Assessing Financial Responsibility
How States Can Do Better
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Introduction

Institutions of higher education receive nearly $100 billion in state and local funding each year. Given the enormity of this public investment at the state and local levels, not to mention the additional $120 billion in federal financial aid funding provided to these institutions, officials at all levels of government should be interested in ensuring that colleges and universities are “financially responsible” and have the ability to manage these public dollars well. In federal parlance, “financial responsibility” is a term of art. It speaks to an institution’s ability to provide the services it advertises, comply with the requirements of the funding programs it participates in, and otherwise meet its financial obligations.

The concept of financial responsibility has been enshrined in Title IV of the federal Higher Education Act of 1965 (as amended) (“HEA”), 20 U.S.C. § 1070 et seq., since at least its 1976 reauthorization. At that time, Congress believed it was necessary for the Commissioner of Education to establish “reasonable standards of financial responsibility” that an institution must meet in order to participate in federal student aid programs. By the 1992 reauthorization, Congress directed the Secretary of Education (the “Secretary”) to prescribe criteria “with respect to operating losses, net worth, asset-to-liability ratios, or operating fund deficits.” Five years later, Congress amended the HEA’s language again to strike the specifics regarding “operating losses, net worth, asset-to-liabilities ratios, or operating fund deficits” and give the Secretary broader authority to prescribe “ratios that demonstrate financial responsibility.”

Since the late 1990s, the United States Department of Education (the “Department”) has calculated, on an annual basis, a composite score to gauge the financial responsibility of each institution participating in federal student aid programs. The calculation uses figures generated from institutions’ audited financial statements. The scores, a single number between -1.0 and 3.0, are composed of an institution’s primary reserve ratio, an equity ratio, and a net income ratio. Each of these ratios are calculated using formulas set forth by regulation and differ based on whether an institution is a non-profit or for-profit. Public institutions are not subject to the composite score requirements.

While composite scores convey meaningful information about institutions’ financial health, there is growing awareness that the Department’s system has important flaws. The Government Accountability Office, for instance, issued recommendations for the Department to update the composite score formula in 2017. The Department has not taken action to address these recommendations. Nevertheless, while the Department amended certain components of its composite score calculations in connection with the 2019 Borrower Defense Rule, the Department has not responded to growing concerns that the composite score methodology is failing to identify schools at risk of financial collapse.

The flaws in the Department’s financial responsibility composite score methodology include:

- **The scores are lagging indicators.** A composite score provides a snapshot view of an institution’s financial condition from a single moment in time. But that snapshot is not provided until much later. By regulation, schools generally must provide their audited financial statements within six months of the completion of their fiscal year. Indeed, as of March 2020, the most recently published statistics at the online Federal Student Aid Data Center are for the 2016-2017 fiscal year. For some of the schools on that data release, the relevant fiscal year closed in July 2016.

Recent closures of schools owned by Education Corporation of America (“ECA”) highlight the problems with these lagging indicators. ECA had a passing composite score for its fiscal year ending December 31, 2015, which apparently prompted the Department to release it from a letter of credit (i.e., a form of surety posted to cover liabilities owed to the Department in the event of a closure or failure to pay) in March 2017. But when the school received a failing score for its fiscal year ending December 31, 2016, it was too late for the Department to get a new letter of credit. ECA ultimately closed its doors.
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Without any posted surety to offset its taxpayer liabilities for closed school discharges provided to students. Likewise, the Charlotte School of Law (discussed below), had a composite score of 1.5 (passing) for its fiscal year ending July 31, 2015, and a composite score of 1.9 (passing) for its fiscal year ending July 31, 2016. By the summer of 2017, North Carolina had determined that the institution was not financially responsible under its own standards, and the school closed in August 2017.

The scores can be manipulated. The formula has not been substantially updated since its introduction in 1997 and the intervening decades have seen great changes in corporate governance and financial complexity. There are a number of ways for institutions to game the system and receive scores that overstate their financial health. For example, schools can take out loans with terms greater than twelve months. Under the Department’s formula, such loans are treated as assets when calculating an institution’s primary reserve ratio. 

The composite scoring process is overly simplistic. An institution’s financial condition is inherently complex and dependent on many factors. The Department’s composite scores do not contain any trend analysis or future projections (including the impact of demographics on enrollment). A high score in one of the three ratios can cover up weaknesses in the others. Moreover, it is at least questionable whether a single ratio can represent the range of nuance and uncertainty that a more fulsome financial model can convey. Indeed, while the HEA affords the Department authority to prescribe criteria regarding “ratios” (i.e., plural) “that demonstrate financial responsibility,” the Department has nevertheless opted to consolidate its ratios into a single composite score that can establish, as a matter of law, that an institution is financially responsible.

States Must Confront School Closures

With the shortcomings of the financial responsibility measures becoming increasingly obvious, several states have started to look at how they can independently measure the financial health of institutions. Beyond talk and analysis, some states have even taken steps to improve their own visibility into schools’ financial health, either through rulemaking or by exercising existing authorities. This paper provides an overview of a few approaches, although many questions remain unanswered. With college closures forecasted to continue to rise in the coming years, it seems certain that more states will be forced to grapple with these issues.

Massachusetts: Taking the initiative to more effectively identify and monitor institutions of higher education at risk of imminent closure.

In May 2018, Mount Ida College announced plans to close in Massachusetts with only a few weeks’ notice, surprising the state Board of Higher Education (“BHE”) and leaving students with little time to plan their fall enrollments elsewhere. Mount Ida “had no contingency plans or similar agreements with other higher education institutions that would provide its students with transfer opportunities necessary to complete their degrees.” As the Massachusetts Attorney General’s office later concluded, the abrupt closure of Mount Ida led to “turmoil on campus” and left students “stunned,” “emotional,” and “desperately question[ing] how Mount Ida could have enrolled them without disclosing its dire financial situation.”
In the years prior to its abrupt closure, federal data show that Mount Ida had repeatedly achieved a federal composite score above 1.5, establishing that the institution was “financially responsible,” at least by the Department’s standards.\textsuperscript{19}

By the close of the fiscal year on June 30, 2017, however, Mount Ida’s score had dropped to 0.8.\textsuperscript{20} This, or the facts giving rise to it, should have signaled to the Department and Massachusetts that the school was in financial trouble. But either no one noticed or no one took action.

Because Mount Ida’s closure blindsided Massachusetts, the state sought to better protect its students from other financially stressed institutions that might close unexpectedly in the future. After more than a year of study, proposals, and public engagement, Massachusetts finalized its own set of financial responsibility requirements for degree-granting institutions earlier this year.

In November 2019, Governor Charlie Baker signed into law new requirements that institutions: (1) post a copy of their annual financial reports on their websites; (2) notify the BHE of any known liabilities or risks that could result in imminent closure; and (3) submit to the BHE for approval a contingency closure plan, which includes timely notification to students and staff, arrangements for students to complete their programs of study, and a plan for the maintenance of student records post-closure.\textsuperscript{21} The law also requires the BHE to establish a process for annually assessing each institution’s financial information to determine whether it is at risk of closure.\textsuperscript{22} In January 2020, consistent with this statutory directive, the BHE voted to approve final regulations.\textsuperscript{23} The regulations establish a process for the ongoing monitoring of institutions deemed at risk, including the submission and review of risk mitigation plans, contingency planning for possible closure, and notification to the public.\textsuperscript{24} The regulations do not yet establish, however, the precise procedures, analytical methodology, and data sources to be used for the annual screening process, leaving it up to the BHE to decide at a later date.\textsuperscript{25} It has not yet been done.

As Massachusetts continues to develop and implement its new financial responsibility requirements, it will be critical to assess how much more effective they are at accurately and quickly identifying institutions at risk of imminent closure. If Massachusetts’ efforts prove successful, other states should follow suit.

### NORTH CAROLINA: Using its licensing authority to shut down financially stressed schools flagged by their accrediting agency and the Department.

Charlotte School of Law ("CSL") was a for-profit law school that operated in Charlotte, North Carolina for eleven years. After several years of growing attrition rates and decreasing bar passage rates,\textsuperscript{26} the American Bar Association ("ABA"), which accredits law schools nationwide, placed Charlotte School of Law ("CSL") on probation in 2016 for “substantial and persistent” noncompliance with its standards.\textsuperscript{27} Specifically, CSL failed to comply with the ABA’s standards requiring law schools to: (1) admit students who were likely to succeed in the program and pass the bar; and (2) maintain a rigorous legal education program.\textsuperscript{28} A month later, in response to CSL’s accreditation problems, the Department ended CSL’s ability to provide its students with federal student loans.\textsuperscript{29} According to federal data, for the fiscal year ending July 31, 2016, CSL received over eighty-eight percent of its total $34.4 million in revenue (at least as calculated for purposes of compliance with the “90/10” rule) from federal student aid sources.\textsuperscript{30} Given CSL’s probation and loss of access to this financial lifeline, North Carolina chose to exercise its own oversight of the law school.

North Carolina’s UNC General Administration ("UNC-GA")—the state agency responsible for conducting compliance reviews to ensure that licensed nonpublic institutions continue to meet state statutory and regulatory requirements—initiated a review of CSL in January 2017.\textsuperscript{31} Part of that review focused on CSL’s financial health. UNC-GA found that CSL was out of compliance with four of its financial responsibility markers, including: (1) failing to demonstrate enough financial resources to maintain operational continuity; (2) failing to demonstrate an adequate financial plan for long-term management; (3) demonstrating a lack of financial stability in recent financial reports and audits; and (4) failing to maintain an adequate tuition guaranty bond.\textsuperscript{32} UNC-GA then recommended that the Board of Governors, which handles state licensure in North Carolina, restrict CSL’s license in several ways. Most relevant here, CSL’s re-admission to the federal student loan program was a mandatory condition of its continued ability to operate in North Carolina.\textsuperscript{33} When CSL failed to meet that condition
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by the required deadline, its license expired. The Attorney General of North Carolina reported the loss of CSL’s license to the Department and ordered CSL to close.

North Carolina effectively used its licensing authority to not only examine an institution’s finances for short- and long-term viability, but also to restrict and revoke that same institution’s license for poor financial health. Although perhaps appropriate given the circumstances in January 2017, North Carolina’s actions are not necessarily a model that other states should follow. The state decided to step in and revoke CSL’s license only after both the law school’s accrediting agency and the Department raised concerns. This type of oversight is inherently reactionary. For that reason, it is not a blueprint for other states interested in predicting and preventing financial distress at their own institutions. Those states should look instead to North Carolina’s approach as an example of what to do when other members of the regulatory triad—the Department, accrediting agencies, or state law enforcement—highlight concerns with an institution’s financial stability. At that point, states should act quickly to limit the harm to current and prospective students.

**Ohio: Reviewing state institutions’ financial health on an annual basis, with the goal of ensuring ongoing financial stability.**

In response to severe financial trouble at Central State University (“CSU”)—a historically black, public university—following a seventy percent drop in enrollment in the mid-1990s, Ohio passed legislation to provide greater accountability and prevent similar financial problems from occurring at other state institutions. That legislation, known as Senate Bill 6, codified many of the state’s successful efforts to save CSU.

Senate Bill 6—together with its implementing regulation—established a mechanism for Ohio to exercise financial oversight over state colleges and universities by:

- **Establishing penalties** for failure to comply with those reporting requirements, such as being placed on fiscal watch;
- **Charging** the Ohio Department of Higher Education ("ODHE") with performing an annual financial ratio analysis for each college and university. This analysis relies upon three ratios (e.g., viability, primary reserve, and net income), which are calculated using the schools’ annual financial audits. Each ratio is then assigned a threshold factor, which is combined and averaged with the other ratios’ threshold factors to produce a final state composite score; and
- **Creating a system for state intervention** that places institutions on fiscal watch or in conservatorship when they demonstrate certain signs of financial instability, such as low composite scores, reportable events, or substantive audit findings.

In April 2015, CSU and Owens Community College (“OCC”) became the first schools to be placed on fiscal watch under this new oversight system. Both schools’ state composite scores had fallen below 1.75 for two consecutive years, an automatic trigger requiring fiscal watch. As a result, Ohio gave each institution three years to improve its finances or face conservatorship. By 2017, both CSU and OCC had managed to raise their state composite scores to at least 2.4 and eliminated all conditions that had led to their prior financial troubles, ending Ohio’s increased oversight of their finances.

This type of oversight system, which focuses on catching and saving struggling institutions before they fail, has been successful in Ohio at helping two- and four-year institutions weather events that could otherwise permanently destabilize them. The system sets up a transparent exchange of information (between the institution and the state) to help detect financial problems early and gives the state power to seize institutional control when necessary. Other states could learn from Ohio’s efforts, while also expanding upon them. States should consider broadening the Ohio system to include other types of institutions, including proprietary, private, and non-profit. This change would ultimately strengthen a state’s ability to exercise the type of financial...
oversight necessary to protect students from all financially unstable institutions, not just state colleges and universities.

Conclusion

Considering the volume of school closures in recent years—over 1,000 campuses since 2014—it is clear that states need to pay close attention to early warning signs of financial trouble. It is equally clear that relying on the Department’s federal composite score as an indicator of financial responsibility is insufficient. While it remains to be seen how effective new approaches, like that of Massachusetts, will be, states can and should do more to protect their students’ from unexpected school closures.
Endnotes


7 As described by the Department, the 2019 Borrower Defense Rule “update[d] the composite score calculations to reflect certain recent changes in Financial Accounting Standards Board (FASB) accounting standards” and “update[d] the definitions of terms used to describe the calculation of the composite score, including leases and long-term debt.” See Student Assistance General Provisions, Federal Family Education Loan Program, and William D. Ford Federal Direct Loan Program, 84 Fed. Reg. 49,788, 49,790 (Sept. 23, 2019).

8 34 C.F.R. § 668.23(a)(4).

9 See GAO Report at 22–23.

10 See GAO Report at 21.


14 Id. at 3.


17 See Mass. Gen. Laws ch. 15A, § 45; id. ch. 69, § 31B; id. ch. 75, § 3A.

18 Id.

19 See 610 Mass. Code Regs. 13.03.

20 Id.


22 Id. at 7–8.


24 See generally ED Recertification Denial.

25 Id.

26 Id.

27 Id.

28 Id.


32 Id. at 2.

33 Id. at 5.


35 Id.


39 Id.

40 See Ohio Admin. Code 126:3-1-01(B)(3).

