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Regulatory Update: Good Enough for Gummint Work

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Our Call:

In case you missed the last episode in *The Adventures of Re-regulation*, one week from last Friday, the Department of Education released, by institution, the rate at which former students have repaid some amount of principal annually on their government-guaranteed student loans. Having a sufficiently high repayment rate is the preferred method to comply with the Department's proposed new rule on Gainful Employment. Preferred because it is the simplest (and thus least expensive,) because it theoretically allows for continued pricing power, and because it is the only method that allows an institution to avoid having to warn current and prospective students "that they may have difficulty repaying their loans." The other method -- a debt/income measure -- involves keeping track of private as well as public sources of financing for each student, and involves ongoing uncertainty regarding graduate earnings over which schools obviously have very little control.

Consolidated loans still actively promoted in direct lending program

Among the difficulties presented by the release of the data were anomalies at several institutions that otherwise had quite low default rates but surprisingly low repayment rates. The discrepancy seems to be due to the poor performance of consolidated loans. Unconsolidated loan data available to the schools led them to believe, even making conservative assumptions regarding deferments and forbearances that are excused in the cohort default calculation but not in the new measure, that they would easily clear the highest repayment hurdle of 45%. Instead, several schools were surprised to find that the complete data suggested that virtually none of the students in loan consolidation were making principal payments during the period measured. (Strayer Education determined that its effective repayment rate among consolidated loans was 2% vs. 56% for unconsolidated loans.) This anomaly in turn seems to be due to the prevalence of interest-only loans that back-end load principal payments in the life of the consolidated loans.

Because the department is concerned by the compounding of principal that can eat away at the ROI of a degree and sometimes compound financial hardship as well, (though this does not necessarily take place with all consolidated loans,) it has taken a hard line, insisting that anything less than immediate payment of principal would encourage unscrupulous for-profit schools to encourage loan consolidation among their students in order to manage their institutional default rates. The logic being that an extended, interest-only loan with a lower monthly payment could serve the short-term goal of preventing a student from defaulting in the three-year cohort near term but result in greater difficulties later once the payments began to increase.

Imagine our surprise therefore to discover this site where the Department of Education encourages students to consolidate their student loans directly with the Department: http://loanconsolidation.ed.gov/help/faq.html#option . Though the presentation is a bit Soviet, the points are all included -- lower your monthly payment, sign up for graduated payments that begin with interest-only payments and increase over time (as much as 25 years) as your income increases. Nowhere on the page do we see cautionary language as to the wisdom or even consequences of graduated payment plans.

Investment Analysis:

There are some that will see in this perfect evidence of the conspiracy on the part of the administration to bring down for-profit schools. We continue to disbelieve that destruction is the goal but instead believe the Department naively thinks it has figured a way to surgically remove margin without damaging access. In the policy contradiction above we merely see evidence of the regulatory design being not nearly as clever as its engineers believe it to be.

Socio-Economic factors loom large

Yet one of the secondary messages from the data itself is that adjusted for ethnicity, income, age, and program type, there seems to be a much, (much) smaller discrepancy in repayment rates. We heard this anecdotally from Bryant & Stratton which reports that in a sample perfectly controlled for recruiting tactics and quality of instruction (i.e. its schools) it sees dramatically different repayment rates between its urban and suburban schools.

ITT Educational Services produced a more rigorous study across the entire data set controlling for the above-mentioned factors (assuming an average incidence) explicitly among two-year schools and saw nearly identical rates with publicly-funded institutions.

Exhibit 1: **Average 2009 Loan Repayment Rates by institution Type (at least two-year institutions with 100 or more enrolled students)**

	n	Mean Repmt. Rate	Std. Deviation	Adj. Mean Repmt. Rate*	Std. Error	95% Conf. Lower Bound	95% Conf. Upper Bound
Private not-for-profit	1,252	58.0%	17.5%	55.1%	0.4%	54.4%	55.8%
Private for-profit	626	37.5%	14.5%	45.5%	0.6%	44.3%	46.7%
Public	1,878	47.0%	16.3%	46.1%	0.4%	45.4%	46.8%

**Assuming independent variables were constant (group average) for all institutions.*

Independent variables: 1) Percentage total enrollments that are black, non-Hispanic; 2) Percentage total enrollments that are Hispanic; 3) Percentage total enrollments age 25-64 (adult students); 4) Percentage 12-month undergraduate enrollment receiving Pell grants.

Source: Department of Education, ITT Educational Services.

Dodging the central debate

This does not absolve for-profit schools from dealing with disadvantaged populations in a responsible way, or even perhaps requiring of minority-serving institutions that they adhere to higher standards for disclosure and remedial instruction for example. However, it does suggest to us that the Department of Education, and by proxy the Obama administration, is dodging the central debate. If we are to improve the participation rates in post-secondary education according to the President's professed plan, it means expanding service to traditionally under-served populations. This in turn means adopting additional risk in terms of remedial education, risk of drop-out and financial risk associated with the repayment of student loans.

If the concern is keeping the cost from burdening the students served by the education by forcing them into state-funded schools, the issue is budget. If students are not bearing the cost of their own education through borrowing, then where will the money come from to educate them? For the foreseeable future it won't be the states and Congress seems unwilling to borrow more to provide direct federal subsidies to the institutions themselves. If the concern is the taxpayer cost, we would note the relatively actual low cost of defaults (low single-digits per the Office of Management & Budget,) but would also welcome more discussion of the type offered below by the CEP of Top School. This simple analysis (it also works on a per-student basis) suggests that including generally better graduation rates at the diploma and two-year level, and corporate taxes, that taxpayers are better off supporting for-profit schools as an instrument of public policy.

http://saasinhighered.wordpress.com/

Things Are Looking Up?

Though coming quite late in the debate, voices are beginning to be heard in calm, cogent, reasonable opposition to the rules as constructed. Though we hold out little hope for reprieve, the chorus suggests the issue and the approach the Department has chosen to take could ultimately and increasingly become a partisan wedge issue:

Washington Post op-ed: *"How to discourage college students,"* August 22, 2010
http://www.washingtonpost.com/wp-dyn/content/article/2010/08/21/AR2010082102468.html?nav=rss_opinions

The Hill: "Don't discriminate against proprietary colleges," by Jock McKernan, August 19, 2010
http://thehill.com/blogs/congress-blog/education/115001-dont-discriminate-against-proprietary-colleges

U.S. Chamber of Commerce: "U.S. Chamber Outlines Opposition to Gainful Employment Regulation," August 18, 2010
http://library.uschamber.com/press/releases/2010/august/us-chamber-outlines-opposition-gainful-employment-regulatio

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			IB Serv./Past 12 Mos.	
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SELL	**1**	**0.7**	**1**	**100.0**

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