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Analysis of Risk-Sharing/Skin-in-the-Game Concepts and Proposals

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The paper provides an overview of the concerns raised in numerous quarters concerning student loan indebtedness and default rates. Much of the concern is targeted at four issues: the ease with which students can access large amounts of borrowed funds, high cohort default rates and low student completion rates at certain institutions, and the risk resulting from default is borne mostly by taxpayers and student borrowers. The paper then provides a summary of the history of legislation and policy regarding federal student loans.

The Concept of Risk-Sharing and Skin-in-the-Game

The central premises of the paper appear to be: (a) under the current mechanism, colleges and universities do not share any risk if students default on their loans, but should; (b) student defaults due to students dropping out can be prevented if only colleges and universities spent more on retention programs; (c) the high amounts of student borrowing are driven by the high cost of attendance; and (d) current accountability metrics, such as cohort default rates and the 90/10 rule, are ineffective.

Based on these premises, the paper provide an argument supporting the rational that colleges and universities must begin sharing the risk of student loan defaults. Various triggers and menus of risk options are discussed, along with legislation along these lines from the previous Congress. These proposals run the gamut from creating risk pools to limiting access to credit to loan guarantees.

The section below provides the Consortium’s commentary on the issues raised in the paper. They are not intended to be a point-by-point rebuttal. Rather, our comments reflect a more general discussion of ways in which it may make sense to conceptualize a risk-sharing approach, as well as ensuring that safeguards are in
place to avoid the unintended consequence of limiting access to students with financial need in the name of lowering loan defaults.

The Consortium’s Analyses of the Issue

The Consortium believes it is vital to get a core fact clearly understood: Just like colleges and universities across the country, Consortium member institutions already have significant “skin-in-the-game” in the very substantial financial resources they provide to students, especially those who have high financial need. Indeed, the higher the student’s financial need, the more “skin-in-the-game” the institution has. For example, colleges and universities that have participated in the Perkins Loan program already have shared-risk in loans. Significant investments through grants are also at risk: should the student drop out, the institution will accrue no return on that investment even through the failure to be able to “count” the student as a completer for purposes of qualifying for funding (for example, for performance funding) or for other completion-related metrics. Consequently, the notion that Consortium members need to be compelled to share the risk does not reflect the reality that they already do.

Having said that, the Consortium would support a reasoned discussion of how to account for the several ways risk-sharing already operates and improved definitions of metrics, especially the rules regarding loan repayment for students who stop out but return. Consider the student who, for whatever reason, stops out long enough to trigger loan repayment. Returning to complete the credential then becomes even more challenging unless loan repayment is allowed to stop and the grace period reset again while the student is (re)enrolled. The Consortium argues that some provision for the loan repayment requirement to stop as long as the student has reenrolled at least half time is essential if institutions are to make progress in reenrolling students so they can complete their credential. No level of student success program intervention will be successful unless students have an ability to reenroll and not be required to make loan payments. Otherwise, the steep financial disincentives against completing are likely to be too great.

One statutory constraint that the paper does not note directly is the limitation placed on institutions to engage in specific financial guidance with students regarding responsible borrowing. Although institutions provide financial responsibility education for students, institutions are barred from actually putting it into good practice regarding advising students to limit their borrowing. The Consortium very strongly supports the removal of the current statutory constraints regarding advising students about responsible borrowing, as that change would be a
much-needed and welcome step toward addressing one of the core issues in student debt.

The paper notes in passing that whatever shared-risk process is put into place cannot have the consequence of restricting access (e.g., instituting an admissions criterion related to student credit worthiness). For this to be true, then the model on which shared-risk is based cannot be based on a simplistic model such as a hard trigger at a specific default rate per institution. That is because those institutions who accept a higher proportion of their students who have higher financial risk are, by definition, at greater risk than institutions that do not. Moreover, the former type of institution is much more likely to have a small unrestricted endowment or other source of funds with which to make good on defaulted loans. For these reasons, the Consortium does not support any one-size-fits-all approach to risk-sharing that sets a hard cut point (e.g., a specific cohort loan default rate) as a trigger for penalties. Unless a more appropriate metric is used, the most likely outcome would be a reduction in access, the very outcome specifically noted in the paper as undesirable.

The metrics used to compute loan default rates need careful scrutiny. The Consortium does not support the use of the current raw computation of cohort default rates as an appropriate metric. Rather, the Consortium supports computing annually the ratio of the unduplicated number of students who earned credentials and the unduplicated number of students who enter loan repayment. The notion underlying this index is that if a much higher number of unduplicated students entered loan repayment than earned credentials, then that institution has a high number of students who incur debt but do not earn a credential before being required to repay. However, this index is not perfect: it captures not only students who dropped out for reasons of poor institutional integrity but also those who dropped out for personal reasons (e.g., to care for an elderly family member). Still, some indicator that reflects the comparison between students who enter repayment because they complete their program and those who enter repayment prior to program completion provides a richer picture of reality.

The Consortium strongly urges the Committee to view student loan defaults as not simply an end in itself, but as a symptom of a more important issue—a shift from grant-based financial aid to loan-based financial aid. The Consortium argues that one better way to address the student loan default concern is to lower the need for students to take loans in the first place by increasing the amount and availability of Pell Grants. Alternatively, the Consortium would support creative approaches to a risk-sharing pool based on the percentage of need-based institutional aid provided (as skin in the game) as compared to federal grant aid or based inversely on the
percentage of students with high financial need enrolled (i.e., higher pool contributions for lower percentages of students with high financial need) as an incentive for institutions to maximize institutional need-based aid and to maintain access. Another alternative could be expansion of the income-based repayment plans that both the federal government and several institutions have implemented. Colleges and universities that implement a loan guarantee program could be exempt from any shared-risk pool. Finally, given that colleges and universities have a long history of experience with the Perkins program shared-risk model, perhaps the best approach might be some modified version being adopted for other federal loan programs. This way, institutions would be familiar with the rules of engagement, have shared-risk, and both disbursement and accountability policies and procedures would be easier to design and implement.

As commonsensical a notion as shared-risk may be, there is an economic reality noted at the very end of the paper: forces well beyond the control of colleges and universities, even beyond the control of the federal government, affect the implementation of any shared-risk program. External economic factors will, at some point, inevitably wreak havoc with any system. As we know from the Great Recession, people go unhired or lose their jobs for no reason under their control, and these life events may result in unavoidable loan default. To hold colleges and universities responsible for these outcomes is inappropriate. (For that matter, holding student borrowers responsible in bankruptcy proceedings resulting from economic downturns makes no sense either.)