Testimony Before the U.S. Senate Committee on Health, Education, Labor and Pensions
Testimony of Steven Eisman
SUBPRIME GOES TO COLLEGE
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Good morning. Chairman Harkin and members of the Committee, thank you for inviting me to testify this morning. My name is Steven Eisman and I am the portfolio manager of the FrontPoint Financial Services Fund. My firm has spent a great deal of time studying the For Profit education industry and understanding how it operates and derives its revenue. It has been an eye opening experience. Until recently, I thought that there would never again be an opportunity to be involved with an industry as socially destructive as the subprime mortgage industry. I was wrong. The For-Profit Education Industry has proven equal to the task.

My testimony today comes largely from a recent presentation I gave at an investor conference entitled “Subprime goes to College”. The for-profit industry has grown at an extreme and unusual rate, driven by easy access to government sponsored debt in the form of Title IV student loans, where the credit is guaranteed by the government. Thus, the government, the students and the taxpayer bear all the risk and the for-profit industry reaps all the rewards. This is similar to the subprime mortgage sector in that the subprime originators bore far less risk than the investors in their mortgage paper.

The for-profit education industry accounts for 9% of the students, 25% of all Title IV disbursements but 44% of all defaults. And the President of the largest for-profit institution is paid nearly 25x the compensation level of the President of Harvard. There is something wrong with this statistical progression.

In the past 10 years, the for-profit education industry has grown 5-10 times the historical rate of traditional post secondary education. From 1987 through 2000, the amount of total Title IV dollars received by students of for-profit schools fluctuated between $2 and $4 billion per annum. But when the Bush administration took over the reigns of government, the DOE gutted many of the rules that governed the conduct of this industry. Once the floodgates were opened, the industry embarked on 10 years of unrestricted massive growth.

Federal dollars flowing to the industry exploded to over $21 billion, a 450% increase.

At many major-for profit institutions, federal Title IV loan and grant dollars now comprise close to 90% of total revenues, up significantly vs. 2001. And this growth has driven even more spectacular company profitability and wealth creation for industry executives. For example, ITT Educational Services (ESI), one of the larger companies in the industry, has a roughly 40% operating margin vs. the 7%-12% margins of other companies that receive major government contracts. ESI is more profitable on a margin basis than even Apple.

This growth is purely a function of government largesse, as Title IV has accounted for more than 100% of revenue growth. Here is one of the more upsetting statistics. In fiscal 2009, Apollo, the largest company in the industry, grew total revenues by $833 million. Of that amount, $1.1 billion came from Title IV federally-funded student loans and grants. More than 100% of the revenue growth came from the federal government. But of this incremental $1.1 billion in federal loan and grant dollars, the company spent only an incremental $99 million on faculty compensation and instructional costs – that's 9 cents on every dollar received from the government going towards actual education. The rest went to marketing and paying the executives.

One major reason why the industry has taken an ever increasing share of government dollars is that it has turned the typical education model on its head. And here is where the subprime analogy becomes very clear.

There is a traditional relationship between matching means and cost in education. Typically, families of lesser financial means seek lower cost institutions in order to maximize the available Title IV loans and grants – thereby getting the most out of every dollar and minimizing debt burdens. Families with greater financial resources often seek higher cost institutions because they can afford it more easily.

The for-profit model seeks to recruit those with the greatest financial need and put them in high cost institutions. This formula maximizes the amount of Title IV loans and grants that these students receive.

With billboards lining the poorest neighborhoods in America and recruiters trolling casinos and homeless shelters (and I mean that literally), the for-profits have become increasingly adept at pitching the dream of a better life and higher earnings to the most vulnerable of society.

But if the industry in fact educated its students and got them good jobs that enabled them to receive higher incomes and to pay off their student loans, everything I've just said would be irrelevant.

So the key question to ask is – what do these students get for their education? In many cases, NOT much, not much at all.

Here is an example of an education promised and never delivered. In the power point presentation before you, there is an article detailing a Corinthian Colleges-owned Everest College campus in California whose students paid $16,000 for an 8-month course in medical assisting. Upon nearing completion, the students learned that not only would their credits not transfer to any community or four-year college, but also that their degree is not recognized by the American Association for Medical Assistants. Hospitals refuse to even interview graduates.

But let's leave aside the anecdotal evidence of this poor quality of education. After all the industry constantly argues that there will always be a few bad apples. So let's put aside the anecdotes and just look at the statistics. If the industry provided the right services, drop out rates and default rates should be low.

Let's first look at drop out rates. Companies don't fully disclose graduation rates, but using both DOE data, company-provided information and admittedly some of our own assumptions regarding the level of transfer students, we calculate drop out rates at most for-profit schools are 50%+ per year.

How good could the product be if drop out rates are so stratospheric? These statistics are quite alarming, especially given the enormous amount of debt most for-profit students must borrow to attend school.

We have every expectation that the industry's default rates are about to explode. Because of the growth in the industry and the increasing search for more students, we are now back to late 1980s levels of lending to for-profit students on a per student basis. Back then defaults were off the charts and fraud was commonplace.

Default rates are already starting to skyrocket. It's just like subprime – which grew at any cost and kept weakening its underwriting standards to grow.

By the way, the default rates the industry reports are artificially low. There are ways the industry can and does manipulate the data to make their default rates look better.

But don't take my word for it. The industry is quite clear what it thinks the default rates truly are. ESI and COCO supplement Title IV loans with their own private loans. And they provision 50%-60% up front for those loans. Believe me, when a student defaults on his or her private loans, they are defaulting on their Title IV loans too.

There is no such thing as a profitable loan where the loan loss provision is 50%-60%. So why do these companies make unprofitable non-FFELP loans? The private loan is much smaller than the FFELP loan and the companies don't bear any losses on FFELP loans, only on private loans. As a result, the losses on the private loans are just loss leaders to get more students in the door.

Let me just pause here for a second to discuss manipulation of statistics. There are two key statistics. No school can get more than 90% of its revenue from the government and 2 year cohort default rates cannot exceed 25% for 3 consecutive years. Failure to comply with either of these rules and you lose Title IV eligibility. Lose Title IV eligibility and you're company's a zero.

With respect to the default statistics, it is my belief that they are manipulated. Since the rule currently revolves around the 2 year default rate, the companies have every incentive to keep that statistic below 25%.

Isn't it amazing that Apollo's percentage of revenue from Title IV is 89% and not over 90%. How lucky can they be? We believe (and many recent lawsuits support) that schools actively manipulate the receipt, disbursement and especially the return of Title IV dollars to their students to remain under the 90/10 threshold. And again, unprofitable private student loans is also a way to keep below the 90/10 threshold.

The bottom line is that as long as the government continues to flood the for profit education industry with loan dollars AND the risk for these loans is borne solely by the students and the government, THEN the industry has every incentive to grow at all costs, compensate employees based on enrollment, influence key regulatory bodies and manipulate reported statistics – ALL TO MAINTAIN ACCESS TO THE GOVERNMENT'S MONEY.

In a sense, these companies are marketing machines masquerading as universities. And when the Bush administration eliminated almost all the restrictions on how the industry is allowed to market, the machine went into overdrive.

How do such schools stay in business? The answer is to control the accreditation process. The scandal here is exactly akin to the rating agency role in subprime securitizations.

There are two kinds of accreditation -- national and regional. Accreditation bodies are non-governmental, non-profit peer-reviewing groups. Schools must earn and maintain proper accreditation to remain eligible for Title IV programs. The relationship of the for-profit education industry and the national accrediting boards is, in my view, similar to the relationship between the rating agencies and investment banks. There, Wall Street paid the rating agencies handsomely for ratings on subprime securitizations that turned out to be overly optimistic. Here, the industry, we believe, controls the national accrediting bodies by actually sitting on the boards of those very same institutions. The lunatics are running the asylum.

Historically, most for profit schools are nationally accredited but national accreditation holds less value than regional accreditation. The latest trend of for-profit institutions is to acquire the dearly coveted Regional Accreditation through the outright purchase of small, financially distressed non-profit institutions and then put that school on-line. In March 2005, BPI acquired the regionally accredited Franciscan University of the Prairies and renamed it Ashford University. On the date of purchase, Franciscan (now Ashford) had 312 students. BPI took that school online and at the end of 2009 it had 54,000 students.

When I was researching the subprime mortgage industry in 2005 and 2006, I found that not every lender was bad -- just most of them. A few subprime lenders actually used considerable discretion and really tried to make good loans to lower-income borrowers that made sense for them. In the for-profit industry, the same is probably true. There are probably a few good institutions that truly try to educate their students.

The core of the problem in both the subprime and the for-profit education industries is a problem of incentives. In subprime, brokers were incentivized to make as many loans as possible because they were paid on volume. They faced no risk of loss due to bad decision-making because the loans were sold off to investors. In for-profit education, every segment of the institution is incentivized to enroll as many students as possible – recruiters are paid on volume, instructors are compensated based on completions, and executives and shareholders are paid based on growth. None bear the risk of loss should the students not get their money's worth or even worse, default on their loans. The incentives to grow far outweigh the incentives to educate. And thus, like in subprime lending, rather than having a fundamentally sound industry with a few bad actors, you have a fundamentally unsound industry with few good ones.

Therefore, the best way to change this industry's conduct is to change the law and force it to bear some of the losses that it creates. In my power-point presentation, I show what would happen to several companies if they bore various loss percentages. The industry still stays very profitable. Just less profitable.

Let me end by driving the subprime analogy to its ultimate conclusion. By late 2004, it was clear to me and my partners that the mortgage industry had lost its mind and a society-wide calamity was going to occur. It was like watching a train wreck with no ability to stop it. Who could you complain to? -- The rating agencies? – they were part of the machine. Alan Greenspan? – he was busy making speeches that every American should take out an ARM mortgage loan. The OCC? -- its chairman, John Dugan, was busy suing state attorney generals, preventing them from even investigating the subprime mortgage industry.

Are we going to do this all over again? We just loaded up one generation of Americans with mortgage debt they can't afford to pay back. Are we going to load up a new generation with student loan debt they can never afford to pay back. The industry is now 25% of Title IV money on its way to 40%. If its growth is stopped now and it is policed, the problem can be stopped. It is my hope that this Administration sees the nature of the problem and begins to act now.

But if nothing is done, then we are on the cusp of a new social disaster. If present trends continue, over the next ten years almost $500 billion of Title IV loans will have been funneled to this industry. We estimate total defaults of $275 billion, and because of fees associated with defaults, for-profit students will owe $330 billion on defaulted loans over the next 10 years.

Mr. Chairman and members of the committee, I will be happy to answer any questions that you have.