Student Aid Policy Analysis

Gainful Employment NPRM Proposes "Three Strikes" Rule

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The US Department of Education will publish the Gainful Employment NPRM on Friday, July 23, 2010. The NPRM will have a 45-day public comment period.

The following summary is based on a press release[2] that was provided to news media at 6 pm on Thursday, July 22, 2010, and additional details that were disclosed during a conference call with reporters. News media were permitted to share copies of the press release with sources at 7 pm on Thursday. Copies of this press release were received from several independent sources, none of whom indicated any embargo on publication of the press release.

This summary should be reviewed with caution, as often a NPRM includes important details that affect the evaluation of a proposed rule. However, taking the press release at face value, the proposed definition of gainful employment appears to represent a reasonable compromise that separates the wheat from the chaff without discarding too much wheat. This report will be updated after publication of the NPRM.

The proposed definition of gainful employment establishes affordable debt restrictions on educational programs at for-profit colleges. The affordable debt restrictions are implemented through three metrics, each of which has two thresholds. If a program satisfies none of the three metrics, it loses eligibility for federal student aid. This is effectively a "three strikes and you're out" rule.

The metrics with the most forgiving thresholds are as follows:

1. A loan repayment rate of at least 35%.
2. A debt-service-to-income ratio of at most 12%.
3. A debt-service-to-discretionary-income ratio of at most 30%.

All three metrics are applied to all borrowers entering repayment, not just those completing the program. The loan repayment rate is applied to just federal student loans. The debt-service-to-income ratio and the debt-service-to-discretionary-income ratio are applied to both federal and private student loan debt.

A program that fails to satisfy at least one of these metrics may not offer federal student aid to new students. It may offer federal student aid to current students for one additional year, provided that it warns them about the program's low repayment rates and high debt-to-earnings ratios.

[1] Corrected an error in the enrollment limits on colleges in the restricted zone.
[2] A copy of the press release may be found at www.finaid.org/educators/20100722gainfulemploymentrelease.pdf.

There are also three additional preferred thresholds. Programs that satisfy at least one of these tighter thresholds are fully eligible for federal student aid. Programs that do not satisfy at least one of these tighter thresholds are subject to certain restrictions and are referred to as "restricted programs."

The tighter metrics are as follows:

1. A loan repayment rate of at least 45%.
2. A debt-service-to-income ratio of at most 8%.
3. A debt-service-to-discretionary-income ratio of at most 20%.

Colleges that do not satisfy **both** the first and either of the second or third of these tighter metrics will be required to disclose their repayment rates and debt-to-earnings ratios to their students.[3]

The restricted programs will be subject to a limit on enrollment equal to the average enrollment during the past three years. This effectively yields a reduction in enrollment the first year a program becomes restricted, since most for-profit programs have been experiencing double-digit annual enrollment growth and the moving average will be below the most recent year's total enrollment figures. Restricted programs will also be required to obtain employer certification that the program satisfies the employer's requirements.

The loan repayment rate counts only borrowers who are making payments to principal. Borrowers who are delinquent, in an economic hardship deferment, in a forbearance or in default will be counted in the denominator but not the numerator of the loan repayment rate. In addition, borrowers in income-contingent repayment or income-based repayment who are not making payments of more than the interest that accrues will be counted in the denominator but not the numerator. This reduces the loan repayment rate by about 7%, since slightly more than half of borrowers in income-contingent and income-based repayment are paying less than the interest that accrues and about 15% of active borrowers are in these repayment plans. However, borrowers in income-contingent repayment or income-based repayment who are participating in public service loan forgiveness will be treated as though they are making payments to principal, reducing that offset slightly. (The press release restricts this offset for public service loan forgiveness to borrowers who completed the program.) The loan repayment rate definition addresses most of the flaws in the cohort default rate as identified by a 2003 audit report by the Office of the Inspector General at the US Department of Education.[4]

The press release reports that the average loan repayment rate for students at for-profit colleges is 55%. The metric's lower 35% threshold is roughly equivalent to the 30% eligibility threshold on 3-year cohort

[3] It is unclear why the US Department of Education is treating the disclosure of loan repayment rates and debt-to-earnings ratios as a sanction, instead of requiring all colleges to disclose this information. Requiring the disclosure of these rates and ratios for all colleges would be beneficial to students, enabling them to compare colleges according to the affordability of the student debt. The US Department of Education should consider disclosing this information on the FAFSA's Student Aid Report, just as it currently discloses graduation rates.

[4] Audit to Determine if Cohort Default Rates Provide Sufficient Information on Defaults in the Title IV Loan Programs, Office of the Inspector General, US Department of Education, ED-OIG/A03-C0017, December 2003. www.ed.gov/about/offices/list/oig/auditreports/a03c0017.pdf

default rates,[5] but precludes the manipulation of default rates by using deferments and forbearances to push borrowers outside the cohort default rate window.

Current default aversion programs emphasize the use of deferments and forbearances to avoid defaulting on federal student loans. These programs will probably start emphasizing income-based repayment instead. Although only about half of borrowers in income-based repayment will count toward the loan repayment rate, that compares favorably with deferments and forbearances, where none of the borrowers count toward the loan repayment rate.

The debt-service-to-income and debt-service-to-discretionary-income ratios are based on all education debt, including both federal and private student loans. Prior debt at the same or a related institution is included. Income is based on actual earnings data from the Social Security Administration. (The use of Social Security earnings data addresses the problems associated with borrowers who do not file a federal income tax return because of low income, since such borrowers still have FICA taxes withheld and reported to the Social Security Administration.) The calculation of discretionary income will be the same as for income-based repayment, reducing income by 150% of the poverty line, and will assume a family size of one.

The use of discretionary income and actual earnings presents an effective solution to differences in degree programs without requiring any kind of a special exception or adjustment for those programs. The same rules will apply to all programs, regardless of educational attainment. For example, the previous proposal to use Bureau of Labor Statistics data had an inherent bias against Bachelor's degrees and more advanced degrees, since an MBA in accounting would map to the same average wage data as for an Associate's degree in accounting. Using actual earnings addresses this problem. Similarly, college graduates with advanced degrees can devote a greater percentage of their income toward repaying debt than graduates who hold just an Associate's degree or certificate, and so are more likely to satisfy a debt-service-to-discretionary-income threshold as opposed to a debt-service-to-income threshold.

The three metrics will be phased in, with programs subject to loss of eligibility starting in the 2012-13 academic year. The US Department of Education estimates that 5% of programs would lose eligibility and 55% would be required to warn students about their low loan repayment rates and high debt-to-earnings ratios.

The press release does not discuss graduation rates or job placement rates, so it is likely that the NPRM will not include a version of the 70/70 rule (or the 50/70 rule variation) as was previously rumored.

There are a few other questions that may be addressed by the NPRM:

- It is unclear how the US Department of Education will measure a borrower's participation in Public Service Loan Forgiveness, as borrowers do not currently file paperwork to document employment in a public service job. The US Department of Education might be able to infer this from the borrower's employer as reported to the Social Security Administration.
- Students who graduate in June typically are employed in a full-time job for less than half the year. It is unclear how the US Department of Education will adjust for this in calculating the debt-

[5] This ballpark analysis assumes the use of median debt with a three-year cohort.

service-to-income and debt-service-to-discretionary-income ratios. Perhaps the US Department of Education will annualize the earnings of such borrowers.

- The press release does not specify whether the debt-service-to-income and debt-service-to-discretionary-income metrics are applied to median debt for a three-year cohort, as in the previous proposal. It seems likely that the definition of gainful employment will be based on median debt, as there is no reason for the US Department of Education to have changed this aspect of the definition. However, the use of a three-year cohort was necessary in the previous proposal because of the three-year publication schedule for Bureau of Labor Statistics wage data. Since the current definition does not depend on Bureau of Labor Statistics data, it is possible that the US Department of Education might use a different cohort. Yet given that the US Department of Education's analysis will have focused on a three-year cohort, the NPRM's definition is likely to continue to use a three-year cohort.
- The press release does not address the treatment of new colleges, colleges with few borrowers or how a college may regain eligibility.

The gainful employment definition will apply only to for-profit colleges (and certain vocational training programs at non-profit colleges) because of the statutory language. However, Congress should consider applying these affordable debt restrictions to all colleges. Just because a college lacks an overt profit motive does not mean that it should be permitted to routinely graduate students with excessive debt.