and outlining several impediments to growth. While exploring the topic from a high level, the paper also conveys the perspective of some of the few students who have received ISAs and of several providers already offering them. It concludes with a discussion of what is next for ISAs, such as possible industry developments—including Purdue's new initiative and other providers' plans—and a flurry of legislative activity.

Students' Futures as Investments: The Promise and Challenges of Income-Share Agreements

This paper is the first in a series examining private financing in higher education from a number of perspectives.

When Elida Gonzalez arrived at the University of California, Santa Cruz, she found herself surrounded by classmates who already had accumulated seemingly inconceivable amounts of student-loan debt. “I met people with \$50,000 in student loans,” Gonzalez said. “I remember the panic on their faces when graduation came along. They could not imagine how they were going to repay that.”¹

Gonzalez was not quite so panicked that day. Having started at a comparatively inexpensive community college, where she earned one associate’s degree in biology and another in math and chemistry, she had covered the first part of her higher education with scholarships and by working. The rest? She paid for it using \$15,000 given to her by a group of New York–based investors in exchange for a portion of her future income.

Gonzalez is among the handful of US students paying for college using income-share agreements (ISAs)—sometimes known as human capital contracts—which provide upfront sums in exchange for a percentage of recipients’ future earnings. In her case, she was given access to money pooled by a group of philanthropic investors. In exchange she pledged to pay back 5 percent of her annual income for 15 years, starting once she makes at least \$18,000 a year.

“The first time I heard about this, I thought, why would these people want to give us money? They don’t even know us,” she said. “I was very hesitant. I was thinking, what’s the catch? There’s got to be more to this than that.”

Gonzalez does not think that any more. Now 24, she has spent \$7,000 of the total made available to her to get her bachelor’s degree in molecular, cellular, and developmental biology. She plans to use some of the

rest to become a physician’s assistant. When the time comes for her to start to pay the money back, Gonzalez is heartened by the fact that, in her mind, the repayments will be different than those for her fellow graduates’ loans—instead of going straight to a bank, they will be reinvested in other students in the same way they were invested in her.

The type of ISA Gonzalez received is the philanthropic version: it requires that she pay back a specified percentage of her future income into a revolving pool provided by investors, who hope the returns will be enough to provide the same support for other students later. Under another incarnation of ISAs, private investors expect returns on the money they put up, essentially gambling on students’ postgraduate incomes being high enough to turn a profit for the investors. In yet a third version, funds such as university endowments would be used to finance students’ educations in exchange for a return that covers at least the operating costs.

When she agreed to accept the terms, Gonzalez said, “I remember thinking, okay, it’s 5 percent. It is a chunk of money. But I thought of it as, I’m keeping my 95 percent. And someone else will have the chance to get that piece of money and use it for their education.”

A potential alternative to loans for candidates such as Gonzalez, ISAs are in their infancy. She is part of a fund that has so far underwritten only 11 students. This is at a time when 1.4 million students who attended public and private nonprofit colleges and universities annually graduate with loans—one-sixth of which are private loans with comparatively inflexible repayment terms.²

The Potential

In a market dominated by conventional student loans, people pushing ISAs have reasons to be hopeful. One is that the student loans that dominate the market now have vulnerabilities against which ISAs provide comparative advantages. For example, as hard as ISAs may be to understand, research shows that student loans are also hugely complex and confusing. Income-based repayment—the government's program allowing federal student-loan borrowers to tie their payments to their income—can also have the paradoxical effect of increasing a loan's ultimate cost, and not all borrowers have access to it.

For the huge proportion of students who never graduate—41 percent do not finish college within six years of starting, according to the US Department of Education—ISAs are like insurance.³ Instead of having student-loan debt hanging over their heads, drop-outs earning much less than they might have with degrees will have to pay little or nothing. ISAs are also an option for people who have an ideological preference for private versus publicly subsidized financing, who have a concern about the state of the economy or an aversion to debt, or who are among the at least one million students who attend schools that do not offer federal student loans, from conservative Christian and community colleges to computer-coding boot camps.⁴

Some advocates say that ISAs represent capitalism with a higher purpose, offering a chance to invest not in tech stocks or commodities futures, but in people's lives. At the very least, those funded by investors seeking a return could bring market forces to bear, steering students toward the institutions and majors that promise the highest prospective pay instead of those with the nicest dormitories and fitness centers or best football teams.

Because ISAs depend on projecting future income, they could push universities and colleges to disclose postgraduate earnings, accelerating a trend already underway but which higher education has largely and fiercely resisted. All these things could create more competitive pressure on schools to increase productivity and lower costs, something the easy availability of government-backed loans gives them little incentive to do now.

High-level interest in ISAs is growing, propelled by broader and bipartisan public anger over escalating student borrowing and college costs that have outstripped families' ability to pay. Bills in Congress would set up regulatory frameworks for ISAs.⁵ US Senator Marco Rubio (R-FL) and New Jersey Governor Chris Christie, among other politicians, have talked about them.⁶ A grant from Google is helping to sustain one fund; another is being backed by a venture-capital firm that owns a movie studio.

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In the biggest development, Purdue University might offer ISAs to students, investing money from its own research foundation and private backing. Insiders say at least one other major university is considering doing the same thing. That could expand the idea from a tiny number of recipients to hundreds or even thousands.

The most important, even existential, question remains: can investors make money from it? "My only response, which is the most candid, is I'll get back to you on that," said Robert M. Whelan Jr., who, in his role as chief executive of 13th Avenue Funding, helped Elida Gonzalez pay for college.⁷

A Rare Case Study

The fifth child of a farmworker father, Elida Gonzalez was determined to be the first to break away. "I was constantly surrounded by people who were working in the fields," she said. "From a very young age my dad would take my siblings and me to work, and I realized that that was definitely not the life for me, to wake up early and make minimum wage. They would pay us

two dollars for a box of strawberries. We would sometimes fill 100 boxes, so that was \$200 a day for 10 hours work for all of us.”

By her senior year in high school, Gonzalez had decided to go straight to a four-year university, making her the first in her family to go on to any kind of higher education. Then doctors told her that her mother had leukemia. She chose to stay close and go to her hometown community college.

It was a mixed blessing. Community college had not been in her plans, but after scholarships, she paid virtually nothing and worked as a tutor to cover expenses. She eventually started getting ready to transfer to a university to get a bachelor's degree.

“I knew that I would end up having to get loans,” Gonzalez said. “It was such a scary thought. When I sat down with my counselors and mentors, it always seemed that financial aid was not going to be able to pay for everything.”

Then 13th Avenue chose Allan Hancock College in Santa Maria, California—the college Gonzalez attended—to launch a pilot program for its tiny ISA, supported by the founding partners' own investments and grants from Google and others. The model sought students like her who were already enrolled in community college but planned to get bachelor's and graduate degrees.

Gonzalez waited to hear about the experiences of the four students who had accepted the deal in its first year. They told her that the partners had taken a personal interest in them, as they later would for her, her sick mother, and her younger sister who also hoped to go to college. “They went out of their way to be there for me for moral support, but they also started giving me information about doctors and the possible ways to pay for them, and clinical trials, and things like that. That was very helpful, especially at a time when I couldn't even think.”

It was another thing that first group of ISA recipients told her, however, that sold Gonzalez on the idea once and for all. “What caught my attention was that it was \$15,000 with no interest,” she said.

Antipathy to conventional debt, especially among low-income families, is increasingly driving decisions about college. Hispanics, Asians, students who are no

longer supported by their parents, and students who are older than traditional age are less likely to borrow than higher-income students and students of other ethnic backgrounds.⁸ This is the case even when they have \$2,000 or more in unmet financial need beyond what they are receiving in grants and discounts. To make up the difference, many work while in college, which makes it far less likely that they will ever finish, or they go to lower-cost institutions with little support and abysmal graduation rates—which are even lower for non-borrowers.⁹

“These are the kids who took all the prerequisites, took all the exams, and would be admitted to good colleges all across the country, but have said, ‘No, I'm not going to take out loans,’” said Casey Jennings, chief operating officer of 13th Avenue. “The risk involved in borrowing just looks untenable from their perspective. This population is loan averse, because in their neighborhoods and in their families they've experienced huge problems caused by debt.” With loans, said Jennings, “For the great majority of college-going students, there is this uncertainty of, ‘How much is this going to cost? Am I getting to get hosed?’”¹⁰

That has not stopped the total amount of money being borrowed from hitting stratospheric levels. While the proportion of students who graduate with debt—about 70 percent—has not changed dramatically in the last 10 years, the Institute for College Access and Success (TICAS) reports that the average amount they borrow has increased by 56 percent, or double the rate of inflation, to \$28,950.¹¹ This equation includes more than \$9 billion in private loans, which generally cost more and come with fewer consumer protections, according to the College Board.¹² The poorest undergraduates, from families with incomes of \$40,000 or less, are more than twice as likely to go into debt.¹³

Meanwhile, grants have not kept pace with college costs. The maximum annual amount of Federal Pell Grants has increased by \$2,900 during that same decade, while the cost of attending a public four-year college or university rose by \$7,400 and a private non-profit one by \$14,400.¹⁴ At the same time, median family income has flattened out or fallen for all but the wealthiest Americans.¹⁵

So it is not surprising that one in three borrowers are at least 30 days behind in their repayments, up from 11 percent a decade earlier. That is higher than for any other type of debt, including credit cards, auto loans, and mortgages, and it can affect recipients' credit ratings and ability to buy such things as cars and homes.¹⁶

The “Chicken or the Egg” Problem

While ISA boosters say they offer advantages over loans—at no cost to the government and at more favorable terms for many students—they remain a minuscule portion of the American college-financing system. That is in part because they do not have enough of a track record to attract significant capital—or enough capital to create a significant track record. It's what investment professionals in the field call the “chicken or the egg” problem.

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A lack of regulatory and tax clarity is also discouraging investors. ISAs can be tough to explain to students and families. Students who expect high incomes—engineers, for instance—may see no value in forking over a percentage of their earnings; for them, fixed loan payments would be more affordable. Without those users, however, an ISA fund could potentially be unsustainable.

Some ISAs envision counteracting this by applying differential pricing, in which engineers and others majoring in the most lucrative fields would commit a smaller proportion of their future pay—not because one program is more important than another, but so students do not end up paying more for their educations just because they are in programs that tend to be more lucrative. And new income-based repayment safeguards for students who take out federal loans—which also require little documentation of creditworthiness—are

tougher to compete with than loans for which the payments are inflexible, regardless of a borrower's postgraduate income.

Other uncertainties also dog the idea. How will students be selected, and how will ISA providers avoid the perception that they are cherry-picking prospects and, in particular, excluding low-income applicants? How will they collect from students who do not pay? How can private entities reliably know people's earnings? Will ISAs be dischargeable in bankruptcy? How, if at all, will they conform to disclosure requirements that govern loans? Will usury laws—consumer-protection regulations that cap the amount of interest lenders can charge borrowers—apply? If a graduate hits it big, could he or she structure his or her income to avoid paying the full amount owed? How long will investors be willing to wait for returns, and how will those returns be taxed?

Because of these and a myriad of other questions, Gonzalez remains among only a trickle of ISA recipients. In a study of the criteria of existing ISA providers that seek out students likely to earn the highest incomes, the American Institutes for Research (AIR) estimates that only about 7 percent of undergraduates nationwide would be eligible for ISAs. Under a broader, pooled approach, that proportion would increase to a still-modest 14 percent.¹⁷ This analysis has been criticized for relying on too small a sample, looking at students only one or two years into repayment, and including private student lenders and ISA providers that do not offer education ISAs, while excluding others that do.¹⁸

Still, a survey by Parthenon-EY of 1,100 students found that only between 8 and 14 percent would sign up for an ISA.¹⁹ A separate poll of 536 parents of college-bound children by *Money* and Kaplan Test Prep ranked it as the least popular financial-aid option, with half of respondents opposed to the idea and only 23 percent in favor of it.²⁰ Even some ISA providers agree that—so far—it is “a market share so small you can only see it with an electronic microscope,” in the words of Andy Davis, founder and CEO of Education Equity Incorporated, which is funding 17 students, most of them in graduate schools, through ISAs.²¹

Some providers, including one begun by former Google employees, have stopped offering ISAs. The

widely publicized Pay It Forward proposal in Oregon, which includes many of the elements of ISAs except with the state as the investor, was also quietly shelved with little fanfare.

Can ISAs Compete with Federal Student Loans?

With such high, and growing, numbers of graduates straining to repay their loans, policymakers have vastly expanded a safety net for borrowers, alternately called income-based repayment (IBR), income-driven repayment, and Pay As You Earn (PAYE). These also tie repayments to income, providing potential competition to ISAs. Borrowers who earn below one and a half times the poverty level will pay nothing; those who earn above one and a half times the poverty level will have their payments capped at 10 percent of everything they make over that amount. Any remaining debt is forgiven after 20 or 25 years, depending on whether a borrower has graduate-school loans.²²

Like many things associated with student loans, IBR rules are complicated. The complex nature of the student-loan process trips up many borrowers, especially those whose parents did not go to college or who are enrolled in public high schools with few college counselors available to help.

“It’s a messy process, especially for people who don’t have the knowledge or understanding or networks to really grasp the whole process, or the financial capabilities on their own to pay for school and need financial aid,” recalled Ulises Serrano, now a political science and ethnic studies double major at Berkeley and another recipient of a 13th Avenue ISA. “It was complicated and annoying, actually. There were so many different steps I had to take in having to apply for something that should just be so much more accessible.”²³

More than 40 percent of people who take out student loans report that they received no federal loan counseling at all, despite it being a federal requirement, according to the advocacy group Young Invincibles.²⁴ Among those who received counseling, 41 percent found it only somewhat informative or uninformative or had no opinion. Nearly half want better information on interest rates and repayment options.²⁵

Even when essential data are available, people do not always use them. For instance, only 14 percent of students surveyed by New America said they would use the federally mandated Net Price Calculator, which helps estimate the actual cost of attendance by showing what students at a particular institution pay for tuition, fees, room, board, and other expenses; how much they have to borrow; and what percentage default on their loans. More than half had never heard of it.²⁶

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Two students in the 13th Avenue ISA pilot program also took out federal loans, and one asked Jennings to help her apply for IBR. Although he is a former senior vice president and managing director at General Electric Capital, responsible for investments worth more than \$3 billion, Jennings confessed that “it took me an hour and a half to even find the name of the loan servicer in this pile of paperwork they’d given her.”

Said Jennings: “Do they understand this stuff? No. They are financially innumerate. Those noneconomic hurdles are major.”

If you want to know how confusing student loans are, “just look at the percentage of students who default on them,” said Robert Kelchen, an assistant professor at Seton Hall University. “There’s no reason anyone with income-based repayment should default on their loans. Huge numbers just don’t get the paperwork in on time.”²⁷

Still, the once very low IBR participation rate among eligible borrowers is picking up. The outstanding balances of borrowers enrolled in IBR account for nearly one-third of all eligible federal loans, or \$188 billion worth, according to the US Department of Education, up from barely one-seventh in 2010.²⁸

This raises concerns about other unanticipated problems. Lowering monthly payments based on income could increase the lifetime of a loan, meaning the ultimate cost is actually higher. A borrower with \$29,400 in debt and a starting salary of \$35,000 a year would pay 26 percent more under PAYE, when adjusted for inflation, than under the standard 10-year repayment plan.²⁹ Prolonging the repayment period could also affect access to other credit or people's willingness to take out mortgages and other kinds of debt that drive the broader economy.

Like IBR and PAYE, repayments to ISAs are variable, by definition dependent on graduates' incomes. But unlike even IBR loans, interest for ISAs does not accrue during periods when graduates earn less, and there is no growing balance for borrowers to watch anxiously. If they earn nothing, there is nothing to pay.

The real problem with conventional borrowing for college stems from students gambling on higher education and losing, failing to earn degrees and dragging along loan debt they cannot discard.

Nor does IBR generally apply to one of the most problematic kinds of federal loans, ParentPLUS, which lets parents borrow toward their children's education. These loans can spiral into six figures and huge monthly payments, even for well-off families and families whose children graduate on time. PLUS loans cannot be transferred, and parents often pay for them well into retirement. As Purdue President Mitch Daniels testified to a congressional committee, those who take out PLUS or private loans "deserve a disproportionate amount of the blame for the nightmarish anecdotes that generate the most public alarm."³⁰

But ISA providers see these same people as their best potential customers. These parents would "clearly prefer the ISA arrangement, partly because they read the papers and see the student debt problem, and having some sort of scaling payment plan appeals to them more

than that fixed balance," said Jeff Weinstein, founder of the economic consulting firm JW Analytics, which is working with top ISA providers. "You change to an income-driven repayment plan, and that last payment date keeps going further and further into the future."³¹

Free Lunch and Other Trends That Could Fuel ISAs

Anxiety about college payment options has given rise to programs such as the JumpStart Coalition for Personal Financial Literacy and the Council for Economic Education's National Standards for Financial Literacy. These programs are meant to be incorporated into schools as early as kindergarten and have already been adopted statewide in Florida.

Increasing financial literacy in this way, said Weinstein, may make ISAs easier to understand and to compare with loans. This benefits students, in turn, by forcing them to think more deeply about what they can expect from their careers. ISAs give institutions feedback, too. University and college leaders "have a vague idea of what happens to their graduates, but no specific way of seeing where they're strong and where they're weak," Weinstein said. With ISAs, they would have to know and disclose how well their students do or risk losing applicants who are much more tightly focused on success rates.

What initially attracted Ulises Serrano to an ISA was something much more basic: a free lunch. When the 13th Avenue investors held a meeting at his community college, they promised snacks would be served.

The more he listened, though, the more he liked the idea of forgoing conventional loans. "You're stuck with the interest, and for a very long time," said Serrano, who is the oldest son of a farmworker and a seamstress and who worked part time while he went to school and full time in the summers. "I would hear about how my teachers and professors were still paying off loans 10, 15, 20 years after they had taken them out."

There was another thing he liked about ISAs: although Serrano is firmly on track to graduate, ISAs are like insurance against having to repay those kinds of

loans for students who do not graduate, make less than they planned, or end up jobless.

The real problem with conventional borrowing for college, said Beth Akers, a fellow at the Brookings Institution, stems from students gambling on higher education and losing, failing to earn degrees and dragging along loan debt they cannot discard. "It really changes the track of a person's life if they make a bad bet," Akers said. "ISAs address that risk. So for the people who do lose—and it's inevitable that some people are going to lose—ISAs create a mechanism for insuring against that sort of risk."³² Even if an ISA recipient is laid off, interrupting his or her repayments, his or her credit score will probably be unaffected, unlike with a student loan.

Not that the comparatively new concept of ISAs is easy for consumers to grasp. "Oh, yeah, they're absolutely confused by ISAs," said Jennings, who has personally explained the idea to community-college students.

One provider, Base Human Capital (Base-HC), actually refers to its ISAs as loans. "It's a communication tool, because no one outside a select pool of people has any idea what an ISA is," said Brendan Florez, founder and CEO of Base-HC. "They know what a loan is, so we start by using language that talks about loans but then say this is a different kind of loan with different kind of provisions. We find that's easier."³³

But Jennings and others say ISAs are simpler than IBR. "Pretty much everyone has a pretty good idea of how much they're making and how much they expect to make," said Nathan Popkins, founder of Cumulus Funding, which offers ISAs to working people for various expenses. "A fixed percentage of that is not only easy math for people, but also intuitive."³⁴

An ISA also has a big advantage over the disparaged student loan: it's simply not one. "From the student's perspective, it's not a loan. If they earn zero, they pay nothing," Jennings said. No matter that their ultimate payoff could conceivably be more than if they had taken out a loan. "It's no longer, 'Am I getting screwed by Wall Street?'" The proof of this, said Jennings, is that 13th Avenue attracted 27 applicants by its second year, when it had enough money to fund only Gonzalez and six others, and 100 by the third year, although the pilot had already run its course by then.

Not everyone is sure that ISAs are always a better option than loans—at least, not federal loans. For all their problems, federal loans allow deferments and forbearances in addition to the new IBR option. Plus, the maximum that undergraduates under 24 can borrow is \$31,000, "which is quite a lot," said Lauren Asher, president of TICAS.³⁵ "It's hard for me to see a context in which a student would be better off [with ISAs] but I can't say for sure that there are no such students and no such situations, depending on what the particular terms are."³⁶

The ISA idea, said Asher, "is a concept that in the abstract many people find appealing. In practice there are lots of risks that people need to take seriously, especially when we have federal loans that come with income-driven repayment and lots of consumer protections." For example, while there is a tax deduction for interest on student loans, the tax treatment for ISA payments and repayments has yet to be settled. Same goes for the disclosure requirements divulging ultimate repayment amounts, as well as whether ISA obligations can be discharged in bankruptcy.

There is also the indentured-servitude argument: that students are committing their future labor to investors who will profit from it. ISA proponents respond that recipients are free to choose their own majors and careers and whether to even work at all, and they are voluntarily agreeing to repay only a portion of their future income.³⁷

Still, even some ISA providers agree that loans may sometimes be preferable. "There are many instances in which students would be better off with ISAs," said Miguel Palacios, a finance professor at Vanderbilt University, cofounder of the South American ISA provider Lumni, and author of a book on ISAs. "But I wouldn't want to build ISAs on the back of people not liking to borrow, even when borrowing might be the best thing for them. I wouldn't advise a student to do something that is against their best interest."³⁸

The trick for ISAs is making sure that they seem a better deal on the whole—and persuading investors that there is demand for them. "The first rule of financial instruments is knowing what you're competing against," said Jennings. "You've got this thing out there called the federal student loan program, this

enormous pile of cheap money that flows to students and doesn't require much documentation. That's the elephant in the room that has slowed the uptake of paying investors a real equity rate of a return—that ISAs are a nice idea, but why would any student decide they want to pay you more than they would have to pay the federal government?"

This, he said, means focusing on not only people who take out private and PLUS loans, but also on students at schools that do not participate in the federal student loan program or who have burned through the federal limit, veterans who have used up their GI Bill benefits, and families that just do not like loans. That may seem like a narrow niche, said Jennings, "but it's a huge market."

He points out that for a student-loan origination business that is expected to reach \$200 billion a year in the next decade, just one two-hundredth would come to \$1 billion a year.³⁹ "There's enough room in there for all the players to build a viable business," Jennings said. "Whether it makes a huge dent, I don't know."

Purdue Changes the Game

Different ISA providers have different approaches to making this dent. Some, like 13th Avenue, use capital from philanthropic sources; others, including Base-HC and Education Equity, use capital from investors who expect to make a profit.

Lumni, the longest-established ISA provider, started in 2002 in Chile with \$837,000 from the Inter-American Development Bank. It has since expanded to Colombia, Mexico, and Peru and now is setting up shop in the United States, where it funds 27 students so far. After 14 years, Lumni has raised \$50 million for 7,000 students. More than half of the funding comes from philanthropies, including the Lex Mundi Pro Bono Foundation, and the rest from institutional and individual investors—including, now, some of its own graduates.⁴⁰

Other companies are getting into the game in new ways and attracting venture-capital attention. One, Vested Finance, was set up by entrepreneur Lorne Abony, who owns the World Team Tennis franchise the

Austin Aces and whose own college education was paid for by a family friend in exchange for a percentage of his future income. With \$5 million in seed money from the venture-capital firm Sandleigh Ventures, Vested was conceived as an ISA provider, but instead the company is working on an app called Schoold, which lets students and their parents simulate college and career choices and compare earnings potential and financing options.

A spinoff, Vemo, chaired by Abony and with industry veteran Tonio DeSorrento as CEO, is setting itself up as an ISA service provider. It has received another \$1 million from Kuala Innovations Limited and \$2 million from FastForward Innovations Limited and has hired Weinstein and Renee Mang, former senior vice president for loan origination at Sallie Mae.

In some cases, so-called "friendly" or internal funds may be pledged by universities or colleges themselves or by people closely associated with those institutions, as is happening at Purdue. Weinstein puts these funds into three principal categories. The first is "returns oriented," underwritten by outside supporters who expect some gains.

The second he calls "evergreen." These are pools of capital that charge only enough to cover their costs and return the money to new sets of students in a continuing cycle. For example, the Oregon Pay It Forward proposal promised residents free four-year degrees in exchange for 3.5 to 4 percent of their earnings over 20 years to help provide the same thing to other students later.

The third is "discounted," in which money from something like a university foundation is used to offer ISAs to students. There are also combinations of strategies—for example, capital from friendly sources "topped off" with money from returns-oriented investors.

Purdue's game-changing plan is to bring together all these approaches, teaming up with Vemo and 13th Avenue to offer ISAs as early as fall of 2016 under the aegis of its Purdue Research Foundation, a \$2.8 billion fund supported by gifts and licensing commissions that handles such tasks as giving scholarships and managing the university's research parks. Seven companies made proposals to be part of the initiative, called "Back a Boiler."

"One of the most encouraging things from just this process is the conclusion that ISAs will happen," said

Steve Schultz, Purdue's legal counsel.⁴¹ Schultz said Back a Boiler will serve as a catalyst to "advance the state of play" of ISAs—especially because Purdue foundation money will be used to prime the pump in the absence of a performance history that could attract outside investors.

Under the Purdue proposal, a student might get \$10,000 upfront and repay 3 to 5 percent of his or her income after graduating, over five to seven years, Schultz said. If he or she chooses the most expensive option of 5 percent over seven years, a graduate who makes \$48,500 a year—the median salary of college-educated Americans—would repay up to \$16,975 over the term of the contract.⁴²

Which students get ISAs and how they are chosen varies as widely as the types of funding plans. Purdue's program will target only undergraduates who might otherwise have taken out private loans or whose parents would have borrowed from the ParentPLUS program. "We start from the perspective that the ISA will not be for all students," Schultz said. "A student that is able to finance their education with grants or [other types of] government-provided loans should do that first."

The 13th Avenue model focused on lower-income community-college students planning to go on to further education and clustered them into cohorts, which it calls "clubs," to spread the risk. "There are a ton of those [kinds of students], so if we just got a large portion of low-income, low-wealth Hispanics, African Americans, poor farm kids, that's a pretty big slice of the demographics of college-age kids right now," said Whelan.

The fund uses census data and income information from PayScale to roughly predict how these recipients are likely to fare—how many students like them end up with degrees and employed and at what level of income. "We can build an awfully nice, visible, data-intensive population just in that market alone." As for higher-income people, Whelan said, "I would submit that the reaction we've gotten from tonier ZIP codes is, 'Gee, I can do a lot better just borrowing.'"

Lumni's underwriters are admissions officers. Most of its primarily low-income recipients need only university acceptance letters, not credit scores. Education Equity invests in Chicago teachers pursuing their

master's degrees to become principals; it has funded 56 so far.

Opportunity@Work, an initiative of the New America Foundation, is working to develop ISAs for lower-income people training for technology jobs. Upstart, the company founded by ex-Google executives, employed a complex algorithm to determine the relative risk of candidates who posted their profiles online and allowed investors to bid on them. It ultimately stopped offering ISAs and now uses its income-prediction model to provide loans.

The number of students who have been provided ISAs is so small and over such a recent time frame that there is little information yet about returns. "We have anecdotes, not data," Whelan said. Adds Florez, of Base-HC: "Even if your track record looks great, if it's based on five students, no one's going to pay much attention."

The most reliable record is Lumni's, whose institutional fund has realized a 9.1 percent gain with a default rate of 1.5 percent. The 13th Avenue plan ultimately seeks to return investors' capital plus a premium of 2 percent a year, with a cap so the recipients as a group never have to pay back more than that. Once the cap is reached, said Jennings, "the students stop paying and the lenders stop receiving."

Even after more experience with ISAs, it will be hard to predict success for students and price ISAs accordingly, said Cumulus' Popkins. Students who have the greatest chance of success—or are convinced they do—may steer clear of ISAs altogether, reasoning that their postgraduate income will be high enough to make a loan a better option for them than committing a percentage of their salaries. "There's a psychology issue related to individual expectations," Popkins said. "It's like *Prairie Home Companion*: everyone thinks they're above average."

Investors, on the other hand, may prefer the highest-earning majors at the most prestigious colleges and universities. Members of Purdue's faculty senate have expressed concern that students in less lucrative majors would be left out, although the university insists that Back a Boiler will be open to all majors. "If the numbers only add up when you're serving those students who are going to have highest return, I can't imagine this works for lots of people on a philosophical

basis,” said Matthew Soldner, who wrote the AIR report on ISAs.⁴³

ISAs may not limit themselves to only certain types of students for another, more practical reason, Weinstein said: it is expensive and time-consuming to figure that out. “That’s a lot of upfront processing, and it ends up being a fairly sizeable cost.”

Brookings’ Akers does not think the cohort idea—the approach 13th Avenue uses—has legs over the long term, either. In an era of big data and predictive analytics, she said, other financial industries are moving away from this kind of group pricing. She compares it to car insurance, which has shifted from the pooled approach to a more finely tuned system of determining risk by charging policyholders based on their own behavior, right down to plugging in accelerometers to measure how fast they drive. “If you’re a provider that’s pooling [ISA risk] across English majors and engineers, someone else will just come in and charge the engineers less,” said Akers.

What’s Next?

It could take years before accurate information about returns come in, considering that many of the people who have received ISAs are still in school or have only just begun up to 15 years of repayment. In the meantime, providers are concentrating on their other challenge: getting decisive regulatory and tax guidance, the absence of which may be holding off investment.

“The regulatory changes can make this go much faster,” said Palacios, of Lumni. “If those are clarified, there will be a ramp up, not overnight; but if it was going to take 20 years, it will now take five.”

All providers need “is something in place,” said Florez. “The broader that is, the better it is for us. Even if it has to be fairly narrowly defined in order to get passed, that’s still better than nothing. At least there are clear guidelines and that gives us a toehold.”

A few providers suggest that ISAs should be dischargeable in bankruptcy, unlike student loans. Purdue’s Daniels said this when he testified to Congress, and advocates including Schultz and Whelan agree. They contend that subjecting ISAs to the same laws that

govern loans could be disastrous. “If we’re really going to shift the burden and shift the risk away from the student, then we should treat it in that fashion all the way along,” Daniels said. “It would probably strangle the plan in the cradle if we let it be subject to usury laws.”⁴⁴

Subjecting ISAs to the same laws that govern loans could be disastrous.

ISAs should be considered not as debt, but as equity investments in a future string of income, Schultz said. This could be complicated by a ruling last year in the US Court of Appeals for the Second Circuit that the usury laws of the state where a debtor lives can apply to even non-bank investors, theoretically including ISAs. While this applies only in Connecticut, New York, and Vermont, it speaks to yet another uncertainty now in the way of ISAs.

Usury laws should not pertain to ISAs, their backers say, for the simple reason that ISAs are not loans; they have no principal balance or interest rate. Putting a ceiling on repayment, as consumer laws do with loans, would limit the money ISA providers could collect from the highest-earning recipients and force them to charge more to the rest, one position paper concluded.⁴⁵ While there are options to create disclosures about future payments much like those for loans, they can only speculate about a user’s future income. Still, students could be shown their likely payments on a simple table based on earnings and compared to loans: if they make such-and-such amount of money, they will be on the hook for this amount per month.

As for the tax implications to investors, under federal tax law, a lender has to report the interest received on a loan as ordinary income. But DeSorrento, the CEO at Vemo and a lawyer, said those first payments back to ISA investors should be considered a return of principal, not interest, and not taxed.

These issues get more complicated when state non-bank lending laws are taken into account. Cumulus, for instance, has had to produce a different contract in each of the 15 states where it operates, according to Popkins. “For me the big issue is implementing good

state regulations,” Weinstein said. “It’s a matter of identifying other bodies in each of the states that are a fit for ISAs.”

The House and Senate bills propose to set federal rules for ISAs. Both would make income-share agreements binding and enforceable, limit repayment to 15 percent of income, exempt ISAs from state usury laws, and charge the Treasury Department with regulating them and creating a model disclosure form. The Senate proposal sets an earnings floor of \$15,000, below which recipients would not have to pay; that is slightly lower than the typical \$17,500 minimum for student loans. The House plan sets the limit at \$18,000. For tax purposes, initial payments to students would not be considered income.

“By clarifying the lawfulness of income-share agreements, this [Senate] bill incentivizes the free enterprise system,” said Rubio, who has spoken about the burden of the \$100,000 in student loans he took out to finance his undergraduate and law school education.⁴⁶

Rubio’s is the kind of story ISAs can help to change,

Palacios said. “The way to see it is not as something that, say the legislation goes through, the crisis is over,” he said. “It’s more like this is the seed for something that is in my view much better [than some kinds of loans], providing different options to students who right now might have none, or who don’t have enough, and providing incentives in the market that are not there today.”

Whatever happens, Whelan said, momentum has picked up. “It’s much more in the public mind these days,” he said. “For us, it’s been like glacial speed, but the world is more and more paying attention to the student debt crisis.”

About the Author

Jon Marcus is the higher education editor for the Hechinger Report and North America higher education correspondent for the *Times Higher Education* (UK) magazine.

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