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WEALTH MANAGEMENT

When Income-Sharing Agreements Are–and Aren't–the Better Option for Student Loans

Income-driven mechanisms of ISAs are already built into many federal student loans, says WSJ Wealth Management Expert Derek Tharp. **PHOTO:** GETTY IMAGES/ISTOCKPHOTO

By

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Income share agreements—agreements that exchange a certain percentage of one's future income for dollars to fund education today—have received much attention lately as a potentially more student-friendly means of financing higher education.

The idea is that unlike a debt financing—which typically has a fixed repayment schedule regardless of one's income and can therefore be a significant burden to recent graduates earning less than they may have hoped—ISAs effectively operate as a form of equity financing that automatically scales up or down with one's income, and therefore may place less strain on a graduate's cash flow during hard times.

While the conceptual appeal of ISAs may be clear for students who are worried about loan repayments becoming a burden on their future cash flow, the reality is that many are not aware that similar income-driven mechanisms are already built into many federal student loans.

For instance, under the Direct federal loan program, most loans are eligible for income-driven repayment plans that cap one's payments at 10% or 15% of discretionary income. Moreover, many students are eligible for loan forgiveness, which is often available after 20 or 25 years of repayments, but sometimes as soon as 10 years of repayments under Public Service Loan Forgiveness.

Of course, the reality for some students is that federal loans are not enough to finance their entire education, and they may need to turn to private loans as a result.

So how do all of these options for financing one's college expenses stack up?

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To examine this question, I recently ran some simulations comparing a hypothetical English major and aerospace engineer financing their education using Direct federal loans, a typical private loan and an ISA according to the terms outlined in the ISA offered by the Purdue Research Foundation.

Under the Purdue agreement, a senior at Purdue graduating in December of 2019 wanting to receive $1,000 in financing would need to pay 0.45% of their income for 116 months if they are an English major, or 0.27% of their income for 92 months if they are an aerospace engineer.

The results suggested that, in most cases, Direct federal loans were a better option for students than an ISA. Interestingly, this was true for the English major at all levels of future income, but the aerospace engineer actually did come out ahead with an ISA if they earned substantially below average for someone of their major ($30,000 to $50,000 compared to an average of $62,000, according to Purdue Research Foundation's comparison tool).

The reason? Direct federal loans actually provide superior downside protection to the terms in the ISA agreement, while also providing better upside in the event that a graduate earned close to an average level of income or higher.

The results were less straightforward when comparing ISAs to private loans. In this case, the decision may come down to how risk-averse a student is and how concerned they are about earning less than expected upon graduation, as ISAs do provide superior downside protection to students, albeit with less upside in the event that students earn near an average income or higher upon graduation. This outcome was due to private loans not providing any type of income-driven relief for lower-earning borrowers, but still being less expensive overall if students do not face difficulty making their payments.

The best scenarios for using ISAs may be cases where students can engage in significant adverse selection—meaning they possess private information about themselves that is unknowable to a third party in an ISA.

For instance, a student in a higher earning major who expects to pursue a lower earning career could come out ahead with an ISA compared to Direct federal loans by receiving financing at a more attractive rate than their expected future income would warrant. Additionally, students who desire to be a stay-at-home parent or otherwise anticipate taking significant time out of the workforce after graduation could come out ahead with an ISA, as, interestingly, the Purdue agreement only "pauses" an individual's repayment obligations for a maximum period of 60 months out of the workforce.

Finally, the way "earned income" is defined in ISAs may provide opportunities for students to selectively opt into such agreements. For instance, those with a business that generates Schedule E income could come out ahead, as the Purdue ISA appears to define income solely as W-2 and Schedule C income. Additionally, because 401(k) contributions do not count toward W-2 income, ISAs may be relatively more attractive to those who can aggressively fund 401(k)s, perhaps due to having a second earner in one's household (spousal income is not counted towards one's income under Purdue's terms).

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