Financial Innovations Lab® Executive Summary

New Models for Funding Post-Secondary Education in Illinois

Report Background and Overview

Education is largely recognized as a gateway to career options and upward mobility, both in the groundwork it lays for job opportunities and the critical thinking it fosters. Yet, for some years now, an increasing number of students, researchers, and policymakers have begun to weigh the immense debt burden associated with tuition and related costs against today's tangible outcomes. The student loan debt crisis hit a record with the Class of 2020, according to a compilation of data by Forbes, which notes that student loans are the second-highest consumer debt category, ranking behind only mortgages. Some 44.7 million student loan borrowers owe on average $32,721 individually, for a total of $1.56 trillion.[1]

There are two main types of student loans available to borrowers: federal and private. Federal loans, such as Direct Subsidized, Direct Unsubsidized, Direct Grad PLUS, or Direct Parent PLUS Loans, assign the federal government as the lender. As a result, these loans can "afford" to be more consumer-friendly through lower interest rates.

Private loans, on the other hand, include any loans issued by banks, credit unions, or online lenders. These loans have fewer repayment options because the lender, who often raises the underlying capital by issuing bonds sold in the capital markets, needs a reliable repayment stream. Emerging alternatives to private loans are income share agreements (ISA) in which the student commits a percentage of future income toward paying their education for a predetermined length of time.

On the regulatory side, the Student Investment Account Act, spearheaded by Illinois State Treasurer Michael Frerichs and signed into law by Governor J.B. Pritzker in August 2019, created an impact investment portfolio called the Student Investment Account. An annual investment of 5 percent ($800 million at the time) from the State Investments portfolio is allocated into the account to be either plowed back into the State Investments portfolio or used to fund loan forgiveness, loan forbearance, loan deferments, hardship assistance, scholarships, and/or educational grants.

With costs and debt loads continuing to rise, it is imperative to continue expanding equitable financing options that address the five key barriers students face when managing their student debt, as identified through the Lab process:

1. **Incomplete risk assessment leaves students behind:** Private lenders typically base their decisions on the FICO score, which predicts the ability to repay a loan based on the applicant's financial history. For students with little to no credit history, the lack of alternative metrics taken into consideration often means they cannot qualify for a loan.
2. **A complicated borrowing process:** Lab participants highlighted three of the most critical gaps in the market after students obtain a loan: a lack of guidance around loan specifics, the need to develop "life-cycle communication," and greater transparency regarding deferment or forbearance, which is especially crucial for at-risk borrowers.
3. **Current private loan terms are onerous:** Privately-owned for-profit institutions, whose business models are based on returns to investors and evade consumer protection laws, target sales tactics to at-risk groups and possess exorbitant interest rates, prepayment penalties, unforeseen fees, and few, if any, flexible repayment plans.
4. **Student debt programs can be misaligned with education outcomes:** Although federal loan programs allow students to obtain a higher education that will translate into better career prospects, soaring debt often means loans could take upwards of 20 years to pay off, in part due to a fundamental mismatch of the returns on investment from earning a certain degree and current debt repayment terms.
5. **Minority and low-income students have disparate access and outcomes:** Generations of wealth accumulation policies with underlying racial biases and underfunded school districts with a lack of financial aid or college counselors have inhibited the economic mobility of minority and lower-income students, contributing to their higher likelihood of taking out larger loans, borrow from private lenders, and amass a greater debt burden.

New Models for Funding Post-Secondary Education in Illinois summarizes the research and key findings of two virtual Financial Innovations Labs®, conducted by the Milken Institute in collaboration with the Office of the Illinois State Treasurer in June 2020 to explore how the state's $800 million capital investment in higher education finance could have the most impact. The Labs brought together educators, government leaders, investors, loan servicers, consumer protection experts, alternative loan providers, and state agencies to develop recommendations to expand the range and availability of traditional loan products and refinancing options, as well as introduce newer financing options. Through months of research, stakeholder interviews, and group convenings, the Milken Institute identified three key financing mechanisms that could drive new forms of capital to the space:

- Create a statewide education impact fund,
- Develop an ISA program, and
- Create a loan navigator platform.

Solutions Overview

As noted earlier, the 5 percent of state investment portfolio funds that the Illinois treasurer will redirect annually into the Student Investment Account is expected to target three areas: new loans and loan products, refinancing products, and creative financing options such as income share agreements. The recommendations below add detail to how each investment can be effectively allocated to currently underserved student markets—emphasizing access for low- and middle-income families, as well as undocumented students.

Solution 1: Create a Statewide Education Impact Fund

To help meet return expectations, Lab participants suggested that the treasurer develop market-rate and impact models for both new loan and refinancing borrowers that cross-subsidize one another. In this way, the portfolio would provide a small return on the State Investments portfolio and meet the treasurer's fiduciary requirements, while also supporting options such as loan forgiveness and educational grants.

- Terms for the market-rate new loan and refinance product options would be in line with existing private options. Borrowers benefit from stronger consumer protection standards as compared to the private market because the Treasurer's Office is the lender.
- The terms on the impact of new loan and refinance product offerings would be slightly lower and more affordable for students, from 0 to 3 percent, and cover the fund's administrative costs.

Target Student Markets

- Any new products and systems must help to enable low-income and minority students, including Dreamers and undocumented Illinois students, to graduate. Another target potential market segment is students who are close to graduating but have a small remaining funding gap. Using a proxy formula with available data, it is estimated that Illinois students have $4.09 billion of cosigner debt.[2] New financing products may focus on relieving this cosigner debt burden to benefit the broader economy.

Eligibility and Underwriting Criteria

- Using alternative metrics such as GPA, satisfactory academic progress, and historical loss rate of the school[3] to underwrite loan products can both expand the pool of students who qualify for loans and loan modifications and increase access for borrowers who need them most. Lab participants looked to other low-cost fund models, such as the Missouri Higher Education Loan Authority (MOHELA), which checks for a history of fraud or bankruptcy rather than excluding borrowers based on a FICO score.
- To resolve FICO lending eligibility barriers, Lab participants suggested working with the credit reporting agency TransUnion to collect information that could enhance students' credit reports and improve future borrowing and refinancing options.
- Most private lenders are restricted in their repayment options due to their responsibility to repay multiple layers of their capital stack while also generating a profit. In contrast, with a specific aim to meet social needs, the Office of the Illinois State Treasurer is in a unique position to set up a

simplified repayment scheme that supports income-driven repayment options and uses a "360-degree" approach to qualify students for refinancing, including the option to remove a cosigner.

Critical Terms

- To protect against default, Illinois could follow a model similar to MOHELA's Keep in Touch (KIT) payment tool, which charges a $5 fee paid to the servicer toward the balance of the loan, establishing good borrower habits early and consumer protection on the back end.
- Along with this mission, Lab participants suggested that any "borrower savings" realized by lower interest rate products be used to fund personal savings accounts as an investment towards homeownership, retirement, or future education costs.

Distribution and Partnership Options

- Lab participants deliberated the merits of partnering with existing providers to leverage in-place distribution channels (i.e., refinancing done through strong alternative options such as SoFi and CommonBond). Creating a new refinance product that applies different eligibility requirements can allow the Treasurer's Office to service those not approved for these providers by leveraging existing platforms and technologies.

Data and Metrics to Assess and Price Risk Effectively

- Lab participants underscored measuring outcomes and equitability in any new loan product across its life cycle. Front-end data measured during the application process could include race, income level, and program type to assess if the funding meets target underrepresented markets. Back-end data measured during the post-graduation period and throughout repayment could track metrics such as on-time repayments, repayment type, employment, individual cash flows, and general economic mobility.
- Exploring the option of alternative lending criteria offers the opportunity to collect data not traditionally available with student debt products—including the economic value that comes when more students overcome financial hardship to obtain their degrees and in fields where entry once seemed impossible.

Solution 2: Develop an ISA Program

An income share agreement is an innovative consumer-driven program whose payment systems comprise a percentage of future income for a set number of years. As a general statement, Lab participants urged students to exhaust all federal aid options before entering into an ISA. To ensure any Illinois ISA program has the most meaningful impact, the Lab focused on the following areas: accessibility, sustainability, and protection.

Target Student Markets

- An ISA lends itself well to bridging gaps in funding, which can be instrumental for students needing a few thousand dollars to cover their last semesters. ISA programs can also help fund post-college education, especially for in-demand careers that require additional degrees and certifications such as nursing, digital marketing, business intelligence, Java programming, or web development.[4]

Critical Terms

- Importantly, an ISA program's contribution should consider the full portfolio of aid committed by the applicant to guide the size of ISAs and determine the upfront agreement amount, ensuring that the program serves its intended purpose as a bridge between the cost of education and the student's loans.
- Lab participants discussed creating more flexible terms around maximum annual payment obligation, also known as the "commitment factor," by selecting an agreed-upon dollar amount tied to an annualized rate that is both capital efficient and protects students.
- Setting the minimum salary that triggers payment is consequential for protecting students from downside risk. Instead of applying a universal minimum salary, the Treasurer's Office could view it as a dynamic factor calibrated to a fixed multiple of the state's poverty rate. In the best interest of the borrower, the program should operate at a level above what is considered minimum self-sufficiency in the area.
- A summary of specific terms is detailed in the full report. Please refer to Figure 8.

Distribution and Partnership Options

- Since the success of this loan product relies on the funding partners who must share expectations on returns, Lab participants agreed that ISA program partners should be philanthropic and have a specific interest in Illinois. Only once the intended impact of this vehicle is demonstrated will blended capital contributors want to participate.
- The employers hiring a graduating workforce should be involved in the ISA design process to verify the type of talent they need and which education programs they view favorably. Fair agreements should sponsor credible certificate programs that align with growing job markets.

Consumer Protection

- In July 2019, the bipartisan-sponsored ISA Student Protection Act of 2019 was introduced in the US Senate, but there has been no action due to contentions around ISA legal protections.[5] If the bill is signed into law, it will contain many of the components of an ISA contract discussed throughout the Lab—individual exemptions, minimum payment caps, and bankruptcy laws.[6]
- The Illinois Legislature is also considering legislation (HB5524/SB3514) to protect consumers. Given the proposed timeline for the treasurer's investment, Lab participants suggested that any ISA product be held to the same level of regulation and consumer protection as current student loan products in the state.

Solution 3: Create a Loan Navigator Platform

Illinois' efforts to improve transparency in the student loan process for students are evident in its Know Before You Owe legislation, which informs students of all their federal financial assistance programs and requires public universities and community colleges to provide their students with information about outstanding education loans each year.

- Lab participants recommended a Know Before You Owe loan navigator platform as the next step, using the information collection model from the current pilot program and adding the data to an online platform with up-to-date interest accrual amounts, total debt, and payment schedules.
- The ISACorps program can be an additional resource for recent college graduates interested in counseling, pairing them with high school students they can mentor. The state could explore the option of integrating the ISACorps program with a Know What You Owe loan navigator tool for timely data and ongoing guidance.

The Lab process has developed tangible recommendations for developing new and creative financing options. With the investment from the Treasurer's Office, Illinois should be able to reach a segment of the student market left behind by traditional products. Finding new ways to cover the bill is essential to ensuring that students who want to graduate can, regardless of their financial circumstances.

Endnotes

[1] Zack Friedman, "Student Loan Debt Statistics in 2020: A Record $1.6 Trillion," *Forbes*, February 3, 2020, www.forbes.com/sites/zackfriedman/2020/02/03/ student-loan-debt-statistics/#56f57542281f.
[2] Of the $1.56 trillion total US student loan debt, private lenders own $123.1 billion (7.7 percent). Research on private loans by the data analytics firm MeasureOne finds that (as of 2018–19), 88.80 percent of total loans or $108.3 billion (undergraduate and graduate) are cosigned. Assuming Illinois represents the same share (3.78 percent) of the private cosigned debt as it does the total national student debt market, then co-signed private debt in the state could total $4.09 billion; "The MeasureOne Private Student Loan Report" (MeasureOne, June 18, 2019), https://docs.wixstatic.com/ugd/0aaff0_5a3f9e397ee247e5b33454f5c014c89d.pdf.
[3] "FAQs," Chicago Student Loans by A.M. Money, accessed July 2020, https://chicagostudentloans.com/faqs.
[4] "San Diego's New Income-Share Program Wants to Help Students Go Back to School Now, Pay Later," CNBC.com, Channel 7, May 17, 2019, https://www.cnbc.com/2019/05/17/san-diego-launches-isa-program-with-the-help-of-donors-like-google.html.
[5] S.2114: ISA Student Protection Act of 2019, Congress.gov, All Actions S.2114, 116th Congress (2019–2020), https://www.congress.gov/bill/116th-congress/senate-bill/2114/text?q=%7B%22search%22%3A%22ISA+Student+Protection+Act+of+2019%22%7D.
[6] Ibid.

View the full report at https://milkeninstitute.org/report/new-models-funding-post-secondary-education-illinois