

**SPOTLIGHT REPORT**

September 20, 2015

## Student Debt Tops the Syllabus

**What's Happening:** President Obama announced yesterday that he and senior members of his administration would be traveling around the country over the next few weeks discussing higher education. While some of their comments and accompanying press releases may be of interest to investors, the real catalysts to watch for will come from October through January, when: (i) information is likely to be released for student loan servicing contracts; ii) the CFPB is expected to file suit against loan servicer Navient; (iii) the Department of Education (ED) ramps up its pursuit of student loan debt forgiveness and clawbacks from for-profit colleges; and (iv) ED issues its long-awaited debt collection contract.

**Why It Matters:** There are several impending catalysts that have been hinted at by ED and White House releases, but that we believe the market has not yet fully digested. These catalysts cover several assets, including the equity and debt of student loan servicers such as Navient, asset-backed securities from the legacy Federal Family Education Loan Program (FFELP), and securities issued by student loan debt collection contractors. ED often releases documents and press statements that contain elements of each of these subsectors because they are written to appeal to the general public and advocacy groups, in contrast to the Consumer Financial Protection Bureau (CFPB) or Treasury Department (Treasury), which have more experience conveying information related to financial issues.

**What's Next:** This research note looks to give a schedule of future events through the remainder of the Obama administration that will impact the broad higher education finance sector, starting with a recap of what occurred this past summer. We deliberately choose not to focus on legislative actions, including the Senate Health, Education, Labor, and Pensions (HELP) Committee's potential work on reauthorizing the Higher Education Act this fall and winter. Although this bill and its House counterpart could have a material impact on higher education finance, we view its prospects for passage into law as limited due to the already crowded legislative agenda for the remainder of 2015 and the further polarized atmosphere that will arise once the election season is in full swing next year. That, however, still leaves more than enough regulatory activity to drive this sector during the remainder

## Student Loan Catalysts

This past March, the White House issued a [presidential memorandum called the Student Aid Bill of Rights](#). This document detailed a series of steps that policymakers were to take to improve the overall student borrower experience, including changing terms of student loans, improving servicing and debt collection, and creating a borrower complaint database and customer service experience mirroring that of the CFPB. The process of implementing this bill of rights is expected to take the remainder of the Obama administration.

### Recap of July/August/September 2015

An interagency task force made up of the director of the Office of Management and Budget (OMB), Education secretary, Treasury secretary, CFPB, and director of the White House Domestic Policy Council (DPC) [released recommendations on best practices for performance-based contracting for student loan servicers](#). We believe that some of this data will be used by ED during the rebidding of student loan servicing contracts as well as the debt collection contract next year.

Next, the compensation structure under the existing student loan debt collection contract was changed to emphasize the administration's desire to get borrowers into an Income-Driven Repayment Program (IDR) in lieu of just extracting cash and charging fees. This ability to use IDR was also fully extended this summer to cover borrowers from the legacy FFELP program, where an additional six million people are now able to pay no more than ten percent of their income per month towards their loans.

Also, this past week, Joseph Smith, the ED appointed special master overseeing the processing of borrower applications for student loan forgiveness after the failure of Corinthian Colleges, issued his [initial public report](#). For investors, the most notable point made by Smith was that rather than waiting for ED to complete its negotiated rulemaking on borrower defense to repayment, which [kicks off with two public hearings this month](#), he intends to work with state attorneys general to expand the number of schools and programs for which borrowers could apply for forgiveness based on violations of state and federal law. This would, in turn, allow ED to pursue dollar for dollar clawbacks of forgiven loans from these schools, most of which are publicly-traded companies (see chart below under Student Loan Debt Forgiveness and For-Profit Colleges).

### October 2015

Secretary of Education Arne Duncan is due to report on interim steps being taken to address consumer complaints as his agency's database is being created and how this

information will be shared with relevant enforcement agencies, such as the CFPB. The complaint database will cover loan servicers, collection agencies, and for-profit schools.

Additionally, a report to the president will be issued by ED, Treasury, CFPB, White House DPC, and OMB discussing whether new regulations and legislation are needed to fully implement the borrower bill of rights. This report is expected to cover how the credit card and mortgage market changes from recent years can inform changes to student loans, including servicing and flexible repayment options, as well as changes to bankruptcy laws. This report will also focus on interim coordination efforts between the Internal Revenue Service (IRS) and ED so that student borrowers no longer need to annually go through servicers to remain enrolled in their IDR plan. We do not expect that any of the legislation discussed in this report will be acted upon during the Obama administration, but it would likely become part of the next administration's higher education policy program if the Democrats retain control of the White House.

#### November 2015

ED Special Master Joseph Smith is expected to release his second report on discharges of student loans and an update on his process for expanding this type of forgiveness to other schools and programs beyond Corinthian. From this point forward, the reporting is expected to be done on a quarterly basis and this would become the reporting cycle through which schools beyond Corinthian subjected to loan forgiveness could be publicly identified.

#### December 2015

ED will release a report covering the public input from two September hearings and written submissions for its negotiated rulemaking on borrower defense to repayment. At that point, the process of nomination and selection of participating stakeholders will begin and, once appointed, the negotiators will begin to meet for three days per month for the duration of 2016.

#### January 2016

The secretary of Education must publish the first of what will be a quarterly performance report on private debt collection agency contractors that includes data disaggregated by contractor. We believe that this first report will cover the past year or two of operations under the existing contract, including the smaller pool of collectors that have been active for most of this year. After this report is released, its findings will help to inform the bidding process for the next contract which we believe could be released simultaneously or shortly thereafter in the winter of 2016.

All federally contracted loan servicers must also meet new standards by this time. These

standards include more disclosure and contact during loan transfers, about applications to change repayment programs, and any delinquency or default. January will also see the results of a pilot program for communicating with borrowers that are at least 140 days delinquent, but not yet in default—this could change how servicers are required to act as a last ditch effort, before a borrower’s account is turned over to debt collection agencies. We also believe that after these announcements, the student loan servicing contract will be rebid in early 2016.

### July 2016

The student loan complaint database run by ED is scheduled to be operational. This system will cover lenders, loan servicers, private collection agencies, and institutions of higher education. The data will also be shared with the CFPB and other enforcement agencies. Additionally, a report on the Treasury debt collection pilot program is due to be released.

### November 2016

The final rule for the negotiated rulemaking regarding borrower defense to repayment will be completed and released so that it can begin to be implemented prior to the end of the Obama administration's tenure.

## **Student Loan Servicing and ABS**

ED announced in 2014 that it would be expanding its IDR program to more borrowers, including those whose loans are in the legacy FFELP program and also make up legacy asset-backed securities (ABS). Under the new repayment terms, borrowers are able to often dramatically reduce the amounts that must be paid each month, capping these payments at ten percent of their adjusted gross income.

This past July, another six million borrowers were allowed to participate, meaning that now nearly all federal student loan borrowers have access to this ten percent cap. ED also announced in August that there had been a 56 percent increase in the number of Direct Loan borrowers enrolling in these plans, though the total number is only around 3.9 million, compared to the 6.9 million students that are in default as of July. Future quarters will give a more accurate picture of the uptake of this program by FFELP borrowers.

One important part of this program to watch going forward is the ability of the IRS and ED to work together to cut out servicers from the annual process of determining eligibility for IDR programs. If these two agencies are able to make this initiative work, it should be viewed as a long-term negative catalyst for all servicers, since it is the largest hurdle to a new system where payments are capped and directly withheld out of borrower paychecks,

similar to payroll taxes. This type of system remains just a concept at DC-based think tanks, but has a real chance of being proposed by whichever new administration comes into office in 2017.

Also this summer, the increased use of IDR by FFELP borrowers caused many headaches for owners of legacy FFELP ABS. Since the fixed repayment cap from IDR could result in significantly reduced cash flows to the owners of legacy FFELP ABS, even though the government guarantee of repayment still exists, several credit rating agencies expressed concern about this asset class which has, in turn, put pressure on bond prices.

At the same time, ED released an interagency memorandum with recommendations for changes to servicing contracts in the future (see calendar above). All of the recommendations contained in this memo are likely to increase costs for servicers and decrease profits per borrower, including mandates for more frequent contact with borrowers, for fulfilling certain timelines in responding to and solving consumer complaints, for increased technology spending to allow for digital document uploads, and for a single point of contact, similar to the reforms necessitated by the National Mortgage Servicing Settlement. There are also changes in new loan allocation and contractor performance that could alter the mix of how certain firms receive more borrower loans to service than others. All of these changes are expected to be part of the new contracts that we believe will be rebid in early 2016. The contracts were originally slated to be rebid this year due to concerns over poor customer service, but this has been delayed based on what ED stated were “competing priorities,” which we take to mean that there is not enough senior staff to work at the same time on all of the other catalysts listed above and on rebidding contracts that were only just modified in 2014. One change that is likely to be made before any new contracts are issued is to publish detailed quarterly contractor performance data to increase transparency (i.e. name and shame) and competition for increased loan volume.

The changes to the FFELP loans particularly hurt student loan servicer Navient, which is the largest servicer of these loans and holder of these loans in portfolio. In addition to pressure from changing repayment schemes and increased administrative costs, Navient reported on August 19<sup>th</sup> that the [CFPB had sent a Notice and Opportunity to Respond and Advise \(NORA\) letter](#), which typically is done immediately prior to the announcement of legal action against a firm. This inquiry has been previously disclosed, but the fact that CFPB has advanced its investigation to this point demonstrates that it is almost certain to bring suit against the firm seeking restitution, civil monetary penalties, and corrective action. This will be yet another materially negative catalyst and it is part of the CFPB's efforts to change behavior leading up to the new servicer contract bidding process in 2016.

## **Student Loan Debt Collection**

As noted above, in July, ED changed the compensation structure for student loan debt

collectors, pushing them towards enrolling defaulted borrowers into an IDR plan, rather than solely extracting partial repayments.

In announcing its changes to the collections process, ED clearly stated that, “The Department’s work to improve the debt collection process is ongoing and additional actions will be announced in the months to come.” From this statement, as well as the release last March by the president of a January timeline for a report evaluating debt collection companies, and the delay in ED rebidding its servicing contracts until 2016 due to “competing priorities,” we continue to believe that the collections contract will also not be bid out until 2016 and the metrics from the January report will be a critical factor in ED’s eventual selection of contractors.

Once these contracts are awarded, the collectors also face an uncertain policy landscape with the potential for thousands of students who are most likely to default to have their loans discharged due to fraud at for-profit schools (the most likely class of borrower to default), and ever-increasing numbers of students immediately entering into IDR programs after graduation.

## **Student Loan Debt Forgiveness and For-Profit Colleges**

On June 25th, Under Secretary of Education Ted Mitchell appointed Joseph Smith as special master to advise ED on all facets of borrower defense issues. Smith is also currently the monitor of the National Mortgage Servicing Settlement between the CFPB and 49 state attorneys general and some of the largest financial institutions. The [first report](#) was issued on September 3rd, 2015 and focuses on how Smith views his role in creating a “durable process—one that would...be applicable to the crisis that unfolded with the closure of Corinthian Colleges, but also one that would apply more broadly to students at all institutions who believe they have been defrauded by their colleges.”

We consider the report's expansion to include other schools to be particularly important to investors, especially as we believe that the risks to the sector outside of enrollment and gainful employment rules have not been fully appreciated. Smith lists three bullets as his primary tasks and the third covers “the process by which the Department can recover money from schools after successful borrower defense claims” almost presuming that the system will be set up such that borrowers will be successful in their claims.

To that end, we have created a brief listing of the most prominent publicly-traded for-profit schools and certain instances where they have had legal settlements that could result in borrower defense to repayment claims, as well as those schools with outstanding investigations from the past two years, notably from state attorneys general, that would allow claims. This is not an exhaustive list, but is meant to show the potential scope of negative catalysts for various institutions.

**Education Management Corp**

- Investigation by 12 states attorneys general, 2014
- Settlement with city attorney of San Francisco, 2014

**Apollo Education Group Inc**

- Investigation by California attorney general, 2015
- Subpoena from Department of Education inspector general, 2014
- Investigation by Federal Trade Commission, 2015

**Bridgepoint Education Inc**

- Settlement with Iowa attorney general, 2014
- Investigation by Massachusetts attorney general, 2014
- Investigation by Securities and Exchange Commission, 2014
- Investigation by Consumer Financial Protection Bureau, 2015

**ITT Educational Services Inc**

- Investigation by state attorneys general, 2014
- Civil complaint by New Mexico attorney general, 2014
- Investigation by Massachusetts attorney general, 2015
- Lawsuit by Securities and Exchange Commission against ITT, chief executive officer Kevin Modany, and chief financial officer Daniel Fitzpatrick, 2013
- Actions by Department of Education, 2014
- Lawsuit by Consumer Financial Protection Bureau, 2014

**Career Education Corp**

- Investigation by 12 state attorneys general, 2015
- Investigation by Federal Trade Commission, 2015

**DeVry Education Group Inc**

- Investigation by New York attorney general, 2014
- Investigation by Department of Justice, 2015
- Document request by Department of Education, 2015

**Lincoln Education Services**

- Lawsuit by Massachusetts attorney general against Lincoln Technical Institute, 2015

Should any of these schools be found to have defrauded students, the law allows the secretary of Education to "initiate an appropriate proceeding to pay the Secretary the

amount of the loan to which the defense applies.”

We fully expect that these types of suits will occur beginning in the first half of 2016 after Smith and his team of attorneys (currently numbering four with more expected to be hired) have more or less completed much of their work on Corinthian and have had time to work with the state attorneys general to discern the facts surrounding the other schools in question.



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