The Subprime Student Loan Racket

With help from Washington, the for-profit college industry is loading up millions of low-income students with debt they'll never pay off.

By Stephen Burd

At the age of forty-three, Martine Leveque decided it was time to start over. For several years, she had worked in the movie business, writing subtitles in Italian and French for English-language films, but her employer moved overseas. She then tried her hand at sales, but each time the economy dipped sales tumbled, along with her income, and as a single mother with a teenage son, she wanted a job that offered more security. She decided to pursue a career in nursing, a high-demand field where she could also do some good.

While researching her options online, Leveque stumbled on the Web site for Everest College, part of the Corinthian Colleges chain, which pictured students in lab coats and scrubs probing a replica of a human heart and a string of glowing testimonials from graduates. “Now I know exactly where I am going. And now I’m making very good money,” enthused a former student named Anjali B. The school, near Leveque’s home in Alhambra, California, offered a Licensed Vocational Nursing program that would take her just one year to complete. When Leveque contacted the admissions office, she was told she would receive hands-on training from experienced nurses in state-of-the-art labs with the most modern equipment—including a recently purchased $30,000 mannequin that could simulate the birthing process. She also says recruiters told her that she would be able to do rotations at the University of California, Los Angeles Medical Center, one of the nation’s best hospitals.

Leveque was intrigued, though she was initially put off by the $29,000 tuition. But the school's recruiters assured her there was nothing to be concerned about: Everest had an exceptional track record of helping students find employment—they claimed the typical Everest College LVN graduates landed a job paying between $28 and $35 an hour straight out of school. And the school would arrange a financial aid package to cover her costs.

In the end, Leveque decided to enroll. The day she came in to fill out her paperwork, she says, the recruiters rushed her through the process and discouraged her from taking the forms home to look over. They told her that she would be taking out private loans in addition to federal loans that are traditionally used to pay educational expenses, but did not explain what the terms of those loans would be. "They just kept telling me that 'we're with you,' and that they would try to get me the maximum amount of federal loans allowed," she says. Only later did she learn that those private loans—which made up 42 percent of her "financial aid" package—carried double-digit interest rates and other onerous terms*.

To make matters worse, the program did not come close to delivering on the promises that had been made. The instructors had little recent medical experience. Instead of really teaching, she says, they usually just read textbooks aloud in class and sometimes offered students the answers on tests ahead of time. On the rare occasions when Leveque and her class were given time in the lab, she found that the equipment was broken down and shoddy—except for the expensive new mannequin, which no one knew how to use. Instead of the promised rotations at UCLA Medical Center, her clinical training consisted of helping pass out pills at a nursing home. (A spokeswoman for Corinthian Colleges denied many of Leveque's allegations, insisting that the company does not condone cheating, that all LVN instructors at Everest College have "at least the minimum qualifications" set by the California Board of Vocational Nursing, and that UCLA Medical Center "is not and has never been" one of the school's official clinical training sites.)

Since graduating in 2008, Leveque has been unable to find a nursing job, perhaps because she never learned how to perform basic tasks such as giving shots. Instead, she works as an occasional home health care aid earning at the most $1,200 a month—not enough to pay her rent on the cramped apartment she shares with her sister and son or keep gas in her car, much less pay off her student loans. As a result, her loan balance has ballooned to approximately $32,000, and she has no idea how she will ever pay it off*. "My credit is ruined," Leveque says. "I made one mistake, and I will be paying for it for the rest of my life."

Leveque's story is far from unique. Each year, more than two million Americans enroll in for-profit colleges, also known as proprietary schools, and their popularity has only grown since the financial crisis. While traditional four-year colleges are struggling with dwindling student bodies and budget gaps, proprietary schools are reporting record enrollments as the newly unemployed try to retool their skills so they can wade back into the job market. Some of the largest for-profit chains say their numbers have doubled over the last year.

The students who are flocking to these schools are mostly poor and working class, and they rely heavily on student loans to cover tuition. According to a College Board analysis of Department of Education data, 60 percent of bachelor's degree recipients at for-profit colleges graduate with $30,000 or more in student loans—one and a half times the percentage of those at traditional private colleges and three times more than those at four-year public colleges and universities. Similarly, those who earn two-year degrees from proprietary schools rack up nearly three times as much debt as those at community colleges, which serve a similar student population. Proprietary school students are also much more likely to take on private student loans, which, unlike their federal counterparts, are not guaranteed by the federal government, offer scant consumer protections, and tend to charge astronomical interest—in some cases as high as 20 percent.

These figures are all the more troubling in light of these schools' spotty record of graduating students; the median graduation rate for proprietary schools is only 38 percent—by far the lowest rate in the higher education sector. What's more, even those students who make it through often can't find jobs. The reason for this is simple: while some proprietary schools offer a good education, many more are subpar at best. Thus large numbers of students leave with little to show for their effort other than a heap of debt. Not surprisingly, students at proprietary schools are far more likely to default on their loans than those at other colleges.

The appalling treatment of disadvantaged students at the hands of proprietary schools ought to be a national scandal, especially at a time when America desperately needs more college graduates to stay competitive. But the problem has barely registered in Washington. That's partly because the proprietary school lobby has enough clout among lawmakers on both sides of the aisle to keep the issue quiet. But Congress and the Obama administration have also had their hands full advancing other higher education reforms—in particular, legislation to kick private lenders out of the federally subsidized student loan program. This will create tens of billions of dollars in cost savings that will go toward larger Pell grants for low-income students. But that measure, vital as it is, affects only lending within the federal student loan program. It leaves untouched the private loans that are increasingly being foisted on students like Leveque and the loosely regulated schools that are profiting as a result.

The for-profit higher education sector is no stranger to scandal. In the 1980s and early '90s, it came to light that hundreds of fly-by-night schools had been set up solely to reap profits from the federal student loan programs, in part by preying on poor people and minorities. The most unscrupulous of them enrolled people straight off the welfare lines, and got them to sign up for the maximum amount of federal student loans available—sometimes without their knowledge or consent.

The rampant abuses caught the attention of the news media, sent shockwaves through Capitol Hill, and led to a year-long, high-profile Senate investigation led by Senator Sam Nunn, the Georgia Democrat. The standing-room-only hearings had all the trappings of scandal, with trade school officials pleading the Fifth and a school owner, who had been convicted of defrauding the government, brought to the witness table in handcuffs and leg irons.

Key lawmakers considered kicking all trade schools out of the federal student aid programs—a virtual death sentence given the institutions' heavy reliance on these funds. But Congress ultimately stepped back from the brink and instead strengthened the Department of Education's authority to weed out problem institutions. Under the new rules, for-profit colleges had to get at least 15 percent of their tuition money from sources other than federal loans and financial aid. Also, if more than a quarter of a school's students consistently defaulted on their loans within two years of graduating or dropping out, the school could be barred from participating in federal financial aid programs. The idea was to get rid of those schools that were set up solely to feed on federal funds and didn't provide the meaningful training students needed to get jobs and pay off their debt. As a result, during the 1990s more than 1,500 proprietary schools were either kicked out of the government's financial aid programs altogether or withdrew voluntarily. In an effort to rein in abusive recruiting tactics, in 1992 Congress also barred schools from compensating recruiters based on the number of students they brought in.

These changes shook up the industry. The old generation of trade schools gradually died off and were replaced by a new breed of for-profit colleges—mostly huge, publicly traded corporations. The largest, the Apollo Group, owns the University of Phoenix, which serves more than 400,000 students at some ninety campuses and 150 learning centers worldwide. Others include the Career Education Corporation, which serves 90,000 students at seventy-five campuses around the world, and Corinthian Colleges, which serves 69,000 students at more than 100 colleges in the United States and Canada.

Not only did these companies promise that their schools would be more responsive to the needs of students and employers than the previous generation, they also said they would be more accountable to the public because, as publicly traded companies, they were heavily regulated. "We've seen a fire across the prairie, and that fire has had a purifying effect," Omer Waddles, then the president of the Career College Association, told the *Chronicle of Higher Education* in 1997. "As our sector has weathered the storms of recent years, a stronger group of schools is emerging to carry, at a high level of credibility, the mantle of training and career development."

In reality, the new breed of schools had quite a bit in common with their predecessors; in some cases, they even operated out of the same buildings and employed the same personnel. What's more, rather than making them more accountable, the fact that they were publicly traded created a powerful incentive for them to game the system. After all, to keep their stock prices up and investors happy, the schools had to show that they were constantly expanding, which meant there was intense pressure to get students in the door and signed up for classes and financial aid.

With so much at stake, these schools quickly found ways to skirt the new rules. To get around the caps on student loan default rates, for instance, many of them began hiring agencies to help former students get forbearances or offering lines of credit so alums could make their student-loan payments—but only during the initial two-year window, when defaults were counted against the school by the Department of Education. After that, students were left to wrestle with the debt on their own. As for the rule requiring schools to get at least 15 percent of tuition from nongovernment sources, it had some unintended consequences. Rather than, say, enrolling people who could afford to pay some tuition out of pocket, many schools started pushing students to take out private student loans.

Previously, this kind of loan had gone exclusively to graduate and professional students pursuing careers in high-paying fields like law and medicine. The financially needy students who attend for-profit institutions couldn't qualify for them because of their less-than-stellar credit records, their lousy graduation rates, and their spotty record of finding work in their field. But this began to change around 2000. At the time, college tuition was skyrocketing—a trend that has only accelerated—and federal grants and loans weren't keeping pace. To fill the gap, financial aid officers started cutting deals with lenders to bring in private loan money. In the case of proprietary colleges, most of the large publicly traded chains forged arrangements with Sallie Mae, the nation's largest student loan company. (Once a quasi-government agency like Fannie Mae, it became entirely private in 2004.) In exchange for pots of private student loan funds that they could dole out at will—meaning without regard for students' ability to repay the debt—the schools gave Sallie Mae the right to be the exclusive provider of federal student loans on their campuses. Lenders vie fiercely for this privilege because federal loans are guaranteed by the government, meaning the Treasury pays back nearly all the money if the borrower defaults. Thus lenders get to pocket generous fees and interest and bear almost no risk.

Sallie Mae clearly understood that these private loans were going mostly to subprime borrowers who might not be able to pay them back; in 2007, Senate investigators uncovered internal company documents showing that executives expected a staggering 70 percent of its private student loans at one for-profit school to end in default. Investigators concluded that Sallie Mae viewed these loans as a "marketing expense"—a token sum to be paid in exchange for the chance to gorge on federal funds.

From the schools' perspective, it didn't much matter whether students would be able to pay off their debt any more than it mattered if they stuck with the program or graduated with the skills they needed. As long as students were enrolled long enough to be considered a "start," meaning that they attended classes for a week or two, the schools got to keep some of the money, and they got to include students in their official enrollment tally, which gave Wall Street the impression they were expanding. Having a cache of private loan funds to dole out also allowed the schools to clinch the deal right away—no need to grind through a stack of forms or wait for a third party to approve the loan application. Thus recruiters could lock students in before they experienced buyer's remorse.

At best, the George W. Bush administration and the Republican-led Congress turned a blind eye to these schemes. At worst, they made it easier for the schools to carry them out. In his first term, Bush packed the Department of Education with allies of the proprietary colleges. Before becoming the assistant secretary for post-secondary education, for example, Sally Stroup worked as a lobbyist for the University of Phoenix. Under her leadership, the agency took the teeth out of regulations that were designed to rein in abuses of the 1990s, including the incentive-compensation ban for recruiters.

Not surprisingly, many schools began resorting to hard-sell tactics to bring students in. In 2004, the Department of Education found that corporate bosses at the University of Phoenix routinely pressured and intimidated their recruiters to put "asses in the classes." At some of the campuses, enrollment counselors who didn't meet their targets were sent to the "Red Room," a glassed-in space where they worked the phones under intense management supervision. What's more, in recent years dozens of former students have filed suits alleging they were misled about classes and programs proprietary schools offered, as well as about their prospects for graduating and getting jobs in their fields of study. While the seriousness of the abuses vary, in some cases they amount to outright fraud, with recruiters pressuring students to sign up for classes that don't actually exist or to enroll in programs where the instructors lack even basic expertise in the field. The push to get students in the door also created more pressure to steer people into private loans.

The frenzy only intensified after Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act in 2005. This made it almost impossible for those who took out private student loans to discharge them in bankruptcy and, not surprisingly, turned the private student loan market into a much more appealing target for lenders.

As a result of these changes, private loan borrowing has skyrocketed. In the last decade alone, it has grown an astounding 674 percent at colleges overall, when adjusted for inflation. The growth has been most dramatic at for-profit colleges, where the percentage of students taking out private loans jumped from 16 percent to 43 percent between 2004 and 2008, according to Department of Education data.

The spike in private loan borrowing is dismal news for students. Unlike traditional student loans, which have low, fixed interest rates, private educational loans generally have uncapped variable rates that can climb as high as 20 percent—on par with the most predatory credit cards. Private loans also come with much less flexible repayment options. Borrowers can't defer payments if they suffer economic hardship, for instance, and the size of their payment is not tied to income, as it sometimes is in the federal program. Private loans also lack basic consumer protections available to federal loan borrowers. With a traditional federal student loan, for example, if a borrower dies or becomes permanently disabled, the debt is forgiven, meaning they or their kin are no longer responsible for paying it off. The same goes if the school unexpectedly shuts down before a student graduates. But none of this is true of private loans. Also, because it is so difficult to discharge private student loans in bankruptcy, when students take them out to attend schools that provide no meaningful training or skills they can find themselves trapped in a spiral of debt that they have little prospect of escaping.

Theresa Sweet, a thirty-three-year-old California resident, took out about $100,000 in private loans between 2003 and 2006 to study photography at the Brooks Institute in Santa Barbara, which is owned by the Career Education Corporation. At the time, she says the Brooks recruiters—who have frequently been accused of misleading students—told her that graduates of their photography program typically made at least $60,000 straight out of school. In fact, since graduating three years ago she has been unable to find paid work in her field, and, while she has managed to get forbearances on her student loans, the interest has continued to stack up. She now owes more than $200,000.

Looking back, Sweet admits that she was naive in trusting the recruiters. But she can't help but wonder how she ever qualified for the loans in the first place, especially given that when she applied she was unemployed. "If it were me, I never would have loaned me the money," she says. "Who in their right mind would lend $100,000 in unsecured debt to an art major?"

Like Sweet, graduates of proprietary colleges often struggle to find jobs in their fields. This is because, in many cases, they don't get the skills they need to compete. After all, it's far easier and less expensive for schools to boost enrollment numbers through aggressive advertising and recruitment than to expend the resources to build quality schools. Corinthian and Career Education, which own the schools Leveque and Sweet attended, have faced the most damning allegations when it comes to educational quality and steering students into shady private loans. Other chains have better reputations on these fronts, among them the University of Phoenix and DeVry University. But even they have a spotty record of graduating students.

For awhile it looked like the meltdown on Wall Street, and the ensuing credit crunch, would put an end to predatory lending at for-profit schools. In 2008 Sallie Mae quit offering subprime private loans to students at for-profit colleges because the astronomical default rates had helped throw its stock price into a nosedive. But the proprietary college industry has found a way around this roadblock, namely making private loans directly to students, much the way used-car lots loan money to buyers rather than going through a third party. For example, in a recent earnings call with investors and analysts, Corinthian said that it plans to dole out roughly $130 million in “institutional loans” this year, while Career Education and ITT Educational Services Inc., another for-profit chain, have reported that they expect to lend a combined total of $125 million.

These loans could prove to be even more toxic than the private ones offered by Sallie Mae. This is because some schools are packaging them as ordinary consumer credit, which has even fewer built-in safeguards than private student loans, especially when it comes to disclosure requirements. This makes it easier for schools to mislead borrowers about the terms of the debt they are taking on. In one class-action lawsuit filed earlier this year, former students of Colorado-based Westwood Colleges allege they were duped into borrowing institutional loans at a staggering 18 percent interest. According to the complaint, the college’s corporate bosses advise their admissions officers to sign students up for these loans without revealing how costly they are going to be. Thus borrowers don’t learn about the steep interest until after they leave school and receive their first loan bill. Worse, the lawsuit alleges that some students have been signed up for loans without their permission.

Jillian L. Estes, a Florida lawyer who represents the plaintiffs in the case, says she has been approached by two dozen former Westwood admissions representatives who admit that they deliberately avoided telling students about the terms of these loans. “They knew they’d never be able to enroll these students if they were up front with them,” Estes explains. (In their written response to the lawsuit, Westwood College officials offered a “categorical rejection” of the allegations brought by Estes and her clients.)

Significantly, many proprietary schools are pushing institutional loans even when they know students won’t be able to pay them off; Career Education and Corinthian Colleges only expect to recover roughly half of the money they distribute through their institutional lending programs, according to communications with shareholders. Why would they lend knowing they won’t get the money back? Because any loss is more than offset by federal loans and financial aid dollars, which, despite the surge in private educational lending, still fund the bulk of tuition at proprietary schools. Say a student gets a $60,000 federal financial aid package and supplements it with a $20,000 institutional loan. The school comes out $40,000 ahead even if the borrower ultimately defaults. Plus, getting students in the door pumps up enrollment numbers, which makes for happy shareholders.

Meanwhile, as the credit crunch eases, traditional lenders may well go back to making private loans to proprietary school students, especially given the changes afoot in the industry. President Obama aims to get rid of the program that allows lending companies to collect lucrative fees and interest for serving as the middleman on federal student loans and instead have the government offer the loans directly. Once forced out of the federal student loan program, traditional lenders will have a powerful incentive to seek profits by wading deeper into the private student loan market, and for-profit schools, with their exponential growth, could once again be an appealing target.

The good news is that the Obama administration seems more inclined than its predecessor to stand up against the abuses of proprietary schools. In May, the Department of Education revealed that it was considering reversing changes the Bush administration made to weaken the incentive-compensation ban. It is also thinking about adding teeth to the rules requiring proprietary colleges to show that graduates are finding “gainful employment” in their field and cracking down on schools that willfully mislead prospective students. “Our overall goal at the Department of Education in post-secondary education is to make sure that students … have the information they need to make good choices,” Robert Shireman, the deputy undersecretary of education, told financial analysts and investors during a conference call earlier this year.

These proposals are a good start, but more steps will be needed. For starters, the Department of Education should publish the data that it already collects on the number of students at each school who default over the lifetime of their loans. At the moment, it only releases the number who default during the first two years after leaving college, which is of limited value, not only because this is such a short time span, but also because the rates can be easily manipulated by schools.

Just publishing lifetime default rates would give prospective students a clearer picture of the risks of enrolling in a particular school. But the impact would be far greater if Congress used this data, along with graduation rates, to weed out abusive institutions; ideally, any school that failed to meet a certain threshold should be kicked out of the federal financial aid programs.

At the same time, Congress should require companies that offer private student loans to give the same kinds of flexible repayment options and consumer protections as are available through the federal student loan program, including allowing borrowers to repay their loans as a percentage of their income. Lawmakers also need to revisit changes Congress made to the bankruptcy code in 2005, which make it exceeding difficult for financially distressed borrowers, including those with private student loans, to discharge their debt in bankruptcy.

These changes would go a long way toward helping people like Martine Leveque escape their mountains of debt and ensuring that future students don’t wind up in the same situation. It would also guarantee that taxpayers don’t go on bankrolling giant companies that profit by exploiting those who are struggling to build better lives.

*CORRECTION: The original version of this article published online and in the November/December 2009 print edition of the *Washington Monthly* incorrectly stated that private loans made up two-thirds of Martine Leveque's financial aid package, and that her total outstanding student loan balance was $40,000. The correct figures are 42 percent and approximately $32,000, respectively. The text has been changed to reflect the corrections.

Response to this article may be found in **•L•E•T•T•E•R•S•** in the January/February edition of *Washington Monthly*.

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