



*Statement Before the United States Congress  
House Committee on Education and Labor  
Higher Education and Workforce Investment Subcommittee  
Hearing on "Protecting Students and Taxpayers: Improving the Closed School Discharge  
Process"*

## **Closed School Discharges**

How an Insurance Mandate for Higher Education Can Protect Students and Taxpayers

**Preston Cooper**

Research Fellow, The Foundation for Research on Equal Opportunity

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Good morning, Chairwoman Wilson, Ranking Member Murphy, and distinguished Members of the Subcommittee. Thank you for the opportunity to testify today on improving the closed school discharge process. My name is Preston Cooper and I am a research fellow in higher education policy at the Foundation for Research on Equal Opportunity, a nonprofit, nonpartisan think tank focused on bringing opportunity to people with incomes or wealth below the U.S. median.

While closed school discharges are an important aspect of the student loan safety net, when they occur, it means we have failed student borrowers. Far better than a loan discharge is ensuring that students have the chance to achieve what they went to college for in the first place: a degree or certificate. To that end, Congress should require institutions to purchase insurance to reimburse taxpayers in the event of a closed school discharge. This policy will provide a financial incentive for institutions to take steps to avoid such discharges, such as improving transferability of credit. An insurance mandate can also fit into a broader system of incentives-based accountability for federally-dependent institutions of higher education.

### **Background on closed school discharges**

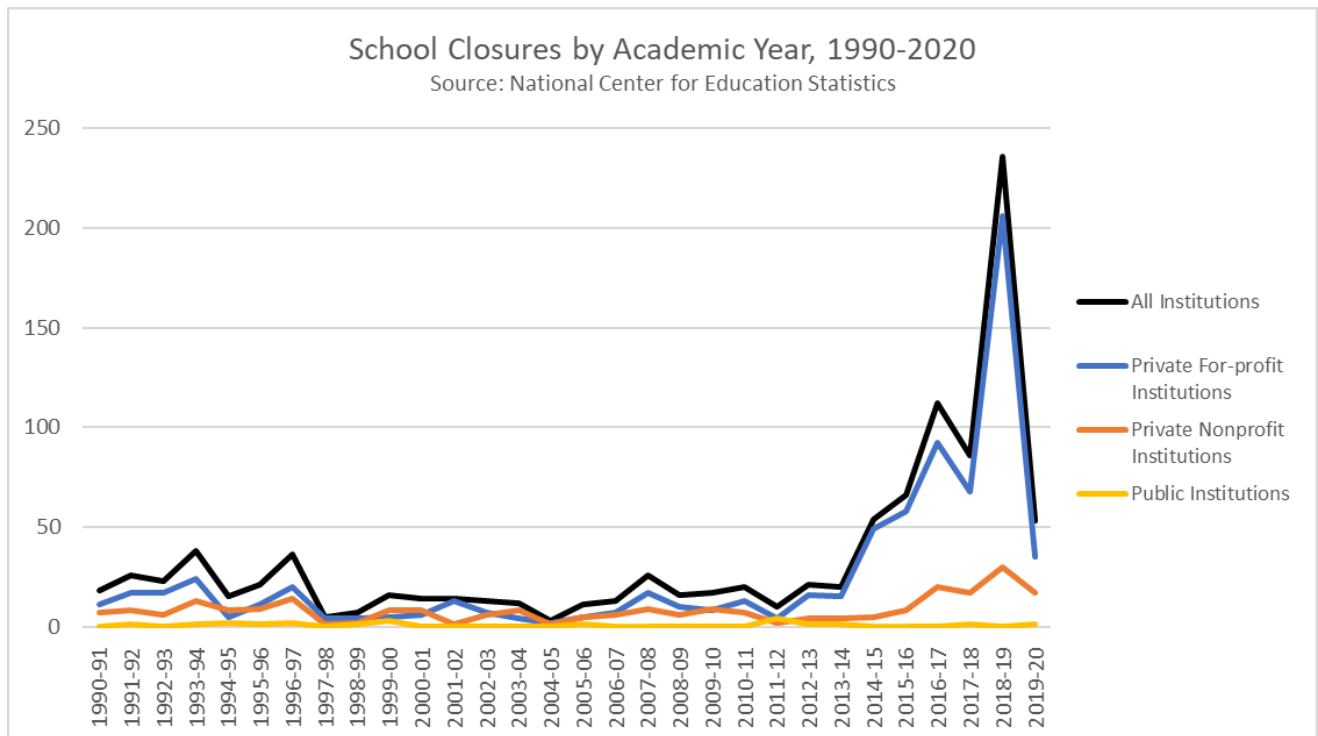
Higher education is a risky investment, so the federal government includes several provisions in its student aid programs to mitigate the risk to students. One of these provisions is the closed school discharge. If a school closes while a student is still enrolled (or closes within 180 days after she withdrew), she may be eligible to have her federal student loans canceled. However, the student is ineligible for a discharge if she completes

her academic program before the school closes, or if she successfully transfers her credits to another school.<sup>1</sup>

In recent years, the Education Department (ED) has taken action to automatically cancel the loans of some students eligible for a closed school discharge. The Obama administration's Borrower Defense to Repayment rule authorized automatic discharges for students who attended a school that closed between November 1, 2013 and July 1, 2020. The Secretary of Education has periodically used his discretionary authority to grant additional discharges, including a recent \$1.1 billion to 115,000 former students of ITT Technical Institute, a now-defunct chain of for-profit institutions. Students are now eligible for a discharge if they withdrew from ITT Tech on or after March 31, 2008 (which is more than eight years before the institution closed).<sup>2</sup>

ED does have some tools available to protect taxpayers from the losses imposed by closed school discharges. For instance, it may require financially troubled institutions to post a letter of credit in order to cover taxpayer losses in the event of a discharge. But this strategy often fails in practice, as the shuttering of ITT Tech demonstrates.

On August 25, 2016, the Obama administration required ITT Tech to post surety equal to \$153 million, on top of \$94 million that the school had already posted. The school was given 30 days to provide a letter of credit. At the same time, ED banned ITT Tech from enrolling new students using federal financial aid.<sup>3</sup> These two actions, though justified in the abstract, had a crippling financial effect on the school. Unable to secure the additional letter of credit and facing a precipitous decline in revenues, ITT Tech closed permanently on September 6.<sup>4</sup> The \$94 million letter of credit it posted covered only a fraction of the closed school discharges associated with the institution, which are still ongoing.



According to U.S. Department of Education data, nearly 700 institutions have closed their doors in the last 10 years.<sup>5</sup> School closures are an inevitable aspect of the higher education system. Indeed, if schools did not periodically close, it would be a sign of stagnation and sclerosis among American colleges. The landscape of a healthy higher education system should change over time as labor market needs evolve and innovation delivers better pedagogical techniques.

The problem is the manner in which schools sometimes close. Too often, schools such as ITT Tech shut their doors with little warning. Students may be unable to complete their coursework or transfer their credits to another institution. While this will make those students eligible for a closed school discharge, loan forgiveness was not their original goal when they began attending school; rather, they pursued higher education in hopes of earning a credential. Closed school discharges should be regarded as a last resort, and not

only because they represent a significant burden on taxpayers. When discharges occur, it means that we have failed our students.

### **Current financial responsibility rules are inadequate**

ED needs a way to recognize ahead of time when a school is in danger of closure. Currently, ED uses a measure called the Financial Responsibility Composite Score to assess schools' financial health. Private institutions are required to submit audited financial statements to ED, which ED then uses to calculate a score between negative 1.0 and positive 3.0. Schools with a score of less than 1.0 are considered not financially responsible. ED may require institutions receiving a failing score to post a letter of credit, or suspend them from participation in federal financial aid programs altogether. Schools with scores between 1.0 and 1.5 are subject to heightened cash monitoring.<sup>6</sup>

However, composite scores have long been recognized as an inadequate measure of schools' financial health. Their power to predict school closures is limited at best. According to a Government Accountability Office report issued in 2017, half of the institutions that shuttered between 2010-11 and 2015-16 received *passing* composite scores from ED right before they closed. Eighty percent of institutions that received *failing* scores in 2010-11 were still operating as of June 2016.<sup>7</sup> As one *Inside Higher Ed* writer pointed out, ED's composite scores suggest that a school for hypnotists is on stronger financial footing than Harvard University, which has a \$42 billion endowment.<sup>8</sup>

GAO found that financial responsibility composite scores do not reflect current best practices in accounting. Moreover, they take two to three years to calculate (the most recent available set of composite scores is from academic year 2018-19), meaning ED is

slow to react to changes in schools' financial health.<sup>9</sup> Scores are also vulnerable to manipulation. Corinthian Colleges, another defunct chain of for-profit schools, took advantage of the fact that composite scores give schools credit for long-term debt by taking out enormous loans, labeling them "long-term debt," and repaying them almost immediately. Corinthian collapsed in 2015, and closed school discharges associated with the school have cost taxpayers hundreds of millions of dollars. The institution received a passing score from ED as recently as 2012.<sup>10</sup>

There is suggestive evidence that score manipulation is ongoing. The most recent set of scores show that eight times as many institutions received a barely-passing composite score of 1.5 as received a score of 1.4, just below passing. In the absence of manipulation, we would expect a much smoother gradient around the passing threshold.<sup>11</sup>

While ED updated its methodology for calculating composite scores in 2020, GAO argues that the changes "do not fully address the current limitations of the composite score formula" and do not "incorporate new financial metrics that would provide a broader indication of schools' financial health, such as liquidity, historical trend analysis, or future projections."<sup>12</sup>

These shortcomings mean that ED often cannot predict ahead of time when schools are in danger of closure, which limits ED's ability to request letters of credit and take other actions to protect taxpayers. By the time a school's financial troubles become apparent, it may be too late to take protective action. Requesting a letter of credit at this stage may even hasten a school's collapse, as occurred in the case of ITT Tech.

Moreover, when schools close, students often cannot transfer their credits to another institution. Transfer students typically lose 43 percent of their credits. Credit loss

rates can be over 90 percent for students who wish to transfer between for-profit and public schools, though the problem is bigger than for-profits: transfers between public community colleges result in a 69 percent loss of credit, on average.<sup>13</sup> Poor transferability of credits both deprives students of the chance to earn a credential and places a greater burden on taxpayers, who must grant closed school discharges when students cannot continue their education.

### **The solution: an insurance mandate**

School closures will always occur in the higher education system. The challenge is not in preventing these closures, but in managing them to ensure students can complete their education elsewhere and do not impose excessive burdens on taxpayers through the closed school discharge process. While closed schools may be a fact of life, closed school discharges do not have to be.

Private-sector analysts have often proven better than ED at assessing the true state of institutions' financial health. For instance, in 2016 ED gave passing financial responsibility composite scores to 30 schools that received "junk bond" status from private credit rating agencies. Analysts in the private sector correctly identified financial weaknesses at those schools which ED's financial responsibility formula missed.

Congress should leverage the deep institutional knowledge and sharper financial incentives of the private sector to help ED predict when schools will close. To that end, Congress should require institutions dependent on federal student aid to purchase insurance that fully covers the financial risk they pose to taxpayers.

Such a system would work as follows. Each year ED would calculate taxpayers' total potential liability in the event of a school closure. Aid-dependent schools would then be required to purchase insurance on the private market to fully cover those potential losses. If the school fails, the insurance company would reimburse ED for all costs associated with closed school discharges.

The initial benefit of this plan is to save taxpayers money in the event of a closed school discharge. But the broader benefit is that it creates incentives for institutions to serve their students better.

Insurance companies would be free to vary the premiums they charge institutions based on the perceived risk each institution represents. Institutions on stronger financial footing would pay lower premiums. Moreover, schools with a well-defined teach-out plan and articulation agreements with other colleges to ensure transferability of credit would also pay lower premiums, since the government's losses would be lower in the event of a school closure. Institutions would need to secure insurance coverage before they gain the right to participate in federal financial aid programs. Insurance companies would therefore provide an additional screen to keep unscrupulous institutions from gaining access to taxpayer funding.

The key advantage of this strategy is that insurance companies have a direct financial incentive to properly assess each school's financial viability, teach-out plans, and transferability of credit policies. Moreover, private companies will be quicker to react to changes in institutions' financial health, and can also update the methodology they use to assess financial responsibility faster than ED.



The insurance mandate is analogous to the letters of credit that ED periodically demands from at-risk schools, but far more proactive. While ED must wait to request a letter of credit until an institution's financial problems have become apparent, the insurance mandate will protect taxpayers at during every stage of their relationship with institutions.

Naturally, such a mandate should have a phase-in period of several years, so that a sudden new requirement on institutions does not itself result in closures. But when such a mandate is fully implemented, it will simply hold colleges to the same standard as average people. The government requires car owners to purchase insurance, and banks may legally force mortgage borrowers to have homeowner's insurance. An insurance mandate is the least we can ask of institutions to protect students and taxpayers, who fund them to the tune of over \$100 billion per year.

### **Incentives-based accountability for colleges and universities**

The insurance mandate for aid-dependent institutions of higher education should fit into a broader policy program of accountability focused on outcomes. The federal government should leverage its financial power to ensure that students and taxpayers are getting the outcomes they expect from federally-dependent schools. The best way to do this is to set up the right financial incentives for institutions to achieve excellence in degree completion, graduate earnings, cost minimization, and loan repayment rates.

Closed school discharges represent more than a cost to taxpayers. If such discharges are happening, then students have failed to earn the degree or certificate they expected from their institutions. It is far better for students to either earn a credential or transfer

their credits to another school than to have their student loans forgiven. Institutions need a financial incentive to ensure their students can do so. An insurance mandate will provide this encouragement.

But degree completion is just one piece of the accountability puzzle. The federal government must also ensure that the credentials it pays for are worth something in the labor market. New data on graduates' earnings from the College Scorecard shows that is not always the case.<sup>14</sup> At the same time, high rates of student loan default reveal the dissatisfaction with which many students regard the education they received.

An insurance mandate should therefore be just one piece of an incentives-based accountability system for American higher education. The insurance mandate rewards institutions for good financial health and adequate transferability of credit. Other policies, such as student loan risk-sharing<sup>15</sup> and prizes for good earnings outcomes,<sup>16</sup> could also constitute pieces of this system.

## **Conclusion**

Closed school discharges should be seen as a failure, both of students and taxpayers. While school closures will always happen, a mandate for federally-dependent institutions to purchase insurance can protect students from the consequences of those closures and make taxpayers whole in the event of a discharge. An insurance mandate should be part of a broader move towards incentives-based accountability in higher education policy, so that students and taxpayers see the best possible return on their investment.

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- <sup>11</sup> U.S. Department of Education, Office of Federal Student Aid, “Financial Responsibility Composite Scores,” <https://studentaid.gov/data-center/school/composite-scores>
- <sup>12</sup> Government Accountability Office, “Education Should Address Oversight and Communication Gaps in Its Monitoring of the Financial Condition of Schools,” August 2017, Update Accessed September 25, 2021, <https://www.gao.gov/products/gao-17-555>
- <sup>13</sup> Government Accountability Office, “Students Need More Information to Help Reduce Challenges in Transferring College Credits,” August 2017, <https://www.gao.gov/assets/gao-17-574.pdf>
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