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Escaping the Student-Debt Trap

An economist-entrepreneur inspired by equal parts Milton Friedman and David Bowie says income-share agreements could rescue higher education.

By KATE BACHELDER
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Student debt in the U.S. now tops $1.2 trillion, spread among 37 million borrowers, 5.4 million of whom have already defaulted. Washington took notice this week, rolling out the usual non-solutions: On Monday, President Obama expanded a federal program that allows students to repay debt based on what they earn, eventually forgiving the balance. Taxpayers pay the rest. On Wednesday, Sen. Elizabeth Warren's idea to tax millionaires to pay for broad student-loan refinancing stalled in the Senate.

But there's one way to slow student-loan debt that didn't make Washington's agenda. What if a tool could help any student pay for college without a loan or government subsidy? If that sounds impossible, ask Miguel Palacios, assistant professor of finance at Vanderbilt University's Owen School of Management. He's the creative force behind income-share agreements.

"College is on average a good investment, but it's a risky investment," Mr. Palacios says. More than 40% of college students don't finish in six years, and in 2012 45% of those who did graduate had jobs that didn't require a degree, according to Federal Reserve data.

Here's his solution in a nutshell: Suppose an industrious young person wants to get a degree at a top university but needs about $50,000. Under an income-share agreement, the student promises an investor a certain percent of his income over a fixed period in exchange for cash. The agreements are not loans, and there is no outstanding balance. Students who earn more pay more, and students who earn less pay less.

Mr. Palacios has seen these income-share agreements in action and thinks they can revolutionize higher education. The startup he co-founded in 2002 with entrepreneur Felipe Vergara, called Lumni, has funded nearly 5,000 students in five countries. In April Sen. Marco Rubio and Rep. Tom Petri, both Republicans, introduced legislation that would give income-share agreements the legal and regulatory clarity to flourish in the U.S.

At first handshake, Mr. Palacios seems easily typecast as an academic. He's poring over spread sheets when I arrive at his Vanderbilt office. A dry-erase board behind him is scribbled with graphs and values of "x," and the bookshelves are stocked with finance textbooks. Even the décor is industry-specific: On white walls hang two pieces of contemporary art, both using outmoded currency notes as a medium.

It's quickly evident, though, that the 40-year-old scholar is part economist, part entrepreneur. "When you were starting college, did you know how much money you would make in the first 15 years of your life?" he asks in his crisp Colombian accent. No, and I still don't.

Federal loan programs "encourage students to pursue any degree regardless of price," he says. Students can borrow cash directly from the feds through Stafford loans. Parents have an even easier line of credit: Under the federal Parent PLUS program, mom and dad can borrow up to the cost of tuition after a credit check. "People are sometimes mortgaging their homes on what their kids will do," Mr. Palacios says.

It's not working. The Consumer Financial Protection Bureau estimated in 2013 that 22% of federal student-loan borrowers who have entered repayment are now in default or forbearance. More than 600,000 borrowers who graduated in 2010 had defaulted by 2012, according to Education Department data.

In response, the Obama administration has taken the "throw money at the problem" approach, as Mr. Palacios puts it, by expanding the Pay As You Earn program, under which students can curb their payments if their earnings don't keep up. Those programs "do not help students make better choices about where to go and what to study," Mr. Palacios says. The federal programs forgive loans after 20 years, 10 years if the borrower works in "public service" (government or nonprofit). But how long can the taxpayer bear that expense?
Mr. Palacios says income-share agreements, or ISAs, can mitigate the damage from what he calls the coming student-loan "train wreck." First, they "send a strong signal about value," he says. Want to get a peace-studies degree for $100,000? Be prepared to pay a hefty portion of your income for a really long time. ISAs give students much-needed information about which programs are more likely to lead to employment. Over time, colleges would be forced to lower costs and offer better value. Most important, ISAs take away "the risk of financial ruin," Mr. Palacios says. If you don't earn any money, you don't pay any money.

Mr. Palacios explains that economist Milton Friedman floated the notion of buying a "share" in an individual's earning prospects in the footnote of a 1945 paper and explored it more deeply in 1955 amid debates over financing higher ed. "The idea morphed into an income-contingent loan," says Mr. Palacios, who calls himself "a liberal in the 19th-century sense," and "not left or right but "pro-freedom."

Yet David Bowie, not Milton Friedman, first inspired Mr. Palacios. In 1997, the rock star announced that he planned to finance his next album by selling shares of future revenues. "I was intrigued," he recalls. Working in Chile as a financial analyst, the 23-year-old Mr. Palacios thought: Why can't bright, talented college students do something like the Bowie idea? In college, he saw "very brilliant people who just wouldn't make it because they didn't have the right funding."

In 1999 Mr. Palacios moved to the U.S. to attend the University of Virginia's business school, where he began researching how to implement human-capital contracts. In 2001 a friend introduced him to fellow Colombian Felipe Vergara, an entrepreneur who liked ISAs and "wanted to do it," Mr. Palacios recalls. "That's how Lumni was born."

In October 2002, Lumni signed contracts with four Chilean university students for one year of funding, later adding two more to the first class. The investment totaled roughly $12,000. The students agreed to pay a small percentage of income—about 3%—for roughly five years. The students thrived: Gonzalo Labbe, for example, met his obligations and now manages corporate accounts for Hewlett-Packard in Chile. The investors did well, too. "We had returns in excess of 10% and on the order of 15%," Mr. Palacios says.

By 2009 the company had expanded to Colombia, Peru and Mexico and reached more than 1,000 students, funding many in community colleges and vocational programs. Nearly all of Lumni's students come from low-income backgrounds, and most are the first in their family to attend college.

How has the fund held up? Pretty well. "The returns have been lower, by design," Mr. Palacios notes. Investors can design the return they want within a certain range, and "many have simply liked the work we do and asked for little or no return." Lumni has raised about $50 million from individuals, corporations and foundations.

In 2009 Lumni began offering contracts in the U.S., funding 27 students so far. Growth has not happened quickly, and here's one major reason: There are lingering questions about the legal enforceability of the contracts. It's also unclear how they'd be taxed or regulated, details that Lumni has mostly worked out in Latin America.

The murkiness has thwarted others interested in ISAs. In the mid-1990s, an entrepreneur named Roy Chapman started Human Capital Resources, seeking to do what Lumni does now. Chapman lobbied Congress for legal and regulatory clarity, and then-Rep. Lindsey Graham introduced a bill in 1999. It went nowhere. In the early 2000s, a firm called My Rich Uncle offered ISAs but soon gave up because, Mr. Palacios thinks, the founders realized that "raising capital for something risky in the regulatory sense is tough."

Most recently, the lending platforms Upstart and Pave began offering the contracts. That didn't last long for Upstart. "We're still huge fans of income-share agreements," company founder Dave Girouard wrote on Upstart's website on May 6, but the startup feared it will "likely take many years" to sort out the regulatory issues.

Why so long? In part because ISAs are often portrayed by critics as indentured servitude. "Part of that is fear, and I think it's completely misplaced," Mr. Palacios says. "ISAs in no way tell anyone what to do. The contract can't force anyone to work." He maintains they are more liberating than student loans: "You have the same freedoms, but you don't have the same worries."

Others view ISAs as exploitation. Dave Bergeron, of the left-leaning Center for American Progress, told Reuters in April that ISAs are unfair to students because some would pay back "substantially more" than they borrowed. "That takes a static view of the student," Mr. Palacios argues, noting some rich ideological inconsistency. "These people who talk about exploiting students have no qualms saying the 1% should pay much more of their income to the federal government. If that student has to pay a lot, it's because that student became part of the 1%. To them, the right tax rate for the 1% is always just 'more.' "

Do ISAs also encourage students not to work? Mr. Palacios suggests keeping payments as a share of income as low as a state income tax rate so students won't be tempted "to go to the beach for the rest of their paying-contract lives."

ISA funds also run the risk of adverse selection, as the best students might see federal loans as a better option. "That's why we don't offer everyone the same contract," Mr. Palacios says. Pricing allows Lumni to be sure it can recoup enough of its investment. The firm also employs psychologists...
to evaluate whether students are being honest about their career intentions. "The concern that we're going to end up with a bunch of French literature students who said they wanted to be investment bankers hasn't panned out," Mr. Palacios says, adding a playful apology to his wife, who teaches French literature.

The biggest hurdle might be Congress. The Rubio-Petri bill would give ISAs a chance by making them legally enforceable contracts, capping the percentage of income at 15%, setting a maximum repayment period of 30 years, with a repayment exemption for those who earn less than $10,000 a year. Contracts would be required to define what constitutes income, and not permitted to dictate career choices.

The bill may pass the House, but it would be dead on arrival in Harry Reid's Senate. Mr. Palacios thinks it might fare better if Republicans retake the Senate in the fall, but then it looked that way for ISAs in the 1990s. Still, Mr. Palacios is bullish: "The momentum for ISAs has never been this strong."

The momentum may reflect the moment. "At this rate," he says, "student debt could be $2 trillion in five or six years."

Lumni isn't waiting around. The organization pledged in 2010 to fund 10,000 students world-wide by 2020, and Mr. Palacios says Lumni is on track to meet the goal. With a little push from Congress, more firms could jump into the market. ISA funds could be run someday by everyone from institutional investors to enthusiastic alumni.

ISAs are "a bright spot in finance," Mr. Palacios says, because they better the lives of individuals and society. "How could anyone be against that?"

Ms. Bachelder is an assistant editorial features editor at the Journal.