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Disclaimer
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Current accountability policies regarding the $150 billion in annual federal financial aid expenditures are structured in ways that limit their ability to hold colleges accountable for their outcomes, instead providing incentives to serve students with a higher likelihood of completion in order to avoid facing sanctions. Current accountability policies regarding student loan default rates also encourage colleges to stop offering federal loans in order to preserve Pell Grant eligibility for their students. In this paper, I propose a new federal risk sharing policy with the following key components:

- Colleges could be eligible for a bonus payment or be required to return a portion of federal Title IV financial aid dollars based on the relative performance of their students who receive Pell Grants or take out federal student loans compared to the performance of a peer group of similar colleges.
- Performance significantly above the peer group average on Pell Grant students' success rates would result in a college getting additional funding from the federal government, while performance significantly below average would result in the college paying a portion of the Pell Grant award to the student out of its own budget without taking that money from institutional grant aid.
- Performance significantly above the peer group average on student loan repayment metrics would result in a college getting additional federal work-study funds for its students, while performance significantly below average would result in the college paying a portion of the defaulted loan out of its own budget.
- Rewards and sanctions for Pell Grant and student loan recipients would be decoupled, so financially needy students with no loans would not be hurt by a college with high loan default rates. Additionally, colleges accepting Pell Grant dollars would also be required to offer their students federal loans.
- This program would be phased in over a period of several years, and colleges facing sanctions could see the penalties reduced for a limited period of time if they agree to undertake institutional improvement plans approved by the U.S. Department of Education or their accreditor.
- The federal government and colleges would also be required to make additional data on student outcomes available to the public.

Performance-based funding or risk-sharing proposals have the potential to improve student outcomes, particularly among students from lower-income families, by focusing attention on how well colleges are serving these students. However, lessons from state and federal accountability policies show that colleges’ responses must be monitored in order to ensure they are seeking to improve their performance without simply becoming more selective or admitting fewer lower-income students.
Introduction

Federal expenditures on student financial aid have more than doubled in inflation-adjusted dollars since 2000, reaching over $150 billion in recent years. Yet although this increase in funding has helped make postsecondary education possible for a large and growing portion of society, policymakers and the public are concerned about the percentage of students who do not graduate or earn a credential with little to no economic value. Nationwide, 60 percent of students who began college; in fall 2006 earned a degree or certificate within eight years, even after accounting for students who transferred and finished college elsewhere. A desire to improve graduation rates and other student outcomes has influenced more than two-thirds of all states to adopt performance-based funding systems that tie at least some appropriations to progress and outcomes metrics instead of solely basing funding on enrollment. With the impending reauthorization of the Higher Education Act, federal performance-based funding or risk-sharing systems have been discussed by people across the political spectrum as a way to improve the current allocation of federal Title IV financial aid dollars.

Colleges are currently eligible to have their students receive federal financial aid if they meet a number of conditions regarding accreditation, state authorization, data reporting, and administrative capacity, as well as minimum quality standards in areas such as student loan default rates and financial health. The current quality standards are frequently criticized for several reasons:

- The standards for maintaining Title IV eligibility are binary in nature, thus applying to only colleges close to a single eligibility threshold instead of affecting a larger number of colleges through the use of a sliding scale. For example, in order to face sanctions for a college’s cohort default rate on federal student loans, the college must have at least 30 percent of students who entered repayment default on their loans within three years for three years in a row or 40 percent in a single year. While colleges with low default rates are allowed to immediately disburse loans to new students and those studying abroad, the financial incentives faced by colleges far from the threshold for losing federal financial aid eligibility are not as large and thus may not affect these colleges’ behaviors.
- Current minimum performance standards are set low enough to allow many colleges that can be considered low-performing to retain access to federal financial aid without facing any penalties. In 2014, 21 of the over 6,000 colleges participating in federal student loans programs faced the potential loss of federal financial aid for having high cohort default rates; all but one of these colleges are small for-profit institutions. Yet only 11 colleges have actually lost access to federal aid in the last 15 years, as colleges have either opted out of loan programs or successfully appealed the initial judgment.
In order to stay eligible for federal financial aid, colleges have incentives to respond in ways that could restrict access to low-income, first-generation, and/or minority students whose success in college is far from guaranteed. For example, a college that recruited only high-income students with more family wealth would expect to see fewer students default on their loans than one that served low-income students.7

In this paper, I draw on lessons learned from current federal and state-level accountability policies to propose a new, flexible federal risk sharing or performance-based funding system for student financial aid dollars with the goals of improving student outcomes and increasing institutional efficiency.8 My proposal centers upon making sure all colleges have at least some “skin in the game” with respect to federal financial aid dollars, instead of just those currently close to the arbitrary cutpoints for losing aid eligibility. However, it is critical to evaluate colleges’ performance compared to demographically and financially similar colleges instead of comparing open-access colleges to elite universities. In the remainder of this paper, I detail the components of the proposal, the requirements for the federal government and colleges, and discuss the pros and cons of risk sharing proposals such as this one.
The federal government requires postsecondary institutions to meet a series of conditions in order for the college's students to be eligible to receive Title IV student financial aid. All of these requirements are specified in program participation agreements (essentially a performance contract) with the U.S. Department of Education that colleges must adhere to in order to remain eligible. In addition to satisfying federal data disclosure and reporting requirements, colleges are required to satisfy a series of performance metrics. Currently, some of the major metrics include accreditation, financial stability, and cohort default rates, with new gainful employment rules now in effect for vocationally-oriented programs. In addition, public colleges and universities are subject to state-level accountability policies such as performance-based funding. In this section, I will introduce each of these major policies, discuss research on their effectiveness, and note some lessons learned for future accountability policies.

The first condition that must be met for a college to receive federal financial aid dollars is being accredited by an agency recognized by the Department of Education. Although the federal government does not directly accredit colleges, they do certify accrediting agencies deemed acceptable guardians of educational quality. However, a recent analysis by The Wall Street Journal found that 11 four-year colleges with federal graduation rates below 10 percent were accredited by one of the six regional accreditation agencies. Additionally, a Government Accountability Office report concluded that many accreditors were more likely to sanction colleges for financial concerns than academic concerns. Part of the relative lack of sanctions for academic reasons may be due to political pressures, as evidenced by the pushback received by the Accrediting Commission for Community and Junior Colleges after its attempt to revoke the accreditation of the City College of San Francisco.

Colleges must also meet a series of financial stability requirements put in place by the Department of Education in order to receive Title IV funds. Heightened cash monitoring policies can result in a delay in federal student aid payments going to colleges if institutions fail to meet certain conditions regarding financial statements, fiscal health, their leadership structure, or other oversight issues. A three-week delay in federal student aid reimbursement under heightened cash monitoring is cited as a contributing factor behind the recent collapse of Corinthian Colleges, formerly one of the largest chains of for-profit colleges. Private nonprofit and for-profit colleges must also pass a financial responsibility test, which is designed to ensure colleges not receiving state funding are stable enough to safeguard federal financial aid investments. Colleges with low scores have to post a letter of credit in order to receive federal aid.
Cohort default rates, which reflect the percentage of student borrowers who defaulted on their federal student loans within three years of leaving college, are perhaps the most visible federal accountability policy currently in effect. Colleges with a default rate over 40 percent in any given year are subject to the loss of federal student loan eligibility, while colleges with default rates over 30 percent for three consecutive years are subject to the loss of all federal financial aid dollars. But although only a small number of colleges actually lose access to federal aid, the threat of facing sanctions disproportionately affects colleges serving high percentages of minority, first-generation, and low-income students and can encourage them to opt out of offering federal student loans in order to protect Pell Grant dollars. Approximately one in seven community college students attends an institution that does not offer its students federal loans, and these colleges are more likely to have higher percentages of minority students.

Programs that the Department of Education defines as vocationally-oriented, primarily at for-profit institutions and community colleges, are newly subject to gainful employment regulations designed to ensure graduates are able to repay their federal loans. If a program fails to meet either of two debt-to-income thresholds in a number of consecutive years, it will be subject to the loss of federal financial aid eligibility. This reflects the Obama Administration’s second attempt at the regulations, as the first set was thrown out by a judge and the for-profit sector has been unsuccessful to this point in suing to block the new set of rules. An effort to tie a portion of financial aid dollars for all colleges to a set of federal college ratings was recently abandoned by the U.S. Department of Education, although additional consumer information tools will be released to the public.

At the state level, performance-based funding (PBF) policies have become a common way for states to tie at least a portion of institutional appropriations to outcomes instead of formulas based on enrollment or historical allocations. These policies have influenced conversations at the national level, as evidenced by the provision in President Obama’s proposal for tuition-free community college that would require participating states to allocate “a significant portion of funding based on performance, and not enrollment alone.”

Approximately 35 states currently tie at least some funds to progress or completion metrics, or are working to implement a system. Performance-based funding policies date back to Tennessee’s adoption of a PBF system in 1979, which was then followed by a wave of states adopting policies in the 1990s. By 2001, colleges in 19 states were subject to PBF. This first wave of performance-based funding (PBF 1.0) was characterized by the use of large numbers of outcome metrics (such as 37 in South Carolina) to determine relatively small amounts of additional funding beyond base appropriations. However, a number of these programs failed to survive the early 2000s recession due to confusion over outcomes and the lack of additional funding to support the allocations.
A second wave of state PBF policies were first implemented in the mid-to-late 2000s and differed from PBF 1.0 in two key ways. PBF 2.0 policies in many states included progress measures such as completing key courses or credit thresholds in addition to outcome measures such as graduation rates or the number of graduates. Additionally, PBF 2.0 was highlighted by including performance funding in the base budget as a small percentage of total funds, often with a transition period to allow institutions to adjust their priorities. In the early 2010s, some states have adjusted their PBF systems to tie most or all funding to process or outcome metrics. An example of these new outcomes-based funding or PBF 3.0 systems is Texas, which ties all funding at its state technical colleges to students’ labor market outcomes.

The existing body of research on the effectiveness of PBF programs in improving student outcomes is decidedly mixed, with most studies finding a range of modest positive to modest negative effects of PBF on graduation rates or the number of graduates. However, there is some evidence that longstanding PBF programs (primarily PBF 1.0) are associated with small but statistically significant increases in degree completions. At this point, it is too early to tell whether PBF 2.0 or 3.0 programs will have similar or larger effects on student outcomes after several years of operation.

PBF policies have had other effects, both intended and unintended, on institutional behaviors that should be considered in a federal PBF policy. Research has found that PBF policies are associated with small shifts of funds away from research and toward instruction, which is likely a goal of state policymakers. However, other studies hint at ways in which colleges may attempt to respond in ways that may not benefit students or the general public. An analysis of a PBF 2.0 policy for community colleges in Washington state showed no effects on associate’s degree production, but a significant increase in shorter-term certificates with less labor market value and less effort required by the college. Interviews with college leaders in three states with high-stakes PBF 2.0 and 3.0 systems suggested that colleges were actively seeking to enroll students with a higher likelihood of succeeding in order to gain additional funding, a finding which is also present in much research on K-12 accountability policy.

Other important lessons for a federal PBF or risk sharing system cannot be learned from state PBF systems. Although state PBF systems exist in more than two-thirds of all states, they exclude private nonprofit and for-profit colleges that might respond to new accountability policies in different ways than public colleges. Some outcomes of interest to the federal government (such as student loan default rates) are not included in state PBF systems, so it is unknown how colleges not currently subject to sanctions on these measures would respond. Finally, the Title IV student financial aid system is not a direct parallel to state PBF systems, as state appropriations through PBF reflects a different mechanism than the voucher-based system of federal aid dollars.
The proposal

My proposal for a federal risk sharing system is a contract between colleges that wish to accept federal financial aid dollars and the federal government that requires both parties to make improvements beyond current practices. This can be seen as a significant step up from the current program participation agreements that colleges already must agree to in order to receive Title IV funding. I detail the requirements that both the federal government and colleges should be held to below.

The federal government’s portion of my proposed risk sharing system would include the following components:

- Eligibility for federal grants and student loans is decoupled in order to separate the performance of students with Pell Grants than those with federal loans, while colleges that wish to accept Pell Grant dollars would also have to offer their students federal loans. Colleges can currently lose access to Pell Grants if student loan default rates are too high, even if the students defaulting on their loans did not receive Pell Grants. As nearly 40 percent of students who took out federal loans in the 2011-12 academic year were not receiving a Pell Grant, it is important to have separate accountability systems with different performance metrics for students with federal loans compared to those with Pell Grants. This is particularly important for community colleges, where a smaller percentage of students borrow but default rates among borrowers tend to be higher than average. Under my proposal, colleges could face a penalty for the performance of students with federal loans while receiving a bonus for the performance of Pell Grant recipients. Students receiving both federal loans in Pell Grants would be counted under both accountability systems.

- The federal government provides better tracking and reporting of outcomes for students receiving federal financial aid. Under the 2008 reauthorization of the Higher Education Act, colleges were required to disclose the graduation rates of Pell Grant and student loan recipients to prospective students upon request — but not report them to the federal government, although a recent investigation revealed that many private nonprofit colleges do not disclose Pell graduation rates. Yet the lack of a requirement for colleges to actually report these outcomes to the federal government and the ban on federal ‘student unit record’ data systems have resulted in these important metrics often not being available to the public. Data on student loan repayment rates, which are collected through the Department of Education’s National Student Loan Data System are extremely limited, with the only currently reported measure being the three-year cohort default rate for subsidized and unsubsidized Stafford loans. Using and publicizing information on cohort default rates over a longer period of time, PLUS loan default rates, the percentage of students in
current repayment, and the percentage of students enrolled in income-based repayment plans would provide a more complete picture of the performance of students with federal loans.

- In order to make more accurate comparisons about student loan performance across campuses, federal guidelines for how the non-tuition components of the cost of attendance are defined would be helpful. Research has found large variations in the off-campus room and board and other expense allowances, which are determined by individual colleges, within a given metropolitan area. Additionally, a significant percentage of colleges are likely understating the total cost of attendance by setting low living allowances, limiting the amount that students can borrow to pay for necessary expenses. Placing colleges on a more level playing field is essential in a system in which funding will be tied to measures of loan repayment.

Colleges must agree to three criteria in order for their students to be eligible to receive federal financial aid dollars:

- Colleges must agree to put “skin in the game” by being willing to match a percentage of Title IV loan or grant aid with institutional funds if their performance falls below a specified benchmark. They must also agree to hold the neediest students as harmless as possible if a college must put up matching funds by promising to not take away institutional grant dollars from Pell recipients. This would replace the current all-or-nothing system of determining federal aid eligibility. As a reward for outstanding performance, high-performing colleges would be eligible for bonus funds.

- Colleges must participate in the Direct Loan program in order for their students to receive federal Pell Grant dollars, giving students the opportunity to access federal student loans subject to federal borrowing limits. Colleges are currently not required to offer their students federal loans, which can result in students having to turn to the private market for loans at less favorable terms in order to finance their education. Requiring colleges to offer federal student loans while accepting Pell Grants would increase the administrative burden on colleges where few students are likely to borrow. However, access to credit (often for living expenses so students can afford to attend college) outweighs this concern as research suggests that students’ progress toward a degree slows down when they have to work too many hours. While a college with low repayment rates could face financial penalties, its access to Pell Grant dollars will not be affected.

- Colleges must be willing to meet heightened accreditation standards that include improved measurement of student outcomes, such as licensure exam pass rates, student learning, and employment outcomes, and making those data available to the public. Not all of these outcomes need to be included in formal accountability mechanisms, but would be useful to students and their families as they choose a college and for institutions as they chart plans for improvement.
Components of the plan

My proposal is to create a federal risk sharing system that consists of three sets of reforms to institutional eligibility for student financial aid dollars, with components to evaluate colleges based on their success in enrolling students from low-income families, helping Pell recipients persist in college and complete a credential, and ensuring that students with federal loans are able to repay their obligations. It is important to consider these reforms as a package, as although it may be possible for colleges to game any individual performance metric, it is far more difficult to successfully game all three metrics at the same time.

Constructing peer groups

In order to develop a performance-based funding system that takes into account differences in the types of students served, types of degrees and certificates offered, and the level of resources different colleges possess, colleges should be grouped with similar institutions when examining outcomes. Current federal accountability systems do not take these differences into account, which contributes to the set of colleges at risk of losing federal financial aid dollars being those with disproportionately large percentages of low-income, minority, and first-generation students. Some state performance funding systems do make distinctions in goals across different types of colleges, and I take a somewhat similar approach in my proposal.

There are two different ways to group colleges in ways that account for important differences across institutions. I propose using peer groups, which could be created using a simple lookup table based on several characteristics; this is similar to how Carnegie classifications are determined. Another method would be to use input-adjusted performance metrics, in which regression techniques are used to adjust for student and institutional characteristics in order to estimate a college’s value-added with respect to a given outcome. Although input adjustment has the appealing property of allowing all colleges’ performance to be compared to each other on the same adjusted metric, the perceived complexity of input adjustment is unlikely to appeal to policymakers or colleges. For that reason, I recommend using peer groups in a federal accountability system.

The first criterion to use when dividing colleges into peer groups for accountability purposes is the type of degree or certificate offered. I recommend that colleges that primarily offer bachelor’s degrees, associate’s degrees, or shorter-term certificates be placed into separate categories due to the different lengths of time required to complete these programs. Special care should be taken to place colleges that offer multiple types of credentials (such as community colleges offering a limited number of baccalaureate programs) into the same category for comparison purposes. I would not
create separate classifications for public, private nonprofit, and for-profit colleges, as they are generally treated similarly in current federal financial aid policies and colleges across sectors may be more similar than some colleges within their own sector. However, I would expect some peer groups to predominantly consist of colleges from one sector due to differences in missions, degree offerings, and resources. I would not divide colleges into groups based on regions, as there is no clear reason why outcomes should vary substantially across different portions of the country after taking selectivity and resources into account.

Colleges and universities which primarily grant bachelor’s degrees should be further divided based on institutional selectivity and resources using a combination of ACT/SAT scores, the percentage of students admitted, the percentage of students receiving Pell Grants, per-student revenues, and per-student endowment values. The use of selectivity in grouping colleges would partially guard against colleges becoming more selective in order to improve performance without actually changing educational practices. Colleges that recruit students with high standardized test scores would likely be placed in a higher-achieving peer group in the future, resulting in them being held to higher performance standards than before. Colleges which primarily grant associate degrees or certificates should be grouped based on institutional resources and the percentage of Pell recipients to reflect differences in state appropriations, pricing strategies, and student resources.

Grouping colleges based on their available resources comes with two main advantages. First, it does not put colleges with few resources (including minority-serving institutions, public colleges with relatively little state support, and private colleges with small endowments) at an immediate disadvantage by comparing them to wealthy, better-resourced institutions. Second, by comparing colleges with similar levels of resources, any differences in effectiveness in improving student outcomes can be put into a cost-effectiveness framework. If one college spends twice as much per student to get a 5 percent higher graduation rate, it is not immediately clear whether that spending is cost effective; but if colleges spending similar amounts have different graduation rates, one college may be operating more cost-effectively than the other.

Peer groups should be adjusted every five years by a committee of experts convened by the Department of Education (similar to the frequency at which Carnegie classifications are revised) in order to account for colleges with changing missions, student profiles, and resource levels. Within each peer group, the outcome levels for facing either sanctions or bonuses should be set using the average performance in the group over the last five years. Using a measure of prior performance as a benchmark for risk-sharing gives all colleges the possibility of earning rewards, while comparing colleges’ current performance to each other would almost necessarily require some colleges to face sanctions. Performance expectations could be set slightly above typical past performance within the peer group in order to incentivize improvement. For example, if the peer group had previously averaged a 50 percent graduation rate, the
expected average for the next five years could be set one or two percentage points higher.

The use of peer groups does come with two significant concerns. First, determining the appropriate number and size of peer groups will be an important task for a panel of experts to consider. Larger peer groups would allow for comparisons to be made across colleges with generally similar missions and resource levels, but the differences between colleges on the edges of the peer group may be substantial. On the other hand, smaller peer groups would allow for more precise comparisons, but dozens or even hundreds of peer groups would create a complicated system that may not be feasible to administer and would be more susceptible to the influence of one college with unusually high or low values. The second concern is that the creation of federally-sanctioned peer groups would be seen as implicitly-endorsed quality ratings. Policymakers and members of the public may see the peer groups of highly-selective, highly-resourced colleges and conclude these are the ‘best’ colleges, even though that is not the goal of creating peer groups for a risk-sharing system. This may cause colleges to lobby to be in a more prestigious peer group, even if it puts them at risk of facing sanctions due to lower-than-average performance.

Access

My proposed policy would reward colleges for enrolling students from low-income families by reallocating funds for the campus-based financial aid programs that go directly to institutions solely based on the percentage of undergraduate students at each college who are receiving Pell Grants. The Federal Work Study and Supplemental Educational Opportunity Grant programs represented a total of $1.7 billion in federal expenditures during the 2014-15 academic year, or roughly 5 percent of a typical year’s Pell Grant awards. The current formulas for allocating FWS and SEOG rely heavily on institutional award levels from the 1970s, effectively rewarding colleges that have participated in the programs for decades over newer, faster-growing institutions. Both FWS and SEOG also currently require institutions to match a portion of federal funding, a requirement which I would eliminate in my proposed system. All colleges receiving federal Title IV financial aid would be eligible to receive these funds, not just colleges that are currently participating.

Although the current formulas for allocating campus-based aid dollars do also take a student’s financial need into account, the weight placed on the cost of attendance results in a larger share of funds going to wealthy private colleges than community colleges or open-access four-year institutions. For example, 17.2 percent of SEOG and 22.1 percent of FWS dollars in 2013-14 went to private nonprofit colleges with a Barron’s rating of “very competitive” or higher, even though these institutions received just 3.9 percent of Pell Grant dollars. Community colleges, which received 43.7 percent of all Pell dollars, got just 26.2 percent of SEOG and 20.4 percent of FWS dollars. If the current pool of $1.7 billion in campus-based aid were to be reallocated,
community colleges would receive approximately $300 million more than they do today.

**Student performance**
The first of the two separate risk sharing components focuses on the outcomes of students receiving federal Pell Grants. While the funds allocated to colleges based on Pell enrollment described in the previous section should be made without regard to outcomes, a portion of the Pell Grant dollars a college receives from students should be tied to progress, transfer, and completion metrics among Pell recipients. If a college fails to meet performance standards, students will still receive the maximum award they qualify for, but the remaining funds must come from elsewhere in an institution’s budget without supplanting a student’s institutional financial aid award. The following metrics for students receiving Pell Grants upon entering the college could be considered:

- Retention rate to second year (bachelor’s and associate-granting colleges)
- Graduation rate within 150 percent of regular time (bachelor’s and certificate-granting institutions)
- Graduation plus transfer rate within 150 percent of regular time (2-year colleges)
- Number of graduates (all institutions, to guard against concerns that colleges would reduce the number of Pell recipients in order to increase graduation rates)

These metrics have two key limitations. First, the use of a 150 percent graduation rate (six years to complete a bachelor’s degree, for example) is a standard accountability measure, but it does exclude some students who take longer to complete while not explicitly encouraging on-time degree completion. This metric reflects a trade-off between getting information on a recent cohort of students and tracking all students through to graduation. Second, these metrics have traditionally included only first-time, full-time students. While using a more detailed measure such as the Student Achievement Measure has advantages, outcomes for colleges not currently collecting these data would not be available for a number of years.41

In order to implement risk sharing, colleges would be divided into peer groups as previously described. Using graduation rates as an example, a college with a graduation rate for Pell recipients of more than 5 percent below the average rate of colleges in its group in previous years would be subject to paying the Department of Education a penalty equal to a percentage of Pell funds awarded out of its own institutional aid budget. For example, a college with an average graduation rate of 55 percent over the last three years in a peer group with an average graduation rate of 65 percent in previous years would pay a penalty equal to 5 percent of Pell awards in the prior year in order to continue receiving federal aid. (To put the penalty into context, a
college would pay $287 to the Department of Education for each student receiving the maximum Pell of $5,730 in the 2014-15 academic year from a source other than the institutional aid budget.) These funds would then go to expanding need-based grant aid programs at colleges with Pell graduation rates at least 5 percent above their peer group average.

To put the potential magnitude of risk-sharing into account, consider the University of Alabama in Huntsville, a public research university with about 5,700 undergraduate students. One-third of undergraduate students received Pell Grants in the 2012-2013 academic year (slightly lower than the national average of 38 percent at four-year public universities), receiving a total of $8.1 million. If UAH’s Pell graduation rate was 10 percent below the group average, it would be subject to a penalty of 5 percent, or approximately $400,000. This is 12 percent of the $3.4 million in institutional grant aid given to first-time, full-time freshmen, but less than one percent of the university’s $125 million in educational and general expenditures. This penalty would not be trivial, as the university would have to reduce spending in other areas in order to fully fund students’ Pell awards without affecting the institutional aid budget.

This simple risk-sharing structure would disproportionately affect colleges with higher percentages of students receiving Pell Grants, which tend to have fewer institutional resources than colleges serving fewer Pell recipients. This could provide colleges with an incentive to enroll fewer Pell recipients, even though it would be partially mitigated by the increase in work-study and SEOG funds for enrolling more Pell recipients as previously described. In order to reduce this concern, the penalty should be less per student at colleges with a higher percentage of students receiving Pell Grants and more per student at colleges serving fewer Pell recipients. For example, colleges with between 20 percent and 50 percent of students receiving Pell Grants would pay the penalty described above for having outcomes that are substantially lower than similar institutions. But colleges with more than 50 percent Pell recipients would pay half the penalty per student (or 2.5 percent of Pell awards) and colleges with fewer than 20 percent Pell recipients would pay twice the penalty (or 10 percent of Pell awards).

Loan repayment
The second part of my proposed risk-sharing system would hold lower-performing colleges responsible for a portion of all federal student loan dollars that are not repaid. In addition to the current metric of three-year cohort default rate, the following additional metrics should be considered:

- Cohort default rate five years after entering repayment.
- Percentage of students current on loan payments one year after entering repayment, excluding those in deferment or forbearance for reasons other than economic hardship.
Percentage of students making on-time payments of at least $1 of the loan’s principal. This is designed to address concerns about students enrolling in income-driven repayment programs, but earning below the poverty line and thus allowing a $0 payment to be considered on-time.

Unlike the current cohort default rate metric, my proposal would include PLUS loans in the reported cohort default rate. Although PLUS loans tend to have lower default rates than subsidized and unsubsidized loans (potentially due to a minimum creditworthiness requirement), default rates for individual institutions have not been released to the public. PLUS loan default rates, as well as the other metrics described above, could be developed using already-existing data in the National Student Loan Data System.

Risk-sharing for student loans would work in the following way, using cohort default rates as an example. If a college’s average default rate over the past three years is more than 5 percent above the previous average in the peer group, it is subject to putting up funds equal to the percentage of loans above the cutoff for facing penalties. For example, a college with a 25 percent default rate in a peer group with an average default rate of 15 percent would pay a penalty equal to 5 percent of all loan dollars, reflecting that the default rate was 5 percent above the 20 percent rate that would trigger sanctions. The average undergraduate loan per full-time equivalent student was $4,840 in 2013-14, meaning that a college with a default rate 10 percent above the peer group (and 5 percent in the penalty zone) would pay $240 for each student with a typical loan. Colleges with default rates at least 5 percent below the peer group average would receive a bonus in a similar manner, which would be used to fund additional work-study awards.

To illustrate how risk-sharing would affect colleges, I turn again to the University of Alabama in Huntsville. Students there borrowed nearly $21 million in 2012-13, which is roughly the national average (on a per full-time equivalent student basis). If the default rate at UAH was 10 percent above colleges in its peer group, its penalty (equivalent to all defaults above the 5 percent cutoff for facing penalties) would be 5 percent of all loans — or approximately $1 million per year. On the other hand, if UAH’s default rate was 10 percent below the peer group average, it would get an additional $1 million per year to use on work-study awards — six times the size of their current work-study allocation of $172,000.

Implementing a risk-sharing system for student loans could have negative effects on students, as colleges will likely seek to limit the amount of money students can borrow in federal loans in order to reduce their level of risk. Financial aid administrators are already seeking statutory authority to limit the amount that broad groups of students can borrow to something below annual federal loan limits over concerns that students are borrowing more money than necessary to pay for college or that they will exhaust lifetime loan eligibility before completing a degree. Although some students could
undoubtedly borrow less money and complete college, care must be taken as a body of research documents a percentage of students who are loan averse — unwilling to borrow even when it would likely be beneficial.\footnote{49}

Colleges would also have an incentive to shift students from federal loans to private loans in order to reduce their risk. This incentive is already present in a slightly different form, as only subsidized and unsubsidized loans are included in the current default rate metric. Defaults on parent and student PLUS loans are currently not used for accountability purposes, meaning that colleges could benefit from encouraging students to take higher-interest PLUS or private loans instead of Stafford loans. Including PLUS loans in the risk-sharing metrics will help somewhat, but little can be done to stop colleges from potentially recommending private loans via preferred lending lists when better options are available.
A high-stakes policy such as a federal performance-based funding or risk sharing system requires careful and scaled implementation in order to give colleges the opportunity to respond to new expectations in productive ways. First, the exact details of any risk sharing proposal should be developed in conjunction with stakeholders from all sectors of higher education, Department of Education officials, representatives of states with longstanding PBF systems, and members of the general public. These details should then be made available for stakeholders to provide feedback before designing the final system.

Research on the implementation of new state-level performance funding policies highlights the importance of phasing in new standards and sanctions/rewards, as it takes several years for colleges to adjust their practices and have those adjustments turn into outputs such as more graduates or higher rates of loan repayment. Additionally, since new metrics will likely be involved, a pilot period is necessary to both set baseline values for these metrics and to make sure they actually reflect the goals set by a risk-sharing system. New state PBF systems often include ‘hold-harmless’ or ‘stop-loss’ provisions, which limit the amount of funds that a college can lose based on their performance for a period of several years following implementation of the new system. Care should also be taken to ensure that colleges are not trying to respond to the new accountability system by simply becoming more selective, as appears to be the case in several states. These concerns can be alleviated by emphasizing that a move to become more selective will result in colleges being placed in a peer group with other selective colleges, thus making it more likely they will face sanctions.

Although rewards will be provided to colleges that outperform peer institutions on access, Pell recipient success, and student loan repayment metrics, the penalties (or skin in the game) that lower-performing colleges will face are likely to gain the majority of attention from colleges and the general public. A million-dollar penalty may be relatively trivial for a well-resourced liberal arts college, but has the potential to seriously affect a minority-serving institution’s budget. For that reason, it is important to provide support to underresourced colleges that can develop a clear plan for institutional improvement that is approved by either the Department of Education or the college’s accreditor. A model program would be School Improvement Grants, which are funded by the U.S. Department of Education and made to individual school districts on a competitive basis by state education departments. Colleges receiving these grants could receive reduced sanctions for a limited period of time as a result of meeting a clear set of improvement criteria.
Conclusion

Given widespread concerns over the price of college and mounting amounts of student loan debt, the concept of tying some federal financial aid dollars to student performance has gained at least some measure of bipartisan support. But to this point, few clear frameworks have emerged that have attempted to outline how a risk-sharing system would work to potentially improve institutional performance while not unnecessarily harming colleges with few resources. In this paper, I offer a potential framework that would decouple rewards or sanctions regarding grant and loan programs while turning the campus-based financial aid programs into a fund that incentivizes colleges to enroll students from lower-income families.

The impending reauthorization of the Higher Education Act provides an opportunity to completely rethink how the substantial investment of federal funds is awarded to students through colleges and universities. The flexibility of risk sharing systems is advantageous given current discussions about expanding federal financial aid eligibility to competency-based education programs and non-college single course providers in addition to potential reforms to higher education accreditation. Using the same framework but a modified set of outcome metrics, all higher education providers could be granted access to federal financial aid contingent on their agreeing to be subject to the basic risk-sharing criteria.

Although risk sharing is an attractive system to hold all colleges at least partially accountable for their performance, lessons learned from state performance funding systems suggest that care needs to be taken in the development and implementation of these systems in order to reduce the risk of unintended consequences. For that reason, the percentage of funds subject to risk-sharing should be modest at first, while some minimum performance standards are also implemented to bar the absolute worst colleges from receiving any federal financial aid dollars.
Endnotes

8 I use the terms “risk sharing” and “performance-based funding” interchangeably throughout this paper.


33 Author’s calculation using the National Postsecondary Student Aid Study.


38 I exclude the federal Perkins Loan program from this discussion because no new funds have been allocated to that program since 2005. If new funding were to be made available, I would treat the Perkins program in the same way as FWS and SEOG. Federal Student Aid (2014). *Federal campus-based programs data book 2014*. Accessed 23 June 2015 from http://www2.ed.gov/finaid/prof/resources/data/databook2014/databook2014.html.


43 Author’s calculations using data from the 2011-12 National Postsecondary Student Aid Study.


46 Ideally, information about the number of dollars in default could be used to better reflect the level of risk generated by borrowers attending any particular college. But as that information is not yet available, I use a percentage of total borrowing, which is likely an overstatement of the number of dollars in default given that the majority of defaults are on relatively small loan balances.


