Investing into students' future: a new asset class?

In the United States, where student debt is skyrocketing, some academics are opting for a financial advance in exchange for a percentage of their future salary for several years. This alternative investment can provide healthy returns to qualified investors.

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What is an ISA (Income Share Agreement)?

While university studies are almost free of charge in Switzerland and other European countries, university tuition fees are often exorbitant in the United States. Some students are lucky enough to be financed by their parents, while others have the courage to work part-time to pay for their studies. But most of them use student loans. They often accumulate a large debt that that becomes a heavy burden for many years, especially if they are unable to find a well-paying job after graduation.

> However, there is an alternative to student loans: the Income Share Agreement (ISA). The idea is that in exchange for paying their tuition, the student agrees to give back a portion of their salary to the funding entity for a certain period of time.

For example, a $10,000 tuition payment may be taken care of today by the funding entity. Upon graduation, the student dedicates a set percentage (say, 5%) of his or her earnings to the lender for a fixed period of time (say, 10 years). If the student earns $40,000 in the first year after graduation, he or she will pay $2,000 per year. And if his or her income five years after college is $80,000 a year, the redistributed share will increase to $4,000 a year.

Most contracts also have minimum income requirements (if you don't make enough, you don't pay) as well as repayment caps (if you make a lot, you only pay back a portion of the amount).

History of ISAs

American economist Milton Friedman proposed the concept of a revenue-sharing agreement in 1955 in his essay « The Role of Government in Education ».

In the 1970s, Yale University tried a modified form of Friedman's proposal with several groups of undergraduate students. All members of the group agreed to repay a percentage of their earnings until the balance of the entire group had been repaid. However, this system had created frustration for students forced to pay more than their share.

In 2013, Oregon State legislators passed a bill called "Pay It Forward" as a system for university funding.

In April 2014, Senator Marco Rubio announced the introduction of legislation in the US Congress that expands the use of revenue sharing agreements. Today, ISAs are offered by some universities and job training programs, such as coding boot camps.

Benefits and drawbacks for students

Benefits

1. It is possible to meet the payment schedule even on a low income since the amount to be paid will never exceed a predetermined percentage of income;
2. Repayment ends after a specified period. Repayment periods range from 30 months to a decade;
3. No co-signer required (which is very different from private student loans);
4. No credit score requirements (FICO).

Drawbacks

1. The risk of "overpaying" over time. When an individual earns a lot of money, the total amount to be repaid may far exceed the amount borrowed to pay for tuition;
2. There may be prepayment penalties.

A new asset class?

Revenue-sharing agreements represent only a small portion of the higher education financing market in the United States.

About $250 million was funded via ISAs in the US in 2019, compared to $1.6 trillion in outstanding student loans.

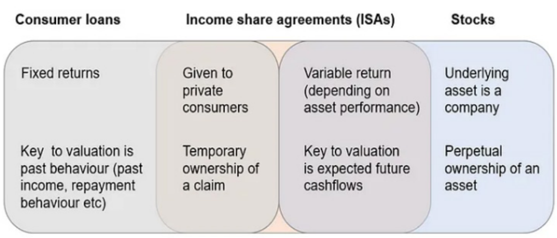
But the ISA market is growing. By 2019, 40 colleges and vocational institutes were offering or developing ISA programs, just three years after Purdue University became the first major university to do so. Experts estimate that 175 schools could issue up to about $500 million in ISAs in the near future.

For investors, ISAs offer significant appeal. This new asset class is positioned on the risk-return scale between consumer loans and equities. Indeed, this investment involves holding a claim on private individuals. But unlike traditional loans, returns are variable. The valuation of this investment depends on future cash flows (just like stocks).

It is, of course, an asset class that is uncorrelated with traditional investments. Returns are relatively attractive - between 12% and 14% per year - but only available to so-called qualified investors (family offices, high net worth individuals and institutional funds).

Investors are also attracted to ISA investments as a hedge against inflation, since the income received is based on a fixed percentage of salary, which is itself correlated to inflation

ISAs fall between consumer loans and stocks



Structural comparison of Consumer Loans, ISAs and Stocks

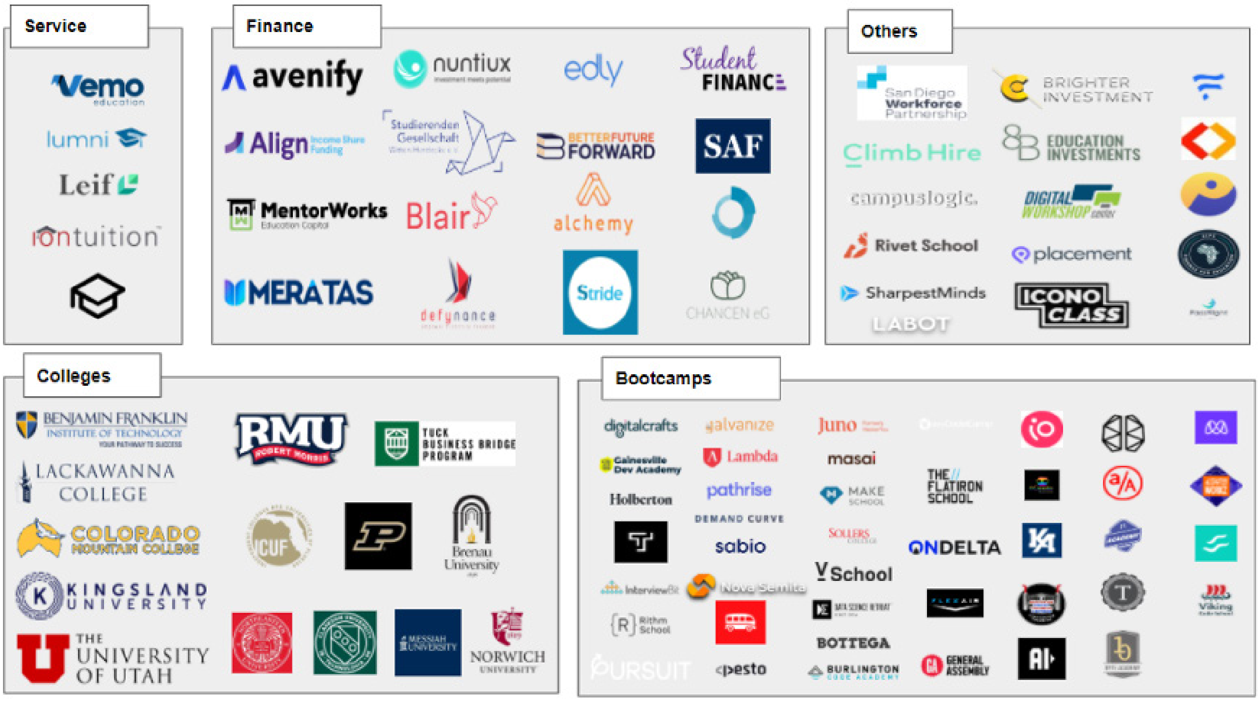
Source: Medium

The ISA ecosystem

A real ecosystem has been created around ISAs. First of all, universities ("colleges") and specialized training schools ("bootcamps") validate and offer students access to this type of financing. The educational world can indeed play a filtering role in the allocation of financing, by sharing information on those who apply for a loan (their grades, motivation, skills, etc.).

Payment companies such as Vemo or the Leif platform facilitate access to cash flows. Placement firms also play a role; students who have received an ISA are often more motivated than average.

The main players in the different sectors of the ISA ecosystem



Source: Career Karma, Medium

A key component of this ecosystem is the marketplaces. Until recently, one of the obstacles to the development of the ISA market was the market itself - or lack thereof.

Here's how the ISA marketplace has traditionally worked. A university decides to offer an ISA program to its students. It must then determine the requirements, set up the business processes and web portal to promote this funding option to students and parents.

The school must then find a way to fund the ISA program. Rather than self-funding, many schools open their ISAs to outside investors to reduce risk. But to do so, they must create some sort of fund and actively seek investors. This is not an optimal process for either party. Most importantly, there was no exchange for a university to find buyers for a $50 million bond that funds a student group.

But starting in 2016, marketplaces like Edly were created to allow ISAs to realize their true potential.

As an intermediary between schools and outside accredited investors, Edly provides a clearing mechanism, liquidity, financial analysis and standardization of contracts and terminology.

Edly focuses specifically on schools that it believes are more likely to produce graduates in higher-income fields, such as technology, nursing, and the professions. Accredited investors can invest either in specific school offerings or in the equivalent of a diversified ISA fund. For example, the EdlyOutcomes I fund requires a minimum investment of $10,000.

ISAs, a niche with immense development potential

As mentioned above, the creation of marketplaces facilitates the meeting between students and investors. But operational complexity and lack of liquidity are major obstacles to the expansion of ISAs.

Blockchain technology could play a major role in the evolution of this asset class. The use of smart contracts to launch and manage the life cycle of ISAs could facilitate their use and lower operational costs. Thanks to the tokenization of ISAs, it will become possible to democratize this market and make it more liquid (via online trading platforms).

This evolution could even open the way to financing other individuals such as sportsmen or artists. Why not help cover the training and transportation costs of young tennis or golf players, in the hope of receiving part of their revenues when they win their first tournaments?

For further information

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