the institute for college access & success

Memo

To: Interested Parties
From: The Institute for College Access & Success (TICAS)
Date: August 21, 2012
Re: Steps the Education Department Should Immediately Take to Curb Default Rate Manipulation

As the recent report from the Senate Health, Education, Labor, and Pensions Committee's two-year investigation of the for-profit college industry clearly documents, many of the largest corporations are artificially keeping their cohort default rates (CDRs) below the thresholds for receiving billions of dollars of federal student aid. This memo discusses three ways companies may be manipulating their CDRs, and the steps the Department of Education should immediately take to ensure full compliance with federal law and protect taxpayers from subsidizing schools with CDRs above the permitted thresholds. The three issues discussed are: appealing CDRs based on "improper servicing" of loans; combining campuses for reporting purposes; and the abuse of forbearances.

1. Appealing CDRs Based on "Improper Servicing" of Loans.

Some for-profit colleges are attempting to artificially lower their CDRs by claiming their students' loans were "improperly serviced." In January 2012, ITT Educational Services (ITT) told investors that it expected its *average* draft FY2009 three-year CDR to be between *34%-36%*--well above the 30% threshold. However, ITT also told investors that it was appealing all of its draft CDRs and estimated dramatic reductions in all of their rates as a result. For instance, in the case of its FY09 two-year CDR, executives said excluding loans they considered to have been "improperly serviced" decreased the rate from 22% to as low as 14%.[1] In April 2012, ITT executives told investors that it had "won all of the appeals we've heard back on, and we're just waiting to hear back on the remainder of them."[2]

According to ITT, its CDR appeals are based on the claim that its "PUT loans" were improperly serviced and experienced higher rates of default as a result. PUT loans are federal student loans that FFEL lenders sold, or 'put,' to the Education Department during the recent financial crisis under the Ensuring Continued Access to Student Loans Act of 2008 (ECASLA).

If higher PUT loan default rates are due to their being improperly serviced, it would be a legitimate basis for a CDR appeal.[3] However, some have said that the higher PUT loan default rates result from the characteristics of the loans, *not* the quality of the servicing (i.e., lenders chose to sell higher risk loans to the Department and to hold on to lower risk loans that were less

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[1] ITT Q4 2011 earnings call, January 26, 2012. Available at http://seekingalpha.com/article/322420-itt-educational-services-inc-ceo-discusses-q4-2011-results-earnings-call-transcript.

[2] ITT Q1 2012 earnings call, April 26, 2012. Available at http://seekingalpha.com/article/532991-itt-educational-services-ceo-discusses-q1-2012-results-earnings-call-transcript.

[3] The rules on improper servicing appeals, including definitions of what it means to be improperly serviced and timelines, are available at http://ifap.ed.gov/DefaultManagement/guide/attachments/CDRGuideCh4Pt6LSA.pdf.

likely to default). If that is the case, then these loans should *not* be excluded from a school's CDR.

Recommended Action: Before any final CDRs are released next month, the Department should carefully review all PUT loan servicing appeals to ensure that such appeals are not being used to evade CDR thresholds.

2. Combining Campuses for Reporting Purposes.

The Department's CDR Guide defines CDR evasion as "an attempt to avoid cohort default rate sanctions by changing a school's name, location, corporate structure, OPEID, or other status."[4] As the Senate report abundantly documents and as explained below, this is exactly what several large for-profit colleges appear to be doing, including Corinthian Colleges (Corinthian), Career Education Corporation (CECO), and ITT.

CDRs and 90-10 ratios are calculated based on assigned six-digit Office of Postsecondary Education ID numbers (OPEID), rather than by campus or corporate owner. Many for-profit companies have multiple six-digit OPEIDs, each of which may consist of a main campus and multiple branch campuses.[5] Schools with multiple six-digit OPEIDs can and do shift campuses to different OPEIDs and classify them as branches regardless of their geographic proximity, even when they are located in several different states.

For example, ITT recently merged 29 separate six-digit OPEID numbers into just 3 OPEIDs. According to the CEO of ITT:

> the reasons for doing that certainly relate to our compliance efforts and risk mitigation associated with all of the different regulatory controls … So, this impacts your CDR, your 90/10 and all those other metrics that exists, including any new metrics that may come our way as a result of regulatory change.[6]

In February 2012, CECO told investors that it had submitted an application to the Department seeking to consolidate up to 19 of its 26 OPEIDs into 1 OPEID. If approved, CECO will operate just 8 OPEIDs. In fact, CECO had six OPEIDs with 90-10 rates above 90% in FY2011, and all six are among the 19 the corporation seeks to consolidate.[7] Four of these six OPEIDS also had

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[4] U.S. Department of Education Cohort Default Rate Guide Glossary, available at http://ifap.ed.gov/DefaultManagement/guide/attachments/CDRGuideGlossary.pdf.

[5] Branch campuses that share a single six-digit OPEID often have unique eight-digit OPEIDs that are based on the common six-digit one. These colleges share a CDR but report some data separately, such as graduation rates.

[6] ITT Educational Services, "ITT at Barclays Capital Inc. Global Services Conference," Lexis Nexis, May 12, 2011.

[7] The six CECO OPEIDS with 90-10 rates over 90% are Sanford Brown in Atlanta, GA; Boston, MA; Farmington, CT; Fenton, MO; and McLean, VA and Missouri College. From CECO's February 27, 2012 10-K: "The six OPEIDs with estimated 90-10 rates above 90% for fiscal year 2011 are all among the institutions included in the pending application for consolidation. These six institutions will cease to separately exist if and when ED approves the consolidation. We would not expect ED to issue them separate 90-10 rates for fiscal year 2012 since they would not exist as separate institutions at the end of fiscal year 2012, but we cannot be certain of ED's procedures in this situation. If ED approves the consolidation, it is uncertain whether the fiscal year 2011 90-10 rates for this smaller group of institutions will affect how ED will calculate or apply the fiscal year 2012 90-10 rate for the larger consolidated institution." http://phx.corporate-ir.net/phoenix.zhtml?c=87390&p=irol-sec&seccat01enhanced.1_rs=21&seccat01enhanced.1_rc=10#8032878.

three-year FY08 CDRs over 24%. Its annual report states "another result of this consolidation will be the calculation of a single student loan cohort default rate and a single rate under the 90-10 Rule for all of the campuses within the consolidated institution."[8] In other words, consolidating campuses with high CDRs and 90-10 rates has the potential to *mask* serious, known quality problems at campuses that may otherwise have exceeded thresholds for federal funding.

Recommended Action: To prevent the evasion of accountability measures such as CDR thresholds (and the 90-10 Rule), the Department should either not allow changes in OPEIDs or require continued compliance under former OPEIDs for at least three years after any change in OPEID and sanction any that would have exceeded the CDR thresholds but for the change in OPEID.[9] Such monitoring would be well in line with other steps the Department takes to prevent gaming of accountability measures: the Department's Federal Student Aid Handbook for 2012-13 explicitly provides for the continued monitoring and enforcement of 90-10 rates when a school converts from for-profit to non-profit.[10]

3. Abuse of Forbearances.

The recent Senate report provides overwhelming evidence that some for-profit college corporations are abusing forbearance and deferment, using them as tools to manipulate the school's CDR regardless of the student's particular situation or whether it is in the student's best financial interest. These corporations are using forbearance and deferment to *delay* defaults until after the period when schools are held accountable (currently during the first two years of repayment for Title IV funds and during the first three years for state Cal Grant funding and for Title IV funds beginning in 2014).

While avoiding default is always in students' best interest, increasing their loan balance and leaving them to default on a higher balance is not. Loans always accrue interest while in forbearance, and unsubsidized loans accrue interest during both forbearances and deferments. The additional interest accrued is added to the principal loan balance at the end of the forbearance or deferment, with the result that interest then begins accruing on an even larger balance. In most cases, students struggling to make loan payments are better served with counseling on how to repay their loans and the availability of Income-Based Repayment (IBR).

Documents from four large companies demonstrate that, on average, over 75% of the delinquent borrowers "cured" (i.e., prevented from defaulting) were put in forbearance or deferment, while only 24% had made payments on their loans. For instance:

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8 CECO's February 27, 2012 10-K. http://phx.corporate-ir.net/phoenix.zhtml?c=87390&p=irol-sec&seccat01enhanced.1_rs=21&seccat01enhanced.1_rc=10#8032878.

9 The Higher Education Act (20 USC § 1085 (m)(3)) specifically authorizes the Secretary to act prevent CDR evasions, stating "The Secretary shall prescribe regulations designed to prevent an institution from evading the application to that institution of a default rate determination under this subsection through the use of such measures as branching, consolidation, change of ownership or control, or any similar device."

10 Federal Student Aid Handbook for 2012-13, July 2012 Ch. 4—Audits, Financial Standards, Limitations & Cohort Rates. http://www.ifap.ed.gov/fsahandbook/attachments/1213FSAHbkVol2Ch4.pdf.

- In 2010, 78% of the ITT borrowers were "cured" by its "default management" contractor by being placed in deferment or forbearance, two-thirds of whom were placed in forbearance.[11]

- In March 2012, Corinthian announced that it had reduced its three-year CDR from 36.1% to 28.8%, *a 7.3 percentage point decrease in just one year*.[12] Corinthian says it expects the two-year CDRs that the Department will release next month to show *a massive 14.8 percentage point reduction in just one year*—from 21.5% to 6.7% between the 2009 and 2010 cohorts.[13] As Corinthian executives told investors in May 2011, "Forbearance, as you well know, is a pretty easy – it's just a question, you have to agree to it and you're on your way."[14] However, the executives made clear that the number of students *repaying* their loans had changed little: "Our repayment rate really hasn't moved a whole heck of a lot from where it was prior to this effort."

The Senate report concludes that many of the tactics used by for-profit college corporations "appear to cross the line from default management to default manipulation." It notes that these efforts to prevent student default often "abruptly halt" after the period when schools are held accountable for defaults.[15]

Recommended Action: The Department should immediately take several steps to prevent the abuse of forbearance and deferment to evade CDR thresholds. First, if the Department has not already done so, it should immediately analyze the extent to which companies are using forbearance and deferment, particularly *serial* forbearance and deferments, which are an indication that borrowers are not receiving proper counseling about IBR and other repayment options. Second, the Department should examine whether the number of defaults at an OPEID spikes after the CDR window closes. For instance, when four additional months were examined for the 2008 cohort, the number of OPEIDs with three-year CDRs *over 40% more than doubled*. The use of serial forbearances and spikes in defaults after the CDR window closes should be used as triggers to prompt an immediate investigation into possible CDR evasion, a program review, and/or an audit. During the student loan negotiated rulemaking process that ended in March 2012, the Department publicly committed to scrutinize serial forbearances, including in program reviews and audits, but provided no timetable for doing so. Finally, the Department should issue additional guidance to schools on what constitutes proper default management and what constitutes CDR evasion, and on the additional steps the Department is taking to prevent both loan defaults and CDR evasion.

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[11] Senate Health, Education, Labor and Pensions Committee, "For Profit Higher Education: The Failure to Safeguard the Federal Investment and Ensure Student Success," July 29, 2012, Part II, ITT Profile, pp. 534-5. http://help.senate.gov/imo/media/for_profit_report/PartII/ITT.pdf.

[12] Corinthian Colleges, Inc., March 9, 2012, Form 8-K. http://investors.cci.edu/secfiling.cfm?filingID=1104659-12-17112&CIK=1066134.

[13] Corinthian Colleges Inc., February 28, 2012, Form 8-K. http://investors.cci.edu/secfiling.cfm?filingID=1104659-12-13472&CIK=1066134.

[14] Corinthian Colleges, Inc., May 3, 2 011, Q3 2011 Investor Call.

[15] Senate Health, Education, Labor and Pensions Committee, "For Profit Higher Education: The Failure to Safeguard the Federal Investment and Ensure Student Success," July 29, 2012, Executive summary and pages 151-158. http://www.help.senate.gov/imo/media/for_profit_report/PartI-PartIII-SelectedAppendixes.pdf.