MEMO

To: Interested Negotiators

From: Maura Dundon and Leslie Parrish, Center for Responsible Lending

Date: September 9, 2013

RE: Rationale for repayment rate accountability metric and threshold for Fall 2013 gainful employment rulemaking

---

The 2011 gainful employment final rule consisted of three accountability metrics that covered both graduates and non-completers: (1) a repayment rate, which took into account all attendees of a given career education program (both graduates and non-completers) and (2) two debt-to-earnings ratios for graduates only. Programs that repeatedly failed all three metrics could become ineligible for Federal financial aid. The threshold for failing the repayment rate metric was successfully challenged in court, which led to most of the rule being vacated.[1]

The Department of Education has re-started the negotiated rulemaking process, and is now proposing to drop the repayment rate metric and include only the debt-to-earnings ratios. The effect of this change is that non-completers are no longer taken into account. ***CRL believes it is a priority to consider the outcomes of all attendees—in some way—in any gainful employment rule.*** One option would be to again incorporate a repayment rate metric into the Department's rulemaking on gainful employment.

I. Rationale for inclusion of a repayment rate metric

There is no insurmountable legal barrier to including a repayment rate metric. *APSCU v. Duncan* did not rule that a repayment metric could never be enacted. The decision is limited to narrow administrative law grounds about how the Department articulated its rationale for setting the repayment rate *threshold.* In this new rulemaking, the Department needs to provide a more in-depth explanation about how the repayment metric and threshold chosen relates to measuring gainful employment.

Under well-established administrative law, the Department need only "articulate a ... rational connection between the facts found and the choice made."[2] The court found that the Department had not provided the necessary "rational connection" because the Department's discussion of the repayment metric only focused on the number of programs that would be eliminated by the chosen threshold. This was irrational because it did not connect the

---

[1] *APSCU v. Duncan,* 870 F. Supp. 2d 133 (D.D.C. 2012).

[2] *Id.* at 149, 153-154.

repayment threshold to the quality of the programs. Instead, the Department was just grading on a curve and eliminating the bottom of the class.

We believe that a repayment metric can be adequately supported by evidence and reason, and can serve as a viable way to include non-completers. Nearly half of attendees of for-profit colleges do not ultimately complete the program, and most of these students acquire debt that they must start repaying.[3] Nearly a third of these non-completers have cumulative federal loan debt that exceeds their annual income, often because they have been unable to find employment.[4] In fact, non-completers are so important that to fail to include them might leave the rule vulnerable to legal challenge: a rule not covering non-completers would arbitrarily ignore the students most harmed by the conduct in question.

More broadly, however, the inclusion of a repayment rate can be justified by the concept's well-established importance in underwriting and consumer protection to assess whether a borrower had an ability to repay a loan. Most federal student loans do not include traditional underwriting standards or an ability to repay assessment. Instead, they depend on the notion that ability to repay is determined based on the expected returns to education (in terms of income received from employment made possible from that education). Thus, ensuring that the program is of adequate quality to allow the borrower a career with sufficient income to repay the loan essentially serves as underwriting. The repayment rate accountability metric—the extent to which outstanding principal can be paid down—serves as an indicator of ability to repay and, thus, whether the program is of sufficient quality to allow a student to ultimately have a well-paying job.

II. Justifications for setting a pass/fail threshold

As noted above, the court's concerns in *APSCU v. Duncan* focused on the arbitrariness of the threshold set for the repayment rate, rather than whether this type of metric was appropriate. There may be multiple options for setting a pass/fail threshold, such as standards set by banking regulators and industry practices in assessing loan portfolios. We discuss each of these concepts in turn.

A. Banking regulator standards

The repayment rate metric is generally measured as the share of student loans in which the principal balance is being reduced over time. Principal will not be reduced if the loan is in default or other non-repayment status; or if the borrower is making payments that are too small to reduce the principal. This is known as "negative amortization." Student loan debt that does

[3] Nearly half (46%) of students attending for-profit institutions beginning in the 2003-2004 school year had not completed their program by 2009. Of these non-completers, 86% left with Stafford or Perkins loan debt. See *Federal Loan Debt Burden of Noncompleters* (NCES 2013-155), Department of Education (April 2013).

[4] Ibid.

not experience a reduction in the principal balance could be considered analogous to negatively amortizing loans in other contexts. The banking regulators have found that negatively amortizing loans raise consumer protection concerns.

- The **Office of the Comptroller of the Currency (OCC)** has stated specific concerns regarding negatively amortizing mortgage loans, As TICAS notes in an August 2013 memo, the OCC recommended a prohibition on negatively amortizing mortgages in 2009 and has noted more recently that such loans "benefit neither of the parties [lender and borrower] involved in the loan."[5]

- In its exam manual on credit cards, the **Federal Insurance Deposit Corporation (FDIC)** notes that the "amortization of principal balances is one of the key factors when determining whether...lending practices are safe and sound...The failure of minimum payments to sufficiently amortize the debt in a reasonable timeframe not only elevates credit quality concerns and consumer protection issues but can understate the level of delinquent accounts."[6] Relatedly, one of the key features of the CARD Act, which reformed many abusive credit card practices, was to ensure that minimum payments were of adequate size to pay down a principal balance.

- **The Consumer Financial Protection Bureau (CFPB)** has emphasized, in press statements, a white paper and its exam manual, concerns related to sustained use of certain loan products, such as payday loans. These concerns focus on whether these loans are renewed over time—either by paying just the interest and extending the loan term or through a series of back-to-back transactions. Turning a short-term loan product into a long-term debt trap in which principal is not paid down could raise concerns of unfair, deceptive, or abusive acts and practices (UDAAP).[7]

These concerns related to negative amortization (or a lack of principal reduction over time) suggest a repayment rate threshold of 50% would be appropriate. Below this rate, the majority of loan debt could be considered to be negatively amortizing, and thus raising the concerns of banking regulators as discussed above.

---

[5] TICAS' "Background for the September 9-11 negotiated rulemaking meeting" memo dated August 19, 2013, available at http://www.ticas.org/files/pub/TICAS_memo_re_upcoming_neg_reg_issues_Aug_19_2013.pdf, describing OCC November 18, 2009 press release at http://www.occ.gov/news-issuances/news-releases/2009/nr-occ-2009-143.html and May 14, 2003 letter to the Consumer Bankers Association in response to CBA comments on private loan modifications at Appendix C.

[6] http://www.fdic.gov/regulations/examinations/credit_card/ch9.html#3sub2

[7] See, for example, Director Cordray's remarks on regulatory risks related to the debt trap here: http://www.consumerfinance.gov/speeches/prepared-remarks-of-richard-cordray-on-the-paydaydap-study-press-call/ and a section of the short-term small dollar loan exam manual at page 169 that describes concerns relating to sustained use here: http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.

B. Industry practices

Another approach might be to assess whether lenders—either in student loans or other contexts—employ any thresholds or "rules of thumb" in assessing the performance of a given portfolio of loans. There may be thresholds at which lenders face greater capital requirements or greater regulator scrutiny for risky origination practices. In addition, because certain student loan portfolios have been packaged together and securitized in recent years, it may be instructive to look at analyses from the ratings agencies to determine whether certain cut-off points for expected performance exist between loan pools of varying quality. If the negotiators decide to re-consider inclusion of the repayment rate metric, CRL can look further into these possibilities.

III. Other considerations

The Department's 2013 draft regulations on gainful employment currently require a program to routinely pass two debt-to-earnings standards in order to be eligible for Federal financial aid. If the Department adds an accountability metric to the two debt-to-earnings metrics proposed, this may have the unintentional consequence of making it easier for sub-par programs to remain eligible for Federal financial aid if programs still must fail all accountability metrics for this to occur. Therefore, negotiators advocating for an additional metric may also want to consider whether to require institutions to pass at least one debt-to-earnings metric AND the additional metric to retain full eligibility for federal financial aid rather than only cutting off aid for programs that repeatedly fail all accountability metrics.