THIRD WAY

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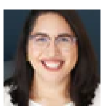
Five Facts You Need to Know about Financial Responsibility Scores



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How do you know when a college is about to close? To answer this question and make sure students aren't left in a lurch, the federal government has in place a diagnostic tool known as financial responsibility composite scores, which are designed to assess the financial health of federally funded institutions of higher education. These scores have been making their rounds in the news as of late, but it's not always clear what they are or how they attempt to hold colleges and universities accountable for their finances. The truth is that they're an imperfect but critical measure of whether a college is financially stable, especially in our rapidly changing fiscal and enrollment environment. And as schools struggle in the wake of the COVID-19 pandemic, they're the best mechanism we currently have to protect students and taxpayers from being left high and dry by institutions that are on the brink of going under. As more attention is paid to financial responsibility scores over the coming months and conversations continue about how to improve them, here are five facts you need to know about how they work:

1. Financial responsibility composite scores attempt to measure the financial health of higher education institutions.

Financial responsibility scores are an accountability tool the Department of Education (Department) uses to track higher education institutions' financial health. Institutions that get federal funding have to submit audited financial statements to the Department each year. Once these statements are submitted, a score is generated based on the information colleges provided that determines whether institutions are responsible enough to participate in federal Title IV financial aid programs and are overall financially healthy. These financial statements are backward-looking (typically two years old) and don't capture the financial situations of institutions in present day.

2. Institutions must have a certain score to be considered "financially responsible" by the Department of Education.

The Department calculates a numeric score for each college and university that can range from -1.0 to 3.0. Financially responsible institutions have a score equal to or greater than 1.5. Schools that fall below that number are considered financially irresponsible and can be subject to sanctions. Schools with a score below 1.5 that can still participate in federal Title IV financial aid programs but are subject to additional cash monitoring (institutions must submit disbursement records to show how they've distributed the funds) and must post a letter of credit, among other requirements.

3. Several different assets are included in the score to judge if institutions are being financially responsible.

The current financial responsibility score favors cash on hand as the marker of financial stability. This can result in inaccurate scores for institutions when the economy takes a significant downturn, like during a recession, as that cash can disappear quickly as schools respond to crises. The score also considers a university's primary financial reserves, equity, and other net income. All of these assets are used to determine the score that institutions receive indicating financial health.

4. Financial responsibility scores are supposed to give an early warning sign that a college may be about to close.

Currently, these scores are one of the only early warning signs the federal government has that an institution is about to close—leaving students with taxpayer-funded loans with nowhere to turn. Other methods to monitor schools to determine which might be on the brink of closure in addition to financial responsibility scores have been proposed but never implemented. Some proposals include having independent financial analysts review and assign the ratings based on a school's risk, making ratings public and easily accessible by all, and requiring that institutions meet a minimum for their cash and liquid assets.

5. Financial responsibility composite scores need improvement.

Though they remain one of the only early warning signs we have, financial responsibility scores have failed to predict nearly half of college closures over the last decade. This is in part because they are backward-looking and only consider older financial statements that may not fully reflect the financial health of a school in real-time. They also don't consider the nuances of individual institutions' finances and use outdated accounting practices, like recording the purchase cost of land and buildings instead of the current market value. These factors combined can give an inaccurate picture of a colleges' financial well-being, especially in times of crisis like we now face. Policymakers should work to strengthen financial responsibility scores, so they better reflect the financial health of institutions in present day and require additional financial metrics from federally-funded institutions to ensure they are fiscally sound. But in the meantime, a warning sign that predicts half of closures is better than none at all, and efforts to waive this requirement risk leaving even more students vulnerable.

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