May 2017

Dear Clients and Friends:

For Amy Wroblewski, a 21-year-old who was already working two part-time jobs and had maxed out her federal student loans, the problem was how to pay for her junior year at Purdue University. She needed $13,000, and didn't want to take on any more debt.

That's when she discovered the "Back a Boiler" program offered by the Purdue Research Foundation. Amy signed up to have the foundation "invest" in her future by giving her the $13,000, and in return she'll give the foundation a percentage of her salary after she graduates, for a certain number of years.

"I felt such a relief that I didn't have to go through the process with Sallie Mae, and my parents didn't have to stress about it," she says. "I think it is an amazing idea." Amy's father was delighted, because he didn't want to cosign on any more of her private loans.

Other colleges are quickly jumping on the bandwagon with these so-called "Income Share Agreements," or ISAs. You might be wondering if this is legal, since it almost looks like a form of slavery. Depending on the size of the investment and how long the graduate is going to be making payments, institutions are able to take as much as 10% of the person's income for up to ten years.

But in essence it's really just a "human capital investment," an idea proposed long ago by economist Milton Friedman. Instead of lending money to students, investors are buying a share in a student's future for a limited period of time. In Amy's case, for example, if she makes little or no money before the time expires, the foundation will lose out, and the contract will terminate. Should she succeed, the foundation will profit, and Amy may end up paying more than if she had taken out a loan.

There are some limitations on how much it will cost. Even if Amy strikes it rich by landing a great job, she'll never have to pay more than 2.5 times the amount she received. On the other hand, she might accept a socially conscious position that pays very little. Purdue grads earning less than $20,000 will have their payments waived, so Amy might never have to make any payments at all.

Who should consider going to college on an ISA, rather than taking out student loans? An obvious candidate would be someone who doesn't want a traditional job after college.

Since payments are based on income and not on a predetermined amount, there are more opportunities to explore after college -- non-profit work, traveling or maybe starting a business. There won't be the pressure of having to make large debt repayments soon after graduation.

Even for those who wind up with a good job, what happens if they lose that job? With an ISA, you don't owe anything if you have no income. Your repayment term typically freezes until you find work again, and then the payments adjust to your new income.

Let's say things don't go well for Amy, and she ends up a few years later having to file for bankruptcy. It's unlikely the bankruptcy court will dismiss her traditional student loans. However, her ISA is based on an investment, not a loan. Like any other unsecured creditor, the foundation's claim will be discharged by the court.

On the downside, payments will probably fluctuate with an ISA, making them unpredictable. As a person's income rises, so will the payments. And unlike a loan, you can't pay the balance off early. You have to keep making the scheduled payments based on your income until the end of the designated term, or until you reach a payment cap set in the initial agreement.

An ISA isn't for everyone, and in general they will end up costing more than a regular student loan. But for the right person, they can make a lot of sense. We're living in an age where parents and grandparents are being asked to cosign on private student loans. As ISAs become an accepted feature of the academic landscape, more students will be checking out this option before asking their families to sign on the dotted line.

Regards,

Chuck

Charles M. Shackelford