AACS
REPRESENTING BEAUTY & WELLNESS EDUCATION
SINCE 1924

Session 2 Summary
Committee 1 – Borrower Defenses & Financial Responsibility
January 8 – 11, 2018

In an effort to consolidate the four days of deliberations into a "brief" summation, we have chosen to share the Department's "Summary of Change" and highlights of the topics and takeaways for each of the eight Issue Papers.

We also focus on a key issue of importance regarding ***lease liability*** contained in the Financial Responsibility Subcommittee's recommendations to the Committee. AACS will be seeking additional information from many within our membership in order to help us formulate a response and additional recommendations prior to the Subcommittee's final meeting in just a few weeks.

Issue Paper 1 – Federal Standard
For loans first disbursed on or after July 1, 2019, borrowers with an eligible Direct Loan would be entitled to a discharge (or recover amounts already paid) of all or a portion of the loan if the borrower established either:
1) an institutional misrepresentation;
2) a court judgment against an institution; or
3) a final judgment from an arbitrator against an institution.

The proposed regulations also describe in detail how a borrower establishes the basis for a claim.

Summary
The fundamental, philosophical and also practical concern of many negotiators who are opposed to the new regulations stems from the enhanced "standard of proof" contained in the new language. Student advocates and others who support the 2016 regulations are outraged that, among other revisions, the new proposal sets a higher standard for the borrower to overcome, one that they believe is insurmountable in many, if not all instances.

As previously noted, these individuals took specific offense to a number of revisions which would require the borrower to provide evidence, that is "clear and convincing", that the institution willfully "acted with an intent to deceive, knowledge of the falsity of misrepresentation, or a reckless disregard for the truth" that was "reasonably relied upon" to make their decision to acquire financial assistance to attend the institution.

Other negotiators, more inclined to support the new language, but also with some of their own requests for modification, countered with the harm that could come from false claims and the financial and regulatory burden that still would have considerable impact on smaller institutions in particular.

Both sides repeatedly returned to observations and took turns attempting to sway the Department and each other of their views on specific terms, language, and definitions used throughout Issue Papers 1 and 4, spending considerable time on "misrepresentation", "materiality standard", "reasonability clause", in addition to those previously mentioned above.

The long and the short of it is that there are considerable differences of opinion regarding the most general of the eight Issue Papers, which are compounded by even greater views and concerns primarily with the regulatory proposals contained in the next three Issue Papers.

Issue Paper 2 – Regulatory Framework
Would establish a regulatory framework for processing BD claims for Direct Loans first disbursed on or after July 1, 2019, including provisions for:

- Forbearance
- The application process
- Adjudication of a BD claim
- Notification of the borrower and school of the Department's decision
- Reconsideration of denials
- Relief that a borrower may receive if a BD claim is approved

Summary
As was the case with the more philosophical Issue Paper 1, there is also considerable differences of opinion regarding the practical framework proposed under Issue Paper 2. Key concepts and discussions regarding this key portion of the proposals once again broke down along the lines of the perspective of the negotiator and the constituency she or he represents.

Those opposed once again took issue with many of the new provisions of the process in its entirety, from the required submission of applications showing harm, to the Department's evaluation and adjudication process – inclusive of information from the institution, and the burden of proof both initially and on appeal.

Those generally more supportive of the new proposal expressed observations and recommendations regarding how to

Ironically, neither group supported the Department's recommendations outlining how borrowers would submit information showing the financial harm suffered as a result of willful misrepresentation based upon earnings data. For entirely different reasons, both sides offered concerns regarding how complex and complicated it would be to use earnings data as the basis for a claim.

While common ground seemed to be within reach on some of the topics of discussion, the views on many were as polarized as those noted above in the summary of Issue Paper 1.

Issue Paper 3 – Financial Responsibility and Administrative Capability
Institutions determined not to be financially responsible would have additional financial protections placed upon them. And, institutions that incur debt and liabilities from borrower defense claims would have their composite scores recalculated.

Summary
Despite the favorable provisions contained within the proposed regulation, several institutional negotiators continued to share their concerns regarding the impact of recalculation of

institution's composite scores. Several recommendations were offered for further Department consideration.

Supporters of the prior regulation expressed frustration with the repeal of the use of automatic triggers and the "narrow" application of the proposed regulation only after adjudication.

Issue Paper 4 – Pre-dispute Arbitration Agreements, Class Action Waivers, & Internal Dispute Process

To facilitate transparency and fully inform prospective, enrolled, and departing students, the proposed regulation would:

- Amend "Reporting and disclosure information" (Section 668.41) to:
  1) Require schools that use pre-dispute arbitration agreements and/or class action waivers to disclose that information in an easily accessible format for students, prospective students, and the public; and
  2) Require these schools to provide an annual notification of this information to enrolled students.

- Amend "Counseling borrowers" (Section 685.304) to include a requirement (similar to the current requirement that schools provide information regarding the FSA Ombudsman) that the school review with the student borrower information on the availability of the school's internal dispute resolution process and provide to the student a written disclosure explaining an internal dispute process;

- Amend "Counseling borrowers" (Section 685.304) to include a requirement for schools using pre-dispute arbitration agreements and/or class action waivers, that the school review with the student borrower the pre-dispute arbitration and/or class action waiver process.

<u>Summary</u>

State Attorneys General, student advocates, legal assistance, and other supporters of the prior regulation and the elimination of the arbitration clauses are incensed by the proposed revisions.

Other institutional negotiators offered recommendations once again designed to address specific concerns related to the proposed regulation, and there seemed to be some support for the direction that this proposal is headed even from the most ardent supporters of the prior regulations.

Issue Paper 5 – Closed School Discharge

Would amend the application requirements for closed school discharges to reflect current practice, which requires that a borrower applying for a closed school discharge submit a completed application form, rather than a sworn statement. The proposed regulation would also expand the window for closed school discharges from 120 to 150 days.

<u>Summary</u>

Several key issues discussed surrounding closed school discharges, aside from the obvious 30 additional 30 days for students who withdrew before a school closes, included how to handle additional location closures, the prospect of student eligibility for automatic discharge, and schools that close surreptitiously and those that properly transition students and close with proper warnings.

While many concepts were offered and discussed, there again seems to be no consensus.

Issue Paper 6 – False Certification
Would amend application requirements for false certification discharges to reflect current practice, which requires that a borrower applying for a false certification discharge submit a completed application form, rather than a sworn statement. The proposed regulation would also update the regulatory requirements regarding false certification of eligibility of non-high school graduates for Direct Loans.

<u>Summary</u>

Issue Paper 7 – Guaranty Agency Collection Fees
The proposed regulation would prospectively bar guaranty agencies from charging collection costs to a defaulted borrower who enters into repayment agreement with the guaranty agency within 60 days of receiving notice of default from the agency.

<u>Summary</u>
With very little discussion, the negotiators at the table appeared willing to support the Department's recommended regulatory revisions barring GA's from charging any future collection fees under the terms noted above. However, during the public comment portion of the final day's negotiations, individuals representing similar interests expressed their vehement opposition to the proposals.

Issue Paper 8 – Recalculation of Borrower's Subsidized Usage Period and Interest Accrual
The proposed regulation would either eliminate or require a recalculation of the subsidized usage period and, if applicable, restore interest subsidy associated with the Direct Stafford Loan(s) fully or partially discharged based on school closure, false certification, unpaid refund, or borrower defense.

<u>Summary</u>
With basically little to no discussion, and what appeared to be little to no opposition as well, the negotiators didn't really have much to say about this particular proposal.

Financial Responsibility Subcommittee:
Issue Paper 2 - Financial Accounting Standards Board (FASB) Accounting Standards Update, ASU 2016-2, Leases (Topic 842), and the Department's Financial Responsibility Standards

Summary

Recent updates to financial accounting standards will significantly change the manner in which most proprietary institutions report operating leases. Under current accounting standards, operating lease obligations are generally not reported on an institution's balance sheet. Rather, the lease obligations are reported in the footnotes to the financial statements.

Financial Accounting Standards Board (FASB) Accounting Standards Update, ASU 2016-2, Leases (Topic 842), published February 2016, changes the reporting for operating leases. Under this new standard, future lease payments are recorded as a liability on the balance sheet. A corresponding "right-of-use" asset would also be added to the balance sheet. This asset reflects the value of the enterprise's right to use the leased space over the remaining lease term, and it is equal in value to the lease liability.

These new accounting standards are not Department of Education requirements. They were issued by FASB, and generally apply to the financial reporting of all business enterprises. However, these new standards raise various issues with how audited financial information is used in the calculation of the composite score under the federal regulations. For example, how will the "right-to-use" asset be characterized for purposes of the composite score calculation? Will it be treated as an intangible asset? And how will the lease liability factor into these calculations?

The Financial Responsibility Subcommittee was tasked to look at this issue and make recommendations for changes to the composite score regulations for the sole purpose of addressing the effects of the new lease accounting rules. The Subcommittee recommended that the leased asset (right-to-use) be categorized with property, plant, and equipment when calculating the composite score. The Subcommittee further recommended that the lease liability be treated as a long-term liability and should be categorized with long-term debt when calculating the composite score.

While the clarification of the asset and liability classification for composite score purposes is good news for institutions, the new accounting rules when fully implemented are expected to have an overall negative effect on composite scores. This is because of the manner in which the Equity Ratio factor is calculated. The Equity Ratio for the composite score is an institution's modified equity divided by its modified assets as those terms are defined in the regulations. The new lease accounting rules will not affect an institution's equity, thus the numerator in the Equity Ratio calculation remains the same. However, the new "right-to-use" asset will increase the institution's assets, thereby increasing the denominator in the calculation and ultimately reducing the institution's Equity Ratio.

The ultimate impact of the lease accounting change will vary among institutions. Based on preliminary analysis, the Subcommittee stated that the impact to composite scores may be between 0.2 and 0.65. Institutions are highly encouraged to stress-test their composite score calculations under these new lease accounting rules to understand how the change will affect their particular circumstances. In effort to soften the impact of these new accounting rules, the Subcommittee recommended a three-year transition period beyond the rule's scheduled effective date. Non-federal negotiator Chris DeLuca, representing AACS on the committee, recommended

that this transition period be extended even further for leases that commenced prior to the publication date of the new lease accounting rules. AACS will be working with member institutions to gather supporting data for Chris' recommendation for when the third and final committee meetings convene in February.