



April 24, 2015

The Honorable Lamar Alexander, Chairman
Committee on Health, Education, Labor and Pensions
428 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Patty Murray, Ranking Member
Committee on Health, Education, Labor and Pensions
428 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Alexander and Ranking Member Murray,

On behalf of the more than 400 public colleges, universities and systems that comprise the membership of the American Association of State Colleges and Universities (AASCU), I write to submit comments on the Committee's March 23, 2015 white paper addressing risk-sharing in student loans.

Background and Contextual Comments

The white paper on risk-sharing is noteworthy because it proposes a novel approach to accountability which may prove effective if properly configured. Before providing specific comments on questions regarding improved allocation of risk, we would like to address the paper's critique of Cohort Default Rates, the 90/10 rule, and the U.S. Department of Education's draft of the gainful employment regulations.

Cohort Default Rates (CDRs). While recognizing that CDRs curb the most egregious abuses of the student loan program, we agree that CDRs are not an ideal proxy for accountability or an adequate metric for outcomes of student loans. As the paper points out, the binary nature of default—a vestigial hold-over from the guaranteed student loan system that no longer makes much sense given federal ownership of the loans and the federal government's virtually unlimited collection powers—renders it susceptible to institutional (and federal) manipulation and gaming. While the paper cites the example of the Department of Education's exclusion of certain defaulted loans from CDRs last year, there is also ample evidence that many high-default institutions utilize sophisticated techniques to artificially lower their CDR by pushing defaults outside the three-year CDR window. Ironically, such gaming techniques actually increase economic costs of defaults that inevitably occur once the school is safely out of the three-year window. Therefore, we agree with the paper's suggestion that repayment rates would be a better metric for determining economic success or failure for student loans.

90/10 rule. We respectfully disagree with the paper’s analysis of the 90/10 rule as creating an “artificial floor” for tuition at institutions to which it applies. The argument that increased student aid forces covered institutions to increase tuition is based on the assumption that the entire student population at such institutions must inevitably consist of extremely low-income students with maximum eligibility for federal aid. The fact that a comparatively expensive school may be unable to enroll a sufficient number of students with a co-pay would speak volumes about the quality of its offerings. The ability of schools to attract multiple funders beyond the federal aid programs is an important market-based validation of their offerings. The 90/10 rule, furthermore, is an efficient model of such a market-validation mechanism in that, as a self-executing metric, it requires minimal federal regulation. Any risk allocation policy should therefore complement, not replace, 90/10.

Gainful employment regulation. Finally, we share the white paper’s concern regarding the complexity of the U.S. Department of Education’s gainful employment regulation. It is important to note, however, that an alternative for the gainful employment construct would be needed to allow non-degree programs to gain eligibility for Title IV financing, and that simply eliminating the language would create a giant and costly loophole in federal law. Furthermore, while the Department’s current configuration of this regulation is not ideal, there is some resonance to the concept that certain programs—such as those that are advertised as pathways to employment—should place a reasonable percentage of their former students in jobs that allow them to repay their educational debt.

Discussion

Turning to the technical details of the issues, we believe that the paper takes too generic a view of risk, and would propose that the Committee examine the distinct types of risk involved in student lending separately, and that it focus on the underlying causality for each.

Interest Rate Risk

Any discussion of the proper allocation of lending risks should address interest rate fluctuations and associated risks to the federal government and to borrowers. Under current law, the interest rate on student loans is a function of a snapshot of the 10-year Treasury note rate, and remains fixed for the entire life of the loan. This creates a binary interest-rate risk allocation problem: borrowers who take out loans when rates are historically low gain an unintended benefit at the government’s expense while borrowers who take out loans when rates are high will be locked into exorbitant rates that will generate a windfall for the federal government. The latter circumstance will cause additional hardship for student loan borrowers because, unlike mortgages and most other loans, they cannot refinance their student loans when interest rates drop.

We believe that the variable rate system instituted in the 1992 amendments to the Higher Education Act provides a better risk allocation model for student loans. The 1992 interest rate formula, which operated for loan cohorts between 1993 and 2006, indexed rates to the bond-equivalent rates of the 91-day Treasury bills with an annual reset that much more fairly—and symmetrically—allocated rate risk. We urge the Committee to re-examine a true variable rate model as a more equitable and more efficient market-based alternative to current law.

Credit Risk

The March 23 white paper focuses on controlling and better allocating credit risk, i.e., the risk of non-repayment, in student loans. While the white paper correctly acknowledges the causalities contributing to credit

risk, it conflates the multiple risk factors potentially contributing to non-repayment of loans and discusses them without distinction. For example, credit risk can be attributed to borrower characteristics, institutional practices, or external factors that neither borrowers nor institutions can control. To accomplish the purposes stated in the white paper, risk retention should focus on the subset of unacceptable outcomes directly linked to institutional practices. The following observations may assist the Committee in its deliberations on the topic.

Insurance model. An insurance model—under which all institutions would pay a risk-adjusted premium to cover future federal losses—would result in a cross-subsidization of bad actors by good institutions. It is critical that any risk-retention system be directly and concretely tied to the actual—as opposed to hypothetical or projected—performance of loan portfolios.

Programs as units of analysis. Programs, not institutions, would be the proper unit of analysis for portfolio performance assessment. Reliance on institutional (as opposed to programmatic) repayment rates would enable institutional bundling of low-performance programs (as “cash cows”) with lower-cost offerings. This, in turn, would allow these institutions to maintain eligibility for all of their programs through the internal cross-subsidization of their underperforming programs’ metrics by their other offerings.

Definition of programmatic performance. A careful definition of programmatic portfolio performance is a critical precondition for a successful risk-retention formula. The most likely metrics in such a definition would be annual and cumulative programmatic loan volumes and the ratio of actual annual repayments to each portfolio’s expected amortization. The repayment term used to calculate this expected amortization index would presumably be tied to program type and vary by credential level.

Credit risk attributable to macroeconomic conditions. Fourth, institutions should be held harmless from the component of credit risk that is clearly associated with macroeconomic conditions (labor-market contractions, recessions, etc.) through mechanisms that index risk-retention to such objective criteria as gross state or regional products, unemployment rates, and similar measures.

Subsistence costs. The paper parenthetically discusses the problem of subsistence costs and astutely points out that borrower consumption financed by student loans works as a drag on the return on investment for these loans. This is an enormously important topic that goes well beyond the discussion at hand. In brief, a logical approach would be to attribute all gift and work-study aid as subsidizing indirect costs, but cap the amount of debt on which institutions would retain some risk to tuition and fees. This would prevent institutional gaming of the system by ensuring that non-loan aid is not artificially used to lower liability, but would also protect them by capping that liability to the portion of loans that institutions actually receive. This arrangement would also be a better alternative to proposals that would allow institutions not to certify loans, since they could use that authority to limit institutional liability by steering students into more expensive non-federal loans.

Institutional risk avoidance. As the paper expressly recognizes, institutional risk-avoidance—(selective exclusion of higher-risk populations)—is a predictable and unintended consequence of an ill-configured risk-retention proposal. A modest level of input-adjustment for student demographics, such as linking risk-retention to enrollment of Pell recipients, would significantly address the problem. As mentioned above, this would not only address the higher credit-risk of lower-income borrowers, it would also mitigate the need to grant institutions the right to refuse federal loans to low-income students that they recruit and admit.

Institutional risk retention. Related to risk avoidance, institutional risk retention should not be designed as a first-dollar liability system, but should only apply above a reasonable threshold of *portfolio* non-performance. Accommodating a reasonable portfolio non-performance—for example, 5 or 10 percent—would reassure institutions that they would not be punished for admission and enrollment of lower-income students. In addition, it would address the challenge of borrower career choices—highly trained borrowers who opt for socially desirable, but non-lucrative, careers—that are beyond institutional control.

Institutional liability. Finally, risk retention should be configured as a modest institutional liability that escalates as a function of increased programmatic reliance on debt financing and decreased portfolio repayment rates. While some may argue that complete disgorgement of loans should set the upper limit for institutional liability, we believe that instructional expenses should be excluded from amounts for which institutions may be held liable.

We thank the Committee for posing important policy questions and creating an open process for interested parties to participate in the Committee’s deliberations on the issues. We hope that the Committee will find these brief comments useful, and would be happy to expand on them should you decide to further explore this important topic.

Sincerely,

A handwritten signature in cursive script, reading "Muriel E. Howard". The signature is written in black ink and is positioned above the typed name and title.

Muriel E. Howard
President
American Association of State Colleges and Universities