THIRD WAY

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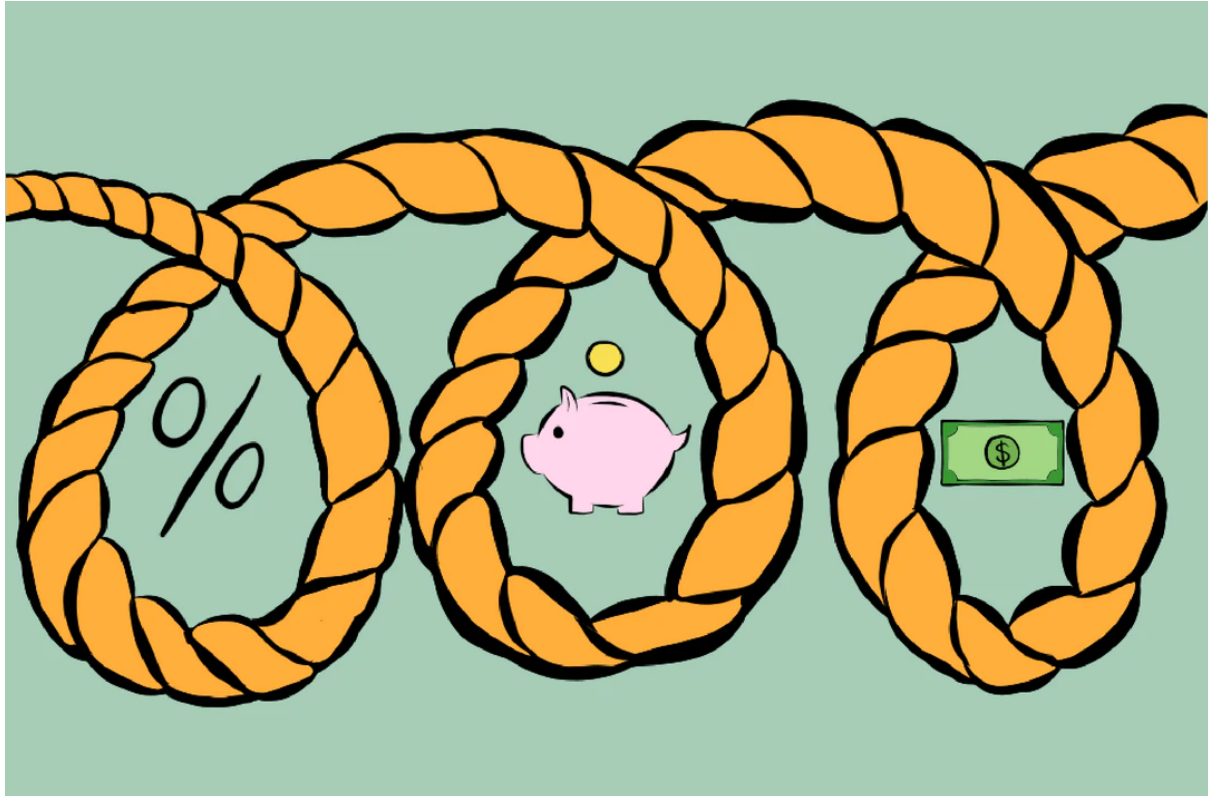
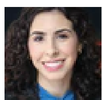
# Three Loopholes that Congress Needs to Close to Protect Students





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The law is the law, and you're either following it or you're not. Right? Not so fast. In some cases, there are loopholes: ambiguities that open the door for people, organizations, or companies to skirt the intention of a law without technically breaking it.

We tend to hear about loopholes when they involve large amounts of money (like the loopholes in the US tax code that wealthy corporations use to lower their income tax payments) or when they're outright absurd (in Wisconsin, for instance, your toddler could legally drink with you at a bar up until a few years ago). [1] These types of loopholes might be the most likely to make the headlines, but exploiting gaps in the law is a problem that cuts across sectors—including higher education.

While we're often inclined to think of colleges as the good guys, that's not always the case. The lack of strong federal guardrails in higher education creates little recourse under the law to curb abusive behavior by predatory institutions—putting both students and taxpayer

dollars at risk. And the fact that the few guardrails that *are* in place have gaping holes preventing them from doing their intended jobs only raises the stakes. Closing dangerous loopholes in higher education law once and for all is long overdue. This memo lays out three of the most egregious examples and explains what it will take to finally sew them shut and protect students and taxpayers.

# The 90/10 Rule Loophole

## Background:

The 90/10 rule is a seemingly simple funding ratio applied to for-profit colleges that is designed to make it more likely that taxpayer funds are used on an education that also has market value. But it has created what is likely the most well-known loophole in higher education, allowing predatory institutions to target student veterans for their military education benefits.

In 1972, for-profit schools became eligible to accept federal student financial aid under Title IV of the *Higher Education Act* (HEA), which includes Pell Grants, work-study programs, and several federal student loan programs. Yet as concern about fraud and abuse in the sector expanded over the following decades, demands for stricter regulation mounted. In response, Congress's 1992 reauthorization of the law instituted a cap on the percentage of revenue that a for-profit college could receive from US Department of Education funds. [2] The new policy was modeled after—and took its name from—a Veterans Administration (VA) provision that had been put in place four decades earlier in 1952 amid similar concerns about the abuse of taxpayer-funded veterans' benefits associated with the extension of the GI Bill to Korean War veterans; known as the "85/15 rule," it mandated that non-accredited, non-degree courses could only enroll veterans and receive VA payments if at least 15% of their students were non-veterans funding their own education. [3]

The 85/15 rule that Congress wrote into the 1992 HEA focused on revenue rather than enrollment, requiring for-profit institutions to bring in at least 15% of their revenue from sources outside of Title IV financial aid, such as students paying tuition out of pocket, employers paying to train their workforce, or providers of private scholarships funding part of the cost of attendance. The rationale was that this threshold would serve as a market test and quality assurance measure: if those schools were really offering a valuable education product, there should be enough demand in the market that someone other than the federal government would be willing to pay at least some portion of the cost to attend.

In the 1998 revamp of the HEA, under intense lobbying from the for-profit college industry, Congress watered down this rule by changing the ratio from 85/15 to 90/10. That's the version

that stands today, meaning that for-profit colleges must bring in at least 10% of their revenue from non-Title IV funding sources like those described above.

## How the loophole works:

Although the rule seems simple enough, it gets more complicated when it comes to which funding sources are counted toward each side of the ratio. Because the rule is written such that only Title IV financial aid funds from the Department of Education count toward the 90% cap, all other federal funding for higher education counts toward meeting the 10% bottom line. That includes military benefits from other government agencies—like the $11 billion in Post-9/11 GI Bill dollars from the Department of Veterans Affairs and $485.5 million in funds from the Department of Defense Tuition Assistance Program doled out on behalf of veterans in fiscal year 2017. [4]

This unintended loophole has not only opened the door for predatory colleges to target veterans and tap into "bonus" federal funding sources, it has effectively incentivized it: for every dollar received from a student's military benefits, a school can take in *nine* dollars in Title IV financial aid. In fact, a 2016 analysis by the Department of Education found that if Post-9/11 GI Bill benefits alone were counted toward the 90% cap, the number of schools that would no longer be in compliance with the funding rule would skyrocket from 17 to nearly 200—showing that many for-profit colleges are receiving close to 100% of their revenue from federal sources, while technically skirting the law's intent that they demonstrate real market value outside of federal aid. [5]

As a result of the 90/10 loophole, scores of military-connected students have been defrauded over the years by predatory institutions that engage in aggressive recruiting practices and misrepresent future employment outcomes in order to woo them to enroll, bringing their hard-earned tuition benefits with them. And for-profit schools take in a disproportionate amount of those benefits, while often providing very little return on investment to students. In spite of receiving only 30% of Post-9/11 GI Bill tuition and fee payments made in 2017, the for-profit sector represented 20 of the 50 colleges receiving the largest total amount of those payments—and accounted for more than half of both the overall $1.4 billion in government funding those top beneficiaries received *and* the nearly 200,000 veterans they collectively enrolled. [6]

Alarmingly, outcomes at those for-profit colleges are also the weakest—by far—among the "top 50" GI Bill-funded schools, with their average 4-year graduation rate hovering at a dismal 22%, compared to 66% at private nonprofit schools and 73% at public schools. [7] Moreover, federal data reveal that some of these schools are spending very little of their GI Bill dollars on costs directly related to educating their students. A 2016 report by Veterans Education Success found that 427 schools that collectively took in over $1 billion in GI Bill

funds spent less than 30% of their gross tuition revenue on instructional costs. [8] Four schools dedicated less than 10% of revenue to instruction—that's less than $1 spent on teaching and learning for every $10 in revenue the institution received. [9] These low-performing schools' aggressive recruitment of veterans leaves military-connected students at heightened risk of using up their education benefits at poor-quality schools that won't support them through degree completion or may leave them with credentials that have little value in the job market.

### How to close it:

The 90/10 loophole puts a clear target on the backs of military-connected students, and closing it is a necessary step to protect student veterans and preserve the integrity of federal education funding programs from abuse by predatory schools.

Fortunately, Senators Tom Carper (D-DE), Bill Cassidy (R-LA), James Lankford (R-OK), and Jon Tester (D-MT) introduced the first-ever bipartisan Senate bill to close the 90/10 loophole earlier this Congress. Known as the *Protect Veterans Education and Taxpayer Spending Act* (*Protect VETS Act*), this legislation would sew shut the loophole by counting education funds provided to military-connected students through the Departments of Veterans Affairs and Defense toward the 90% side of the funding ratio, rather than the 10% side. [10]

Passing the *Protect VETS Act* either as a standalone bill or as part of the next HEA reauthorization and ensuring that *all* federal funding counts toward the 90% limit is a commonsense, bipartisan solution—and a must-do to defend student veterans and taxpayer dollars. [11]

## The Cohort Default Rate Loophole

### Background:

A federal student loan is considered to be in default when a borrower has been unable to make payment on their debts for 360 days, or just under one year. Defaulting is the worst possible outcome for borrowers, often resulting in long-term financial consequences such as damaged credit scores, garnished wages, and withheld tax refunds applied toward repayment on the defaulted loan. [12] The federal government monitors this worst-case scenario by using a metric known as the cohort default rate (CDR), which measures the share of an institution's borrowers who default on their student loans within three years of entering repayment.

CDR was initially written into law in the 1980s and gained relevance in the early 1990s following a period of steep upticks in student loan defaults nationwide. [13] To address the budding crisis, Congress used CDR threshold tests to block institutions with very poor student loan outcomes from continuing to access federal financial aid dollars. Originally defined as the percentage of a school's borrowers who defaulted within two years of entering repayment, the

two-year CDR was replaced by a three-year metric in the 2008 *Higher Education Opportunity Act* —the most recent comprehensive reauthorization of the HEA.

The 2008 rule also raised the percentage threshold for triggering CDR-based sanctions. As the law stands today, if a college has a CDR that is above 30% for three years in a row, or above 40% in any one year, it loses eligibility to receive federal grants and loans. [14] Initially, this CDR test seemed to be doing its job: following its introduction, many of the low-quality colleges that lost access to federal aid shut their doors, and overall default rates dipped. But a few key developments since the 1990s have changed that prospectus, notably the rollout of a variety of income-driven repayment plans as well as predatory colleges mastering ways to game the system to avoid sanctions even if most of their students can't repay their loans. [15]

## How the loophole works:

Under the right conditions, income-driven repayment plans and temporary deferment or forbearance are options that can benefit struggling borrowers. But they also open a loophole for low-performing colleges to manipulate the CDR metric in order to avoid the all-or-nothing penalty of losing access to federal aid—a sanction that would close many schools down.

While CDR is effective at capturing the very worst outcome—loan default—it is unable to capture borrowers who may be in serious financial distress but have yet to hit that rock bottom point, or who have used borrower protection measures to delay it. As a result, the introduction of repayment plans that tie monthly payment rates to income has meant that borrowers who are making zero-dollar payments (because they aren't earning enough to pay down their debt) are buffered from defaulting, even though their financial circumstances may be dire. But those students are not counted as in distress in the CDR metric when looking at their school's performance. Likewise, CDR cannot account for struggling borrowers who have legally paused or delayed payment on their federal loans by entering deferment or forbearance, both of which help eligible borrowers avoid default by allowing for the temporary postponement of monthly payments.

That means some predatory colleges, especially those at risk of failing a CDR test because of the high proportion of their students that default, have a clear financial incentive to game the metric by keeping borrowers out of default during their first three years of repayment. By encouraging high-risk borrowers to apply for forbearance even when it's not their best financial option, predatory colleges can strategically keep those students outside the bounds of their calculation. A 2018 report by the Government Accountability Office (GAO) found that over 1,300 colleges have hired private "default management consultants" to communicate with their borrowers with the intention of pushing them to enter into forbearance whether or not it is in their best financial interest, in some instances by providing misleading or

inaccurate information.[16] The GAO report found that nearly 70% of borrowers who entered repayment in 2013 spent some part of their first three years in forbearance—and that borrowers who were in long-term forbearance were more likely to default on their debts in the *fourth* year after entering repayment, when (you guessed it) their college could no longer be held accountable for their loan outcomes through the CDR test.[17] When GAO went a step further and excluded borrowers who were in forbearance for 18 months or longer from the CDR calculation, they found that default rates for the 2013 cohort increased at 98% of the schools in their study, and that 265 additional colleges would have had a CDR exceeding 30% for that period.[18]

## How to close it:

Last year, CDR caught *just 10 colleges*—less than 1% of all institutions of higher education receiving federal aid—despite the fact that millions of borrowers have defaulted on their student loans. Not only does the loophole in CDR calculations clearly distort data on colleges' outcomes, but it can also hurt borrowers by pushing them toward decisions that could put them at greater financial risk in the long run. It's no surprise that this accountability measure is widely considered to lack teeth, making it ripe for renewed policy attention.

This past fall, the House Education and Labor Committee introduced the *College Affordability Act* (CAA), a comprehensive bill to reauthorize the HEA.[19] The House proposal would make key changes to strengthen the effectiveness of the cohort default rate, including modifying the metric to account for varied levels of borrowing across institutions by honing in on the share of a school's students that take out loans and closing the forbearance loophole by counting borrowers in forbearance for more than three years as defaulting. It would also change the parameters for imposing sanctions on colleges, bumping out the review window from one single year or three consecutive years to consider default rates at the three, six, and eight-year markers.[20] Together, these changes would severely limit predatory colleges' ability to game the CDR metric.

While the CAA represents a step forward when it comes to CDR, there is still plenty of room to strengthen loan default and repayment measures and implement accountability standards to ensure students aren't encouraged to take out federal loans to attend colleges that won't set them up to pay them back. For example, the CAA also introduces a new "on-time repayment rate" metric that would measure the percentage of an institution's borrowers who have paid 90% of the monthly payments on their loans over three years. But this version of a repayment rate doesn't fix the loopholes that allow borrowers who are in income-driven repayment with monthly payments of zero or who are in certain categories of deferment and forbearance to count toward an institution's percentage of "on-time payments." Stronger language in this and future legislation is essential to ensure these metrics can be used to protect students from

schools that are clearly not providing a return on investment—and that the loopholes that have made the current CDR ineffective are fully closed.

# The Incentive Compensation Ban "Bundled Services" Loophole

## Background:

Enrollment management is a core function of colleges and universities, whose financial bottom lines benefit from successfully recruiting and matriculating students. To quell institutional impulses to act in bad faith in the admissions process, an incentive compensation ban was put in place at the federal level to prohibit colleges that accept Title IV funding from paying employees or third-party recruiters based on the number of students they enroll. [21]

This sector-neutral ban was instituted in the 1992 HEA reauthorization to address well-documented practices of aggressive student recruiting by predatory colleges, where contracted "admissions counselors" often operated like high-powered sales teams, with their salaries reliant on meeting steep enrollment quotas. [22] By removing that performance incentive, the ban was intended to promote ethical marketing and recruiting behavior that aligned more closely with the best interests of prospective college students.

But the Department of Education's enforcement of the ban flip-flopped several times over the following decade. In 2002, the Department published guidance diluting the consequences of violating the ban and approved a series of protected payment arrangements that schools could use without violating the law. [23] Eight years later, in 2010, that set of rules was rescinded under the next administration, which instituted new regulations strengthening the original ban.

## How the loophole works:

In 2011, the Department issued guidance clarifying that there was a specific way tuition revenue could be shared with third-party companies without violating the ban: if the compensation was provided for a "variety of bundled services," which could include things like marketing, student advising, technology support, and (notably) student recruiting, you were in the clear. [24] In other words, the bundled services loophole gave colleges a way to legally dole out incentive compensation payments to contractors that were responsible for recruiting their students, so long as those companies provided other services, too.

This exception was carved out in response to heavy lobbying by Online Program Managers (OPMs), an industry that emerged as a powerful new player in the 2000s as the expansion of the internet opened new frontiers in the higher education space. OPMs—like well-known

players 2U and Academic Partnerships, among others—are contracted by colleges to handle the management and operation of over 2,000 online education courses and degree programs. Today, over 500 colleges have contracts with an OPM, and while there is rarely any trace of an OPM's footprint on program websites or marketing materials, they are often doing much of the work behind the scenes, including recruiting students. [25] In return, the OPM takes a significant cut of the money a college receives for that course or degree program (typically to the tune of about 60% of tuition revenue or more), creating a multi-billion dollar market for these services. [26] The incentive compensation ban threatened to destroy that lucrative tuition-sharing model, so it's no surprise that OPMs fought hard to secure a specifically-designed loophole that would protect their ability to profit.

In the early days of OPMs—and the advent of online education itself—it was easier to make the case for such an exception. The first major players in the space contracted with well-regarded public and private nonprofit colleges like the University of California-Berkeley and Yale and presented themselves as good actors dedicated to lowering tuition costs and increasing access to quality distance education. [27] But what happened next was probably inevitable. OPMs expanded their reach, buoyed by the federal government's signoff on their tuition-sharing models. The risk for incentivizing predatory recruiting grew in tandem, with OPMs' bottom lines dependent on their employees' success in enrolling ever-increasing target numbers of students. With no incentive to pass the cost-savings from online learning down to students, the cost of these programs has skyrocketed. And the very ban that was designed to protect students from unscrupulous, paycheck-chasing recruiters has ended up with a loophole big enough to fit thousands of online programs of widely varying levels of quality, fueled by tuition-sharing agreements between universities and OPMs that are clearly designed to benefit the industry, not the students. [28]

## How to close it:

The straightest path to closing the bundled services loophole is for the Department of Education to rescind its 2011 guidance, remove the bundled services exception, and actively enforce the incentive compensation ban. This would be a simple solution to ensure that tuition-sharing models between colleges and third-party contractors cannot reward recruiting on a per-student basis. And in fact, the OPM industry is already undergoing a shift away from financial models based on revenue-sharing and toward fee-for-service agreements, so a change in the federal guidance could contribute to a fundamental reshaping of the industry that would better serve students across higher education sectors. [29]

Economic downturns typically lead to college enrollment booms, so as the country braces for a recession, ensuring quality in taxpayer-funded online education warrants increased attention from legislators. To take even more meaningful steps to protect students pursuing online programs, the Department and Congress can build on a growing base of knowledge around the

OPM industry and its response to incentive measures to inform future guidelines and legislation. New and revised federal regulations should promote greater transparency and stricter consequences for abuse by predatory online programs and include measures to push institutions to rein in tuition hikes for online offerings by passing on the cost-savings they receive from running those programs to students (not contractors).

# Conclusion

It's no secret that the higher education system lacks the type of robust guardrails that are necessary to place a check on the behavior of unscrupulous institutions. As legislators work toward a comprehensive rewrite of the *Higher Education Act* that includes measures to protect students, veterans, and taxpayer dollars, we must start by patching up the gaping holes in current law and injecting integrity back into these provisions.

While loopholes in the 90/10 rule, cohort default rate, and incentive compensation ban aren't the only places where exploitable ambiguities exist, they all present dangerous invitations for predatory colleges to manipulate federal law at the expense of students. New regulations and legislation must contain measures to protect the earned education benefits of student veterans, ensure that metrics tied to loan default and repayment rates have real teeth, and shut the door on recruiting abuses tied to enrollment-based incentive payments. Failing to address these and other loopholes will continue to limit the power of the law to foster educational opportunity and ensure that federal dollars flow only to colleges and programs that are providing a return on investment to students—not bad actors that clearly don't have student interests at heart.

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