



RESEARCH REPORT

Getting Risk Sharing Right

Creating Better Incentives for Colleges and Universities

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Executive Summary

Policymakers have put forth “risk sharing” proposals designed to hold colleges and universities accountable for the loan defaults of their students, rather than leave taxpayers to foot the entire bill. These proposals to give colleges “skin in the game” typically focus on improving long-term student loan outcomes, such as the three-year cohort default rate or the three-year student loan repayment rate. But building incentives around these metrics may not induce the institutional behavior changes that policymakers expect. We suggest a new approach that relies on a short-term metric of semester completion and a set of changes to the federal financial aid program aimed at reducing the overall risk within the student-borrower pool.

Existing policies governing participation in the federal aid program, such as limits on an institution’s cohort default rate and pending gainful employment regulations, already create some degree of risk sharing in higher education. These policies have induced a number of institutional behavior changes, some of which have had adverse consequences for students. For example, some community colleges have opted out of the federal student loan program, opting to push students into the private loan market rather than jeopardize their eligibility for federal grant aid under current cohort default regulations.

We argue that current Congressional risk-sharing proposals will most likely increase these adverse consequences, rather than support desirable changes in underlying institutional behavior. Three-year student loan repayment metrics are many years removed from the institutional decisions on student admission and financial aid that precipitated them. Further, loan repayment metrics are poor indicators of the actual return a student receives from her education.

We believe that the concept of risk sharing is better implemented through a policy that puts the focus on student completion and risk reduction rather than solely on long-term loan repayment outcomes. The following are our recommendations:

- Require the disbursement of aid—grants and loans—to the student for living costs over the course of the semester rather than in a lump sum near the start of the term.
- Require institutions to return a portion of the financial aid of students who drop out before the end of the term, and limit institutions’ abilities to pass along this cost to students.

- End federal aid eligibility for colleges where a high proportion of students earn unacceptably low wages after leaving.
- Require participation in the federal loan program for all colleges that participate in any federal grant programs.
- Experiment with federal aid strategies that may reduce the risk of student debt, such as tying loan limits more closely to students' course loads and front-loading Pell grants for first-time students

This set of proposals is designed to accomplish the same goals as current Congressional risk-sharing proposals—create incentives for institutions to generate better outcomes for students and reduce the overall risk of student loan default, benefitting both students and taxpayers. We offer these proposals as a starting point for a new approach to risk sharing.

Getting Risk Sharing Right: Creating Better Incentives for Colleges and Universities

Policymakers, students, and the public have all acknowledged the damaging impact of defaults on the expanding portfolio of federal student loan debt. Borrowers who fail to make their loan payments face negative consequences, such as damaged credit, referral to collections agencies, and possible garnishment of wages or tax refunds. And because the federal government provides the vast majority of student loans, taxpayers are on the hook for unpaid loans, including the cost of loan collections as well as loans that are forgiven through various income-driven repayment plans.¹

In response to continued student loan defaults, a bipartisan group of policymakers has proposed “risk sharing” or “skin in the game” policies that would force colleges and universities to bear some of the risk currently faced by students and taxpayers. In the words of Democratic Senator Elizabeth Warren: “Right now, when borrowers default on their loans, students and taxpayers pay the cost—not colleges. That means colleges reap all the benefits of student loan funds, while students and taxpayers bear all the risk. If we want colleges to pay attention to rising costs and failing students, then they need to bear some of that cost too.”²

The majority staff of the Senate Committee on Health, Education, Labor and Pensions, chaired by Republican Senator Lamar Alexander, has touted the market-based elements of such proposals: “Instead of blunt government regulations and policies that are complex and conflicting, federal law should provide colleges and universities participating in the federal aid programs with market-oriented systems that enable these institutions to lower student borrowing yet still be held accountable for financial risks to students and taxpayers.”³

But there is little research or policy analysis on how specific risk-sharing policies would work in practice. The goal of this paper is to begin to fill that gap by describing the incentives such policies would create for institutions serving different students, explaining potential unintended consequences, and illustrating how these policies would interact with current policies governing federal aid programs.

Risk-sharing policy proposals have two important objectives. The first is to create incentives for institutions to use federal aid dollars more wisely and generate better outcomes for students. The majority staff of the Committee on Health, Education, Labor and Pensions argues that risk sharing

“would encourage colleges and universities to establish appropriate admissions practices for at-risk or uncommitted students, motivate students to complete more quickly, and graduate students with less debt.”⁴ By focusing on student-aid outcomes, such as loan repayment, risk sharing is aimed at improving overall higher-education and economic outcomes for students.

The second objective of risk sharing is to reduce the risk students and taxpayers face. Borrowers who take out student loans face significant uncertainty about their chances of completing a degree and their economic prospects after leaving school. Students who do not have a safety net of financial backing from their families or other sources face the risk of taking on loans they will struggle to repay.⁵ Students who report that paying for college was “very difficult” are 2.7 times as likely to stop out of college (leave college with the intention of returning) as their demographically similar peers who report no difficulty paying for college, even after controlling for family socioeconomic background (Terriquez and Gurantz 2015). And the Senate Committee on Health, Education, Labor and Pensions points out that “approximately 70 percent of borrowers who defaulted on their loans withdrew from college before completing their program.”⁶Error! Reference source not found.

In this report, we argue that the risk-sharing elements of current federal policy, as well as recent proposals to give colleges more skin in the game, are unlikely to achieve the objectives of improving student outcomes and reducing risk, in part because they are overly focused on the repayment behavior of past students. We argue for an alternative vision of risk sharing aimed at improving outcomes by focusing on students’ progress toward degree completion and their overall economic outcomes.

Risk Sharing in Current Policy

Participation in federal student aid programs is by no means risk free for colleges and universities. Under current policy, the primary risk they face is that they will lose access to these programs, which, for many institutions, can spell their demise.⁷ All institutions that provide federally backed student loans are judged by their cohort default rates—the percentage of borrowers who default within three years after entering repayment. Schools with sufficiently low cohort default rates are eligible for more flexibility in the timing of student loan disbursement. Schools with high cohort default rates are subject to harsh penalties. Specifically, if a school’s three most recent official cohort default rates are all 30 percent or greater, the school loses its eligibility for federal aid programs for the remainder of the year and the following two years. If a school’s official cohort default rate rises above 40 percent in a single year, the school loses loan program eligibility for the same period (Federal Student Aid 2016).

But the risk of the cohort default rate metric shutting off the faucet of student aid is low for most institutions, at least in recent years.⁸ In fall of 2016, 10 colleges faced penalties for high cohort default rates, pending appeal.⁹ Since 1990, the highest number of schools that have faced possible penalties in a given year was 21, in 2014.¹⁰

The number of institutions penalized under these regulations has been moderated, in part, by adjustments to the cohort default rate calculation that Congress and the US Department of Education (ED) have made. In 1998, Congress redefined default as failure to make a payment for 270 days (up from 180 days), which may have artificially lowered the default rate.¹¹ In fulfillment of the Higher Education Opportunity Act of 2008, ED began to measure cohort default rates over three years, rather than two, after concerns that the shorter period was not accurately capturing student loan outcomes.¹² In 2014, some colleges received a reprieve from ED sanctions through a calculation “tweak” that allowed for the removal of borrowers with one defaulted loan and one nondefaulted loan.¹³

A subset of postsecondary programs—nearly all for-profit institutions, as well as certificate programs at public and private nonprofit institutions—are also subject to gainful employment regulations. Programs that produce graduates whose loan payments are high relative to their incomes would lose eligibility for federal student aid.¹⁴ In addition, beginning in 2017, these programs will be required to disclose information on program-specific outcomes, such as graduation rates and median debt on promotional material.¹⁵ Though sanctions have not yet been implemented, ED estimated that 1,400 programs (serving roughly 840,000 students) could eventually become ineligible for federal student aid if they do not improve.¹⁶

Current federal regulations that impose a ceiling on poor outcomes (e.g., loan defaults and loan payment amounts) have had intended and unintended consequences. With pending gainful employment regulations, some for-profit schools have already started making changes. The University of Phoenix, a large for-profit provider, announced intentions to shutter most of its associate degree programs and improve admission standards, and Career Education Corporation has begun to pare down its programs, initiating teach-out plans at 14 campuses and reducing its holdings to Colorado Technical University and American InterContinental University.¹⁷

But not all of the responses from institutions have prompted behavior changes that may improve institution quality and outcomes for students. Some community colleges have opted out of the federal student loan program, citing the consequences of a high cohort default rate for students and institutions (including the loss of institutional eligibility for federal grants). The Institute for College Access & Success estimates that nearly one million community college students (9 percent of all

community college students nationally) did not have access to federal student loans through their institution in the 2015–16 school year (Cochrane and Szabo-Kubitz 2016).

Lack of access to federal loans forces many students to rely on higher-interest private student loans, which are riskier for students because they have much weaker consumer protections. And reducing students' federal borrowing may have negative impacts on their academic outcomes. One study compared Pell-eligible students who enrolled before and after their institution opted out of the loan program and found that students were more likely to borrow for their education when their college offered federal loans. Pell-eligible students who borrowed also attempted more credits in their first year and were more likely to attempt math and science courses than nonborrowers (Wiederspan 2015).

Limitations of Current Risk-Sharing Proposals

Lawmakers on both sides of the aisle have proposed changing federal higher education policy to give institutions more skin in the game. Nearly all proposals use metrics based on loan repayment outcomes and issue a graduated set of sanctions to institutions that fall short of specified targets (as opposed to cutting off access to federal aid, as is the focus of current policy).

The Protect Student Borrowers Act, introduced by Senator Jack Reed of Rhode Island and cosponsored by Senators Durbin, Warren, and Murphy, would require any institution with more than 25 percent of its student body participating in the federal loan program to make a risk-sharing payment based on the level of the institution's most recent cohort default rate.¹⁸ A school with a cohort default rate between 15 and 20 percent would be required to pay 5 percent of the dollar amount of defaulted loans, those between 20 and 25 percent would pay 10 percent, and those between 25 and 30 would pay 20 percent of the defaulted balance.

The Student Protect and Success Act, a bipartisan bill introduced by Senator Jeanne Shaheen of New Hampshire and Senator Orrin Hatch of Utah, would measure student loan outcomes through the three-year repayment rate, calculated as the percentage of borrowers with nondefaulted, nondeferred loans who pay at least one dollar toward the principal of their federal loans. In the first year of the proposed legislation, institutions with a three-year repayment rate of less than 45 percent would be ineligible to participate in the student loan program for three years. The bill also establishes a risk-sharing policy that would require institutions to pay 20 percent of the nonrepayment balance, adjusted for the national unemployment rate.¹⁹ Institutions with a strong record of supporting low- and moderate-income students would be awarded grants underwritten by this repayment fund.

Both of these risk-sharing proposals focus on measuring the medium- to long-term repayment outcomes of former students at each institution, and issuing rewards or sanctions based on one or more threshold cutoffs. There is not a strong evidence base on which to evaluate these proposals, but we believe that these types of proposals are unlikely to induce institutions to change their behavior in ways that reduce risks for both taxpayers and students.

Long-Term Outcomes Ill-Suited for Accountability Purposes

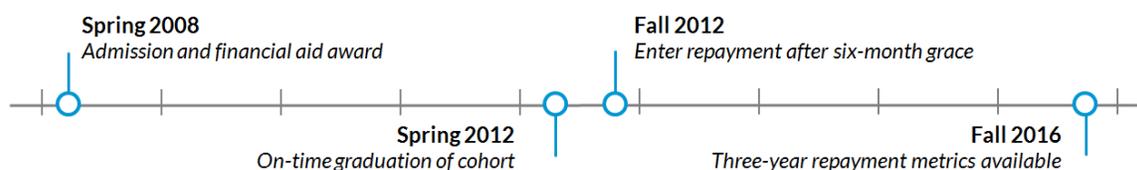
The use of long-term repayment outcomes in risk-sharing proposals means that institutions would be held accountable for actions they took several years ago. Both of the proposed Congressional risk-sharing bills use three-year metrics to measure outcomes, but the calculation of these metrics could be as far as a decade from the decisions that affected them. As a result, administrators would often be held accountable for the behavior of their predecessors, and the consequences of their own behavior would likely fall on their successors.

Imagine a cohort of students admitted to a four-year college. Based on the institution's perception of academic qualifications and financial need, students are admitted and awarded financial aid, including loans, in the spring of 2008. Assuming all students in the cohort graduate on time in spring of 2012 and enter repayment after a six-month grace period, their cohort default rate will be measured as part of the fiscal year 2013 cohort, meaning that their default rate will not be available until fall of 2016. From cohort admission to cohort performance metric, eight and a half years have elapsed—longer than the average tenure of a university president (seven years in 2011).²⁰

FIGURE 1

Timeline for Measurement of a Cohort of Borrowers at a Four-Year School

Assuming all cohort members graduate on time



Source: Urban Institute analysis of cohort default measurement.

This is an admittedly simple case, but variations on this example show the wide variance in the length of time between the granting of student loan packages and outcome measurement. Institutions

with a high number of withdrawals could potentially see more immediate results (as close as 4 years from the initial financial aid award) in their cohort default rates, and institutions with a high number of part-time students may not see the fruits of administrative efforts until more than 12 years after enrollment.

The challenge of assessing current performance using lagged outcomes is evident on the 2015 College Scorecard, on which University of Phoenix students are recorded as earning salaries, measured 10 years after enrollment, comparable to students from Rutgers, University of Connecticut, and New York University. However, this measurement is based on the cohort of students who graduated in 2001–02, when the institution primarily served adult learners finishing their bachelor degrees. As the profile of incoming Phoenix students changed over the next decade, so did their earnings outcomes (as seen in early metrics available in the full College Scorecard dataset).²¹

The long delay between institutional action and outcomes measurement could cause institutions to change organizational behaviors that are most directly measured rather than address underlying performance (van Thiel and Leeuw 2002). Evidence from previous higher education performance incentive policies provides some support for this line of reasoning. Performance funding in Indiana, which allocated a portion of state funding based largely on the number of completed degrees and the on-time graduation rate, was found to have no effect on the number of graduates, but it did lead to declining admission rates and increasing selectivity, which had the potential to disproportionately affect low-income and minority applicants (Umbricht, Fernandez, and Ortagus 2015).

The state of Washington implemented a performance funding system for its community colleges designed to increase retention rates and number of degrees awarded. However, a recent study found that this incentive system did not substantially affect retention rates and only significantly increased the number of short-term certificates awarded, possibly as a result of colleges retroactively awarding certificates to students who stopped out of a longer-term degree or certificate program (Hillman, Tandberg, and Fryar 2015).

Colleges at risk for federal sanctions based on their cohort default rate respond in divergent ways, which vary by sector. For-profit colleges were more likely to slightly reduce their “sticker price” tuition when facing accountability pressure, and nonprofits were more likely to raise both tuition and living allowances (Kelchen 2016).

When faced with long-run performance measures that have an immediate impact on their operations, such as performance funding or impending cohort default sanctions, institutions of higher

education have a track record of responding in ways that are unanticipated and may run counter to the intentions of the performance measures.

Repayment Metrics Undermined by Borrower Behavior

Implicit in the use of student loan repayment outcomes for accountability purposes is the assumption that institutions improve the earnings of their students and that improvement in earnings is closely tied to debt repayment. But research shows that individual borrower characteristics are more closely associated with student loan default than institutional characteristics.²²

Two students could have similar income outcomes and similar borrowing but different loan repayment outcomes. For example, loan repayment outcomes can be affected by the degree to which the borrower prioritizes her student loan debt. Former students may be less likely to prioritize student debt if they have other, higher-interest debt, have family responsibilities, or have less experience with being borrowers. Policymakers may reasonably expect institutions to educate borrowers about repayment options and the consequences of default, but institutions lack influence over the financial decisions that their students make after leaving the institution.

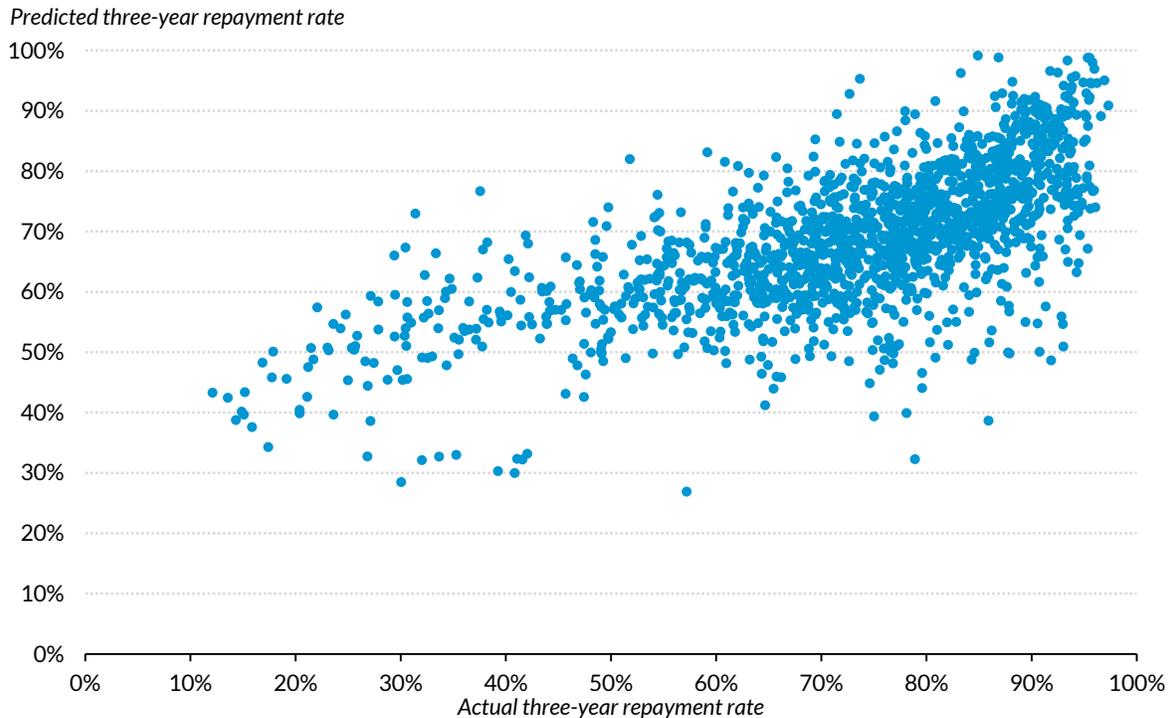
We find that institutions whose students have similar borrowing and earnings levels can vary substantially in their repayment outcomes. Borrowing and earnings only explain 54 percent of the variance in three-year repayment rates for institutions in the 2015 College Scorecard data.²³ Though post-enrollment earnings and debt predict a sizeable share of student loan outcomes in the form of repayment after three years, the remaining unexplained variation is likely a function of individual borrower characteristics (e.g., age, experience with credit, other financial obligations) and institution influence on behavior. This variation can still be substantial: on average, a predicted three-year repayment rate based on average borrowing and earnings was 11 percentage points off of the true value (figure 2).

Holding institutions accountable for behavior beyond their control runs counter to the goal of incentivizing institutional behavior that improves student outcomes, and increases the risk that institutions try to game metrics (e.g., by encouraging former students to seek deferments) rather than make meaningful, lasting change.

FIGURE 2

Prediction of Repayment Rates Based on Institution-Level Cohort Income and Debt Levels

Using three-year repayment rates for fiscal year 2012, for four-year schools



Source: Urban Institute analysis of College Scorecard data.

Notes: Because the three-year repayment rate is calculated for students who have not defaulted, we reweight this metric to account for the institution's three-year cohort default rate. Predictions are based on median earnings, median debt at exit, the ratio of median debt to earnings, and the percentage of students earning more than \$25,000 six years after graduation.

Risk Sharing Focused on Completion and Earnings

The problems with holding colleges and universities accountable for the long-term behavior of their former students suggest a natural solution—focus on short-term outcomes when possible, and hold institutions accountable for metrics over which they have more control. These issues also push us to use federal financial aid as a lever for improving student outcomes and reduce overall risk for students.

Our approach aims at strengthening incentives for institutions to improve student persistence and degree completion. It has been said that the student loan crisis is a completion crisis, because failure to attain a postsecondary credential is the single strongest predictor of default (Gross et al. 2010). Even when controlling for loan size, academic background, institution type, and demographics, individuals

who leave school without a degree or certificate are over two times more likely to default than completers (Hillman 2014).

The upshot is that policies that are successful at improving completion are likely to improve the economic prospects of students and reduce default rates. We believe that tying incentives to institution and student actions and reducing the overall risk in the system will do more to improve borrower well-being (including default reduction) than policies that target loan repayment directly.

Our proposal has several component parts, rather than a single risk-sharing system, to avoid unintended consequences, such as gaming behavior by institutions, which can emerge from the use of a single-performance measure:

- Require the disbursement of aid—grants and loans—to the student for living costs over the course of the semester rather than in a lump sum near the start of the term.
- Require institutions to return a portion of the financial aid of students who drop out before the end of the term, and limit institutions' abilities to pass along this cost to students.
- End federal aid eligibility for colleges where a high proportion of students earn unacceptably low wages after leaving.
- Require participation in the federal loan program for all colleges that participate in any federal grant programs.
- Experiment with federal aid strategies that may reduce the risk of student debt, such as tying loan limits more closely to students' course loads and front-loading Pell grants for first-time students.

Shape Student and Institution Incentives to Promote Completion

An under-studied fact about US higher education is the significant number of undergraduates who leave college before the end of the term (e.g., semester, trimester, or quarter). Data from the National Postsecondary Student Aid Study 2011–12 and the 2004/09 Beginning Postsecondary Students Longitudinal Study (BPS: 04/09) show that roughly 6 to 7 percent of beginning first-time students leave their institution before the end of the term.

Borrowers who drop out before the end of the term are less likely to ever earn a degree or credential and more at risk of defaulting on their loans. The BPS: 04/09 data show that, among

borrowers who dropped out before the end of a term, just 14 percent went on to attain any degree within the following six years. Of borrowers who dropped out before the end of the term and who did not earn a degree, 38 percent experienced federal student loan default by 2009, and just 31 percent of these borrowers either repaid their loans or were in repayment. In contrast, among those who stopped out at the end of the term and did not receive a degree within six years, 22 percent had a default and 50 percent were either in repayment or repaid (table1).

TABLE 1

Student Loan Outcomes by Degree Attainment and Stop-Out Behavior

Stop-out and loan behavior from BPS institution attendance

Borrower status	Percent of BPS borrowers	Worst Status on a Federal Student Loan Issued during BPS Institution Attendance			
		Default	Deferral or forbearance	In repayment or repaid	Other
Left institution at end of term Attained degree by 2009	14%	5%	20%	61%	14%
Left institution at end of term No degree by 2009	17%	22%	15%	50%	11%
Left institution before end of term Attained degree by 2009	<1%	34%	17%	23%	25%
Left institution before end of term No degree by 2009	4%	38%	11%	31%	21%

Source: Urban Institute analysis of BPS: 04/09.

Notes: Based on National Student Loan Data System status as reported in BPS dataset for loans recorded as starting during the period of BPS institution enrollment. A crosswalk of National Student Loan Data System codes with this charts' statuses is available from the authors upon request.

We propose a system that embeds stronger incentives for institutions to track and support student persistence and completion.

DYNAMIC DISBURSEMENT

It is difficult for students, particularly for those who live off campus or are financially independent, to correctly estimate the amount they should borrow to cover living costs. As a result, many students would be better served by a more dynamic aid disbursement system that provides living-cost funds over the course of the semester and allows students to adjust their borrowing (within the parameters of federal loan limits).

One goal of such a system would be to reduce the number of students who borrow too much or too little. Uncertainty about on-campus job opportunities, availability of affordable housing, and the cost of living in an unfamiliar area might encourage students to borrow the maximum at the start of enrollment. But students can also underborrow for college, perhaps because they are averse to taking on debt, and end up relying on higher-interest credit to cover the gap. Twenty-five percent of students who started college in 2004 and were still enrolled in 2006 reported that they were carrying credit card debt, and a substantial number of those students did not access the Stafford loan program before taking on credit card debt (Avery and Turner 2012).

A dynamic disbursement system would replace the existing system, in which students who need more aid in the middle of an academic year must file a “professional judgment” review with their college, documenting the change in financial status (e.g., the death of a wage earner, unexpected medical bills) that merits the additional aid. A modernized system would reduce the risk to students and taxpayers by taking steps to make student loan borrowing more flexible and responsive to student need. This is particularly important for students who face the greatest uncertainty in their financial needs over the course of a semester, including first-time students and students who do not receive significant financial support from their families (e.g., low-income and older students).

Under our proposal, aid for tuition and fees would continue to be provided directly to the institution at the outset of the semester, but funds for living costs would be disbursed over the course of the semester, with a slightly larger disbursement at the start of the semester for book purchases and other start-up costs.

This model could take the form of staged reimbursements from the college (similar to the Aid Like a Paycheck model, which has shown promising early results), or a staged disbursement scheme directly to the student from ED for living costs.²⁴ Students would be allowed to reduce the size of their disbursement or create an emergency reserve if funds are unneeded, and the implementation of a high-touch disbursement system would allow for the possibility of a more flexible appeals process for additional funds if needed.

MAKE INSTITUTIONS PAY FOR MID-SEMESTER DROPOUTS

Currently, through a process called Return to Title IV (R2T4), colleges return a portion of federal student loan and grant aid when a student withdraws. However, R2T4 does not prevent institutions from billing students for the remainder of the tuition cost, and institutions are allowed to pursue a student’s unpaid costs through a collections process. A small survey of 148 two- and four-year public and private schools in 2009 found that roughly 24 percent of students had an unpaid balance at the end

of a given fiscal year, and 5.5 percent of all student accounts were placed in collections (National Association of College and University Business Officers 2009).

The current R2T4 system requires that institutions return a portion of federal student loan and grant aid when a student withdraws before completing at least 60 percent of their semester. For example, a student who withdraws one month into a four-month semester would earn a fourth of her aid, and would have to return 75 percent of the dollar amount of her loans and grants. If this return of funds leaves a portion of the tuition bill unpaid, her college has the option to bill for the unpaid amount. This system places a disproportionate burden on low-income students, who may be unable to clear their debts at the college and are therefore unable to access their academic record or reapply for federal aid until all federal debts are also repaid.²⁵

There is little known about the effect that R2T4 has on the behavior of institutions. The National Association of Student Financial Aid Administrators convened a task force of 10 financial aid administrators from institutions who estimated their typical return of aid they receive each year as 1 to 2 percent (NASFAA 2015). Aside from the burden on students, there is growing evidence that the R2T4 system is overly burdensome for institutions—ED provides more than 200 pages of explanation for the process, and errors in the R2T4 process are frequently the most-cited audit risk for institutions (Barnett and Weams 2014).²⁶

We propose eliminating R2T4 and requiring institutions to share in the risk of noncompletion by assuming responsibility for part of the tuition of students who drop out during the semester. Instead of tracking precise withdrawal dates for the first 60 percent of the term, institutions would be required to perform two enrollment audits over the course of the semester or equivalent term, and identify federal aid recipients who dropped out before the midpoint of the semester and between the midpoint and end of the semester. Drop-outs could take the form of official withdrawals (where a student gives notice that she is no longer attending), or unofficial withdrawals identified at the audit point (e.g., failure to show up for midterm or final exams).

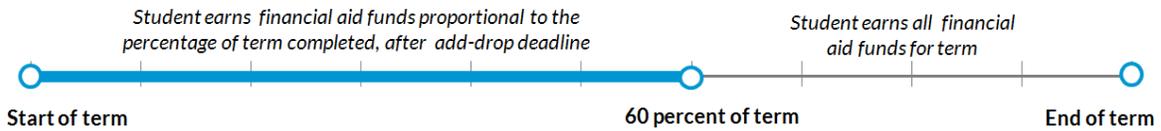
The US Department of Education would request a return of 50 percent of financial aid funds paid to the institution (for tuition and fees) for students who drop out before the midpoint of the semester, and 25 percent of funds for students who drop out before the end of the semester (figure 3). From the student's perspective, our proposed dynamic disbursement model means withdrawing mid-semester would stop the flow of disbursements to cover living costs. As a result, their federal borrowing would be limited to the funds already disbursed, not the full amount of a loan designed to last for the entire

semester. Similar to the current R2T4 system, the amount returned would recover loans first, followed by grants.

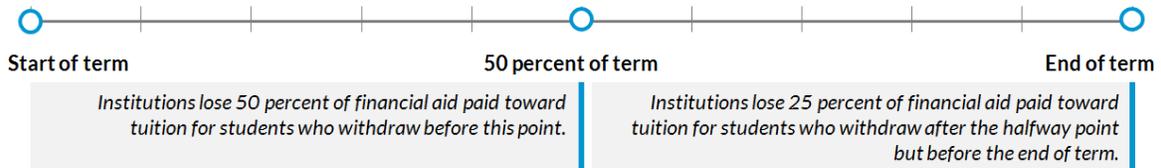
FIGURE 3

Comparison of Current and Proposed Systems to Return Federal Financial Aid

Current system



Proposed system



Under the current system, many schools initiate a collection of unpaid tuition if the student drops out after the first week or two of classes but before the current 60 percent of term guideline. In the current system, the threat of a tuition bill upon withdrawal may reduce the fraudulent use of Pell grants. To prevent frictionless withdrawals from institutions under our proposed system, schools would be permitted to charge students a small financial penalty for dropping out mid-semester. For example, institutions could charge the student for a small proportion (less than 50 percent) of the tuition now unpaid by federal aid.

Institutions are unlikely to recoup all tuition that was previously paid by federal aid and thus have strengthened incentives to encourage students to complete each term for which they are enrolled. But our proposed policy would still permit using other measures to reduce the misuse of student aid, such as delaying the first disbursement for new students or providing the first disbursement of financial aid funds through the college bookstore for the purchase of supplies.

Hold Institutions to a Post-Enrollment Income Standard

Institutions have already shown that they are responsive to a single “ceiling” measure of student outcomes, in the form of the three-year cohort default rate. In some cases, these institutional responses are not those policymakers intended, such as gaming the cohort default rate metric or opting out of the

student lending program. Despite the weaknesses of using long-term student outcome measures, the government should maintain a “high-water mark” for aid-eligible institutions to protect students and taxpayers from having aid dollars wasted at low-quality institutions. In our view, such a ceiling would be most effective if it is difficult to game and easy for institutions to understand and influence.

We propose that institutions be held accountable for the income outcomes of their students after separation from the institution, not their borrowing and repayment behavior. Student loans are issued based on the premise that a college education will result in higher earnings over time. An effective ceiling measure, therefore, should rely on the measurement of the borrower’s earnings rather than their debt repayment.

Under our proposal, institutions where a large proportion of students earn less than a specified minimum for multiple years would be subject to sanction. This minimum would be relatively low, similar the federal poverty level, since it seems reasonable to expect colleges to produce graduates that earn more than poverty-level wages. Sanctions under this earnings-based proposal would be similar to the sanctions currently used for institutions under the cohort default rate regulations. For example, if colleges consistently have a high number of students whose incomes do not reach this minimum threshold across three years of measurement, they would lose federal aid eligibility.

This straightforward metric would allow institutions to demonstrate and measure the value that they add to their students’ earning potential. Unlike the cohort default rate, an earnings measure is easier to adjust and much harder for institutions to game. This income threshold could be adjusted for local economic conditions and for the level of degree sought by the institution’s students. It could also exclude students who are not actively in the workforce or are participating in a federal program, such as those on total and permanent disability or active-duty deployment, or those participating in Peace Corps or AmeriCorps programs.

There are a small number of specialized institutions that produce graduates with relatively low incomes but who are still successful in other ways. For example, the average income for those who enroll in conservatories, such as The Juilliard School or the Berklee School of Music, is lower than for similarly selective four-year schools, yet borrowers from these schools have high student loan repayment rates. Rather than add complexity by writing in exemptions for institutions that produce a high number of students who enter low-paying but socially valuable professions, we suggest a “fail-safe” metric of high student loan repayment rates. An institution would be exempt from this income threshold if they have a three-year loan repayment rate higher than 80 percent. We estimate that about 29 percent of aid-eligible institutions would be eligible for this fail-safe measure.

Use Federal Aid as a Means of Reducing Borrower Risk

The above proposals focus on placing more risk on institutions by holding them accountable for short- and long-term student outcomes. Though ED has generated a number of ways to protect borrowers while they are in repayment, we believe that the disbursement of federal aid can be changed to further reduce the overall risk introduced into the student loan system and thus reduce the risk to student borrowers and taxpayers.

REQUIRE PARTICIPATION IN THE STUDENT LOAN PROGRAM

As we have discussed, some institutions, particularly community colleges, have dropped out of the federal student loan program, fearing that running afoul of the cohort default rate metric will result in their exclusion from the federal grant programs on which many of their students rely. As a result, students at these institutions who need to borrow have to turn to the private market, which tends to charge higher interest rates, restricts access to credit, and has less flexible repayment terms.

Federal loans have more favorable interest rates and repayment plans than private loans, and denying students the right to access these loans has the potential to cause harm. Furthermore, access to federal student loans is not subject to credit score limits or other tests of ability to repay. In this way, the federal student loan system is similar to other federal entitlement programs.

The flexibility to provide Pell grants to students without also offering the federal student loan program allows institutions to thrust all of the risk of student loans on students. Because of the less-forgiving interest rates and repayment plans of private loans, this practice may even increase default risk for students who take on private loans. To reduce this risk for students, we propose that institutions cannot accept Pell grants or other federal grant aid without also participating in the federal student loan program.²⁷

LEVERAGE AID TO REDUCE BORROWING

An attempt at higher education is a substantial risk; students face an opportunity cost (e.g., lost wages) as well as the actual cost of attendance. Of all first-time students who started in fall 2012, 31 percent did not return to any college by fall 2013.²⁸ This is a poor outcome for students, but if these students borrowed federal financial aid, it is also, pragmatically, a poor outcome for taxpayers, since students who do not complete are also less likely to repay their student loans. When student loans default, just 3.4 percent of the loan balance is recovered by collection agencies within a year.²⁹ In some instances, student loan borrowers default repeatedly, racking up more recovery costs. Student loan defaults can affect a borrower's credit, cut off their access to additional federal aid, result in wage and benefit

garnishment, and even affect job prospects with state and federal agencies. Though we are unable to fully estimate the costs of default, it is conceivable that a small defaulted student loan—less than \$1,000—could exact more than \$1,000 of overall economic loss as a result of collection costs and the borrower’s loss of creditworthiness.

To reduce the risk to the student, we propose that student lending support student completion. It has been shown that taking 15 credits, instead of the baseline 12 credits for full-time status, is associated with a significant increase in the likelihood of graduation within six years (Attewell and Monaghan 2016). Policies that promote the completion of 15 credits per semester are also associated with higher grade point averages for students and an increased rate of on-time completion (Klempin 2014).

We propose a pilot program that would allow a bump in the borrowing limit of \$500 a semester for students who take 15 credits, to acknowledge that students who study more need to work less in order to succeed. Thus, a first-year student who takes 30 credits instead of 24 would have access to \$6,500 in student loan credit per year rather than \$5,500. This proposal echoes an Obama administration proposal, the On-Track Pell Bonus, which would increase the maximum Pell grant by \$300 for students who take 15 credits per semester.³⁰ Our pilot project would also reduce the borrowing limit for those who take 9 or 6 credits (or the equivalent for a less-than-full-time course load at a given institution) by \$500 a semester (to a maximum of \$4,500 for a first-year student). This proposal is designed to lower the risk for students (who have a higher chance of completion with a full course load) and for taxpayers (allowing more student loan funds to flow to students who have the highest likelihood of completion and are thus less likely to default on their loans).

To further reduce the risk of attempting college, we propose resurrecting an old idea—a pilot to front-load the Pell grant for first-time students. There is evidence that additional grant aid can increase a student’s probability of continuing from their first semester to the second (Castleman and Long 2016). In line with this evidence, our front-loading proposal is a modest one, used only for first-time students in their first year. If a student receives a financial aid package that includes loans, they may allocate up to 25 percent of their spring Pell grant (roughly \$725 under the current Pell grant maximum) toward their fall semester. This would reduce or eliminate student loans needed to start a program for at-risk students. If students continue to their spring semester, they receive their remaining Pell grant, along with the same amount of loans that they would have had under a program that is not front-loaded.

Potential Impacts on Institutions and Students

Our proposal is designed to reduce the overall risk in the student loan borrower pool, as well as strengthen incentives for behavior changes from institutions. Though it is difficult to predict how a sector will respond to a new policy, we estimate that the majority of the impact will be felt by public two-year and private for-profit colleges, which have the highest proportion of first-time beginning students who leave before finishing a semester. For-profit colleges have the highest proportion of students leaving before the end of the term (roughly 17 percent of beginning students). We estimate that they would return an average of \$1,060 dollars per first-time student, and public two-year schools, with a lower average tuition cost, would return an average of \$690 per student (table 2).

TABLE 2

Estimated Costs of Students Who Leave before the end of Semester

Based on first-time beginning students in the 2011–12 school year

Sector	Students leaving before the end of the term (%)	Students Who Left before the end of the Term		
		Share with federal loan (%)	Share of federal borrowers receiving full refund of loan (%)	Average amount of aid returned per student
Public four-year	2	31	48	\$1,110
Private nonprofit four-year	2	47	19	\$1,350
Public two-year	9	14	67	\$690
Private for-profit	17	47	28	\$1,060

Source: Urban Institute analysis of National Postsecondary Student Aid Study 2011–12.

Predicting the effect of the income threshold measure is more complex. The College Scorecard provides only one threshold measure: the percentage of students who earned more than the average earnings of a high school graduate ages 24 to 34 (\$25,000) six years after enrollment. If we remove institutions from federal aid eligibility based on having more than 75 percent of students below this \$25,000 earnings threshold over three cohort years, we estimate that 117 institutions would be subject to this sanction. The majority of these institutions are for-profit trade schools.

Unfortunately, we do not have enough data to assess a more granular income threshold, such as a threshold based on the type of degree typically offered by the institution or one based on a period of

years after a student's departure (drop-out or completion), rather than the period after enrollment. As with any new policies, we recommend that these income thresholds be phased in over time to allow institutions the opportunity to assess their progress toward meeting the income threshold and change course as needed.

The focus of our proposal is placing incentives for student retention and completion as close as possible to the actions of institutions and students. Further, we have complemented our proposal with policies that help students optimize their borrowing and chances of completion by providing aid funds dynamically, giving more funds to students who are on track to finish their degree on-time, and reducing the risk of a first try at college. However, any policy that attempts to change the behavior of an institution may also introduce unintended consequences. For example, it is possible that institutions may raise tuition prices to recover funds lost from exiting students. Institutions may also attempt to block enrollment for students they perceive as a risk, either for exiting before the end of semester or for having low income after enrollment.

Hazards are inherent in any higher-education risk-sharing proposal. By setting prices, admissions standards, and course offerings, institutions have a large degree of control over their inputs, and we acknowledge that risk-sharing policies may push institutions to limit access. This is acceptable to the extent that the excluded students, if accepted, are likely to end up with debt but no degree, but not if it undermines the mission of the federal aid to increase educational attainment.

We believe that our proposal minimizes these hazards relative to current Congressional proposals and existing policy. For example, if an institution raises tuition under our plan, they also directly increase their financial liability, in the form of repaid student aid, if students leave before the end of the semester. We recognize that many students at open-access institutions, such as community college students, may enroll and stop-out multiple times over their college career. Our plan creates incentives for institutions to help students successfully achieve credits over a given semester, rather than assuming continuous term-to-term enrollment, and uses student loans as a lever to promote a path to completion, minimizing risk for both the institution and the borrower.

Conclusion

Next year, Congress will again turn to the overdue reauthorization of the Higher Education Act, which governs all of the federal aid programs discussed in this paper. The concepts of risk sharing and risk reduction could be front and center in that process, but the evidence suggests that current

Congressional proposals would do more harm than good. Using student loan repayment metrics does not create the right incentives; the metrics are too far removed from institutional behavior and too closely tied to other factors, such as borrower preferences, student loan repayment policy, and economic conditions.

Our proposal illustrates a potential alternate approach. We create better incentives by placing them as close as possible to institutional behavior and prevent wasting taxpayer-funded student aid dollars at low-quality institutions by setting a minimum post-enrollment income threshold. We hope this proposal can be a starting point for reforming higher education policies to better support students' chances of degree completion and lifelong success.

Notes

1. According to CFPB analysis, in some cases, the government pays up to \$40 for every dollar recovered through student loan rehabilitation. Consumer Finance Protection Bureau. October 2016. "Annual report of the CFPB Student Loan Ombudsman: Transitioning from default to an income-driven repayment plan." http://files.consumerfinance.gov/f/documents/102016_cfpb_Transmittal_DFA_1035_Student_Loan_Ombudsman_Report.pdf
 2. Elizabeth Warren, Remarks to the Shanker Institute and the American Federation of Teachers, "The Affordability Crisis: Rescuing the Dream of College Education for the Working Class and Poor," <http://www.warren.senate.gov/files/documents/ShankerInstitute-AFTEducationSpeech.pdf>.
 3. Senate Committee on Health, Education, Labor and Pensions, "Risk-Sharing/Skin-in-the-Game Concepts and Proposals," http://www.help.senate.gov/imo/media/Risk_Sharing.pdf.
 4. Ibid.
 5. The federal government has taken steps to reduce these risks through a series of policies and programs for borrowers. Individuals who have a total and permanent disability or who were attending schools that closed are eligible to have their student loans discharged. Borrowers who enter a low-paying public service field, such as teaching or nonprofit work, are eligible for loan forgiveness. In addition, there are a number of income-driven repayment plans that allow borrowers to cap payments at a percentage of their income and spread payments over longer repayment period. However, substantial risks still remain. Despite the availability of these safety nets, the three-year cohort default rate is 11.3 percent for students who entered repayment in the 2013 fiscal year ("Official Cohort Default Rates for Schools," Federal Student Aid, US Department of Education, last modified September 28, 2016, <http://www2.ed.gov/offices/OSFAP/defaultmanagement/cdr.html>).
 6. Senate Committee on Health, Education, Labor and Pensions, "Risk-Sharing/Skin-in-the-Game Concepts and Proposals."
 7. Melissa Korn, "ITT Technical Institute Shuts Down after Government Cut Off New Funding," *Wall Street Journal* September 6, 2016, <http://www.wsj.com/articles/itt-technical-institute-to-close-after-government-cuts-off-new-funding-1473163181>.
 8. In the late 1980s and early 1990s, the cohort default rate accountability rules were enacted to shut down hundreds of so-called "fly-by-night" trade schools; vocational programs that accepted Pell grants and student loans without leading to better student outcomes (Doug Lederman, "A More Meaningful Default Rate," *Inside Higher Education*, November 30, 2007, <https://www.insidehighered.com/news/2007/11/30/defaults>).
- Two-year cohort default rates fell substantially during this time, from 22.4 percent for borrowers entering repayment in 1990 to 4.5 percent for those who entered repayment in 2003 ("National Student Loan Two-Year Default Rates," Federal Student Aid, US Department of Education, accessed November 21, 2016, <http://www2.ed.gov/offices/OSFAP/defaultmanagement/defaultrates.html>).
9. "National Student Loan Cohort Default Rate Declines Steadily," US Department of Education, press release, September 28, 2016, <http://www.ed.gov/news/press-releases/national-student-loan-cohort-default-rate-declines-steadily>.
 10. Michael Stratford and Paul Fain, "Default Rates Dip (Slightly)," *Inside Higher Education*, September 25, 2014, <https://www.insidehighered.com/news/2014/09/25/default-rate-federal-loans-ticks-down-slightly-21-colleges-face-sanctions-high-rates>.
 11. Jonathan D. Glater, "It's Payback Time." *New York Times*, April 23, 2016, <http://www.nytimes.com/2006/04/23/education/edlife/spendingit2.html?pagewanted=print&r=0>.

12. "First Official Three-Year Student Loan Default Rates Published," US Department of Education, September 28, 2012, <http://www.ed.gov/news/press-releases/first-official-three-year-student-loan-default-rates-published>.
13. Stratford and Fain, "Default Rates Dip (Slightly)," Jeff Baker, "Adjustment of Calculation of Official Three Year Cohort Default Rates for Institutions Subject to Potential Loss of Eligibility," Federal Student Aid, US Department of Education, September 23, 2014, <http://www.ifap.ed.gov/eannouncements/092314AdjustmentofCalculationofOfc3YrCDRforInstitutSubtoPotentialLossofElig.html>.
14. Programs are required to keep their graduates' estimated annual loan payment at 20 percent of their average discretionary income or 8 percent of their earnings ("Fact Sheet: Obama Administration Increases Accountability for Low-Performing For-Profit Institutions," US Department of Education, press release, July 1, 2015, <http://www.ed.gov/news/press-releases/fact-sheet-obama-administration-increases-accountability-low-performing-profit-institutions>).
15. "Gainful Employment Information 2014/2015/2016," Federal Student Aid, US Department of Education, accessed November 21, 2016, <https://ifap.ed.gov/GainfulEmploymentInfo/indexV2.html>.
16. "Obama Administration Announces Final Rules to Protect Students from Poor-Performing Career College Programs," US Department of Education, press release. October 30, 2014. <http://www.ed.gov/news/press-releases/obama-administration-announces-final-rules-protect-students-poor-performing-career-college-programs>.
17. Julia Glum, "For-Profit Colleges: Gainful Employment Rule Takes Effect, Sparking Change For Schools And Students," *International Business Times*, July 1, 2015. <http://www.ibtimes.com/profit-colleges-gainful-employment-rule-takes-effect-sparking-change-schools-students-1992233>.
18. Protect Student Borrowers Act of 2015, S.1102, 114th Cong. (2015), <https://www.congress.gov/bill/114th-congress/senate-bill/1102>.
19. Student Protection and Success Act, S.1939, 114th Cong. (2015), <https://www.congress.gov/bill/114th-congress/senate-bill/1939/text>.
20. American Council on Education, "The American College President Study," *Faculty Issues*, Spring 2012, <http://www.acenet.edu/the-presidency/columns-and-features/Pages/The-American-College-President-Study.aspx>.
21. Kristin Blagg, "University of Phoenix's 'top 25' claim isn't false, but it won't last," *Urban Wire* (blog), February 24, 2016, <http://www.urban.org/urban-wire/university-phoenixs-top-25-claim-isnt-false-it-wont-last>.
22. The relationship between institutions and student debt repayment is still under scrutiny. Some studies have found little to no association between student loan outcomes and institution characteristics (such as sector or type of degree offered) after controlling for borrower characteristics (Knapp and Seaks 1992; Monteverde 2000; Volkwein and Szelest 1995). A more recent study showed that attending a for-profit institution was associated with a higher probability of default, even after controlling for student characteristics (Hillman 2014).
23. Aligning cohorts in the College Scorecard data is methodologically difficult. We used the cohort of students who entered in 2006–07, 2007–08 for earnings measures after six years, and the cohort of individuals who exited in 2009–10, 2010–11 for the median debt, three-year cohort default rate, and the three-year repayment metric. When running regressions separately for predominantly two- and four-year schools, we found our variables explained roughly 47 percent of the variation for four-year schools, and roughly 27 percent of the variation for two-year schools. Because the three-year repayment rate is calculated for students who have not defaulted, we reweight this metric to account for the institution's three-year cohort default rate.
24. "Aid Like a Paycheck Project Overview," MDRC, accessed November 23, 2016, <http://www.mdrc.org/project/aid-paycheck#overview>.

25. Higher-education advocates have asserted that R2T4 is already a form of risk sharing, since colleges lose funds when students stop out (American Association of Community Colleges, “Congressional Risk-Sharing Proposals Pose a Threat to Community Colleges,” October 8, 2015, http://www.aacc.nche.edu/newsevents/News/articles/Pages/10082015_1.aspx). However, since institutions may pursue funds through collections process, the risk is that institutions are unable to recoup the debt from the student, not that institutions directly lose the funds.
26. National Association of Student Financial Aid Administrators, “NASFAA Reauthorization Task Force Recommends Changes to Return of Title IV Funds,” June 3, 2013, http://www.nasfaa.org/news-item/1696/NASFAA_Reauthorization_Task_Force_Recommends_Changes_to_Return_of_Title_IV_Funds.
27. Changing accountability metrics from repayment behavior to the incomes of former students should encourage more institutions to participate in the loan program, even in the absence of this requirement, because their aid eligibility is no longer tied to loan performance.
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