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# Special Allowance Payments to New Mexico Educational Assistance Foundation for Loans Funded by Tax-Exempt Obligations

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## FINAL AUDIT REPORT



**ED-OIG/A05E0017**  
**MAY 2005**

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U.S. Department of Education  
Office of Inspector General  
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MAY 24, 2005

Mr. Elwood G. Farber, President  
New Mexico Educational Assistance Foundation  
7400 Tiburon  
Albuquerque, New Mexico 87109

Dear Mr. Farber:

Enclosed is our final audit report, Control Number ED-OIG/A05E0017, entitled *Special Allowance Payments to New Mexico Educational Assistance Foundation for Loans Funded by Tax-Exempt Obligations*. This report incorporates the comments you provided in response to the draft report. If you have any additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following Education Department official, who will consider them before taking final Departmental action on this audit:

Theresa Shaw  
Chief Operating Officer  
Federal Student Aid  
U.S. Department of Education  
Union Center Plaza  
830 First Street, NE  
Washington, DC 20202

It is the policy of the U. S. Department of Education to expedite the resolution of audits by initiating timely action on the findings and recommendations contained therein. Therefore, receipt of your comments within 30 days would be appreciated.

In accordance with the Freedom of Information Act (5 U.S.C. § 552), reports issued by the Office of Inspector General are available to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

Sincerely,

/s/

Richard J. Dowd  
Regional Inspector General  
for Audit

Enclosure

**SPECIAL ALLOWANCE PAYMENTS  
TO NEW MEXICO EDUCATIONAL ASSISTANCE FOUNDATION  
FOR LOANS FUNDED BY TAX-EXEMPT OBLIGATIONS**

**ED-OIG/A05E0017**

**TABLE OF CONTENTS**

|   | <u>Page</u> |
|---|-------------|
| <b>Executive Summary</b> .....  | 1           |
| <b>Background</b> .....   | 2           |
| <b>Audit Results</b> .....  | 4           |
| <b><u>Finding No. 1</u></b> – After loans were transferred as security for new obligations and prior obligations were retired, New Mexico Educational Assistance Foundation continued to bill for payments using the 9.5 percent floor calculation..... | 4           |
| <b><u>Finding No. 2</u></b> – New Mexico Educational Assistance Foundation received special allowance payments, under the 9.5 percent floor calculation, for loans funded by obligations that were issued after October 1, 1993.....                    | 13          |
| <b><u>Finding No. 3</u></b> – New Mexico Educational Assistance Foundation incorrectly categorized a \$4.7 million loan balance as eligible for the 9.5 percent floor calculation.....  | 16          |
| <b>Objective, Scope, and Methodology</b> .....  | 17          |
| <b>Appendix A</b> – New Mexico Educational Assistance Foundation Bond Genealogy....   | A-1         |
| <b>Appendix B</b> – Analysis of Loan Balance Distribution.....  | B-1         |
| <b>Appendix C</b> – Potential Overpayment in Finding No. 2.....   | C-1         |
| <b>Appendix D</b> –New Mexico Educational Assistance Foundation Response to Draft Audit Report.....   | D-1         |

**EXECUTIVE SUMMARY**

Special allowance payments are made to lenders in the Federal Family Education Loan (FFEL) Program to ensure that lenders receive an equitable return on their loans. In general, the amount of a special allowance payment is the difference between the amount of interest the lender receives from the borrower or the government and the amount that is provided under requirements in the Higher Education Act of 1965, as amended (HEA).

The HEA includes a special allowance calculation for loans that are funded by tax-exempt obligations issued before October 1, 1993. The quarterly special allowance payment for these loans may not be less than 9.5 percent, minus the interest the lender receives from the borrower or the government, divided by 4. When interest rates are low, this 9.5 percent floor calculation provides a significantly greater return than lenders receive for other loans.

The objective of our audit was to determine whether the use of tax-exempt obligations by the New Mexico Educational Assistance Foundation (NMEAF) to finance student loans, billed at the 9.5 percent special allowance rate, is in compliance with requirements in the HEA, regulations, and other guidance issued by the Department. To accomplish our objective, we examined NMEAF's issuance of tax-exempt obligations, the criteria NMEAF used to determine whether a loan qualified for the 9.5 percent floor calculation, and other information.

We determined that NMEAF received improper special allowance payments under the 9.5 percent floor calculation for loans that were—

- Transferred as security for a new obligation after the prior tax-exempt obligation was retired. We determined that an average of \$301.3 million in ineligible loans were included in billings for the five quarters covering the period from October 1, 2002, through December 31, 2003. We calculated that the amount of overpayments received on these loans may potentially be \$18.4 million.<sup>1</sup>
- Funded by tax-exempt obligations issued after October 1, 1993. Our informal calculation, based on 70 loans selected judgmentally, indicates that NMEAF might have received special allowance overpayments on loans in this category totaling about \$17.2 million for the five quarters covering the period from October 1, 2002, through December 31, 2003.<sup>1</sup>
- Incorrectly categorized and billed. While researching one of our questions, NMEAF discovered that it had incorrectly categorized loan balances of approximately \$4.7 million as eligible for the 9.5 percent floor calculation, causing a \$688,767 overpayment.<sup>1</sup>

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<sup>1</sup> These calculations cannot be added to determine a total, unduplicated liability. Many of the loans for which NMEAF received overpayments were included in two or more of our findings.

We recommend that the Chief Operating Officer (COO) for Federal Student Aid (FSA) instruct NMEAF to include only eligible loans in the amounts it identifies for payment under the 9.5 percent floor calculation. We also recommend that the COO for FSA calculate and require the return of the overpayments described in this report.

A draft of this report was provided to NMEAF for review and comment. In its comments, NMEAF objected strongly to our findings and recommendations, stating that, other than for the misclassified amount it identified for the OIG during its audit, it has been billing the Department correctly for special allowance payments under the 9.5 percent floor calculation. Where appropriate, we have incorporated into this report summaries of NMEAF's comments and our responses. We provide NMEAF's response to our draft report as Appendix D. Other than revising the presentation of certain criteria in Finding No. 1, we did not change our findings or recommendations based on NMEAF's comments.

## BACKGROUND

A lender participating in the FFEL Program is entitled to a quarterly special allowance payment for loans in its portfolio. In general, for Stafford loans,<sup>2</sup> the amount of the quarterly special allowance payment is calculated by—

1. Determining the average of the bond equivalent rates of 91-day Treasury bills auctioned during the quarter,
2. Adding a specified percentage to this amount (the specified percentage varies based on the loan's type, origination date, and other factors),
3. Subtracting the interest percentage the lender receives on the loan from the borrower or the government, and
4. Dividing the resulting percentage by 4. (34 C.F.R. § 682.302(c))<sup>3</sup>

Under Section 438(a) of the HEA, the purpose of special allowance payments is to ensure—

. . . that the limitation on interest payments or other conditions (or both) on loans made or insured under this part, do not impede or threaten to impede the carrying out of the purposes of this part or do not cause the return to holders of loans to be less than equitable . . . .

The Education Amendments of 1980 (Pub. L. 96-374) created a separate calculation for FFEL Program loans made or purchased with proceeds of tax-exempt obligations, and the Higher Education Amendments of 1992 (Pub. L. 102-325) continued this separate calculation for loans with variable interest rates.

In general, the quarterly special allowance payments for these loans is one half of the percentage determined under the method described above, using 3.5 percent as the specified percentage in Step 2. However, the separate calculation also provides a minimum payment. The special

<sup>2</sup> The calculation used for other types of FFEL Program loans is slightly different.

<sup>3</sup> All regulatory citations are the version dated July 1, 2002.

allowance payments for these loans “shall not be less than 9.5 percent minus the applicable interest rate on such loans, divided by 4.” (Section 438(b)(2)(B) (i) and (ii) of the HEA)

In this report, we refer to this separate calculation as the “9.5 percent floor calculation.” The Student Loan Reform Act of 1993, which was included in the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66), repealed the separate calculation for loans made or purchased with the proceeds of tax-exempt obligations, including the 9.5 percent floor calculation, restricting it to loans made or purchased with the proceeds of tax exempt obligations that were originally issued before October 1, 1993.

When interest rates are low, the 9.5 percent floor calculation results in significantly greater special allowance payments than the lender would otherwise receive. For example, for the quarter ending December 31, 2003, for a FFEL Program Stafford loan made on January 15, 2000, with an average daily balance of \$5,000, a lender would receive \$76 under the 9.5 percent floor calculation (payment rate of 1.52 percent). Under the calculation that would be used if the same loan was not eligible for the 9.5 percent floor calculation (payment rate of 0.0025 percent), the lender would receive \$0.125.

NMEAF is a private, nonprofit corporation, located in Albuquerque, New Mexico, and was created by the New Mexico State Legislature. It participates in the FFEL Program as both an originating lender and as a secondary market, and uses tax-exempt obligations to fund its FFEL Program loans. Eight of NMEAF’s tax-exempt bonds were issued before October 1, 1993 (pre-1993), and were eligible to fund loans qualified to receive special allowance payments under the 9.5 percent floor calculation:

**Table 1**

| # | Bond Issue     | Original Issue Date | Original Issue Amount | 9.5% Amount Outstanding on 09/30/93 |
|---|----------------|---------------------|-----------------------|-------------------------------------|
| 1 | 1985           | 8/21/1985           | \$ 94,925,000         | \$ 0                                |
| 2 | 1987           | 4/13/1987           | \$ 31,745,000         | \$ 5,255,000                        |
| 3 | 1988           | 7/28/1988           | \$ 69,740,000         | \$ 43,805,000                       |
| 4 | 1988-B         | 12/29/1988          | \$ 71,835,000         | \$ 0                                |
| 5 | 1992 A & B     | 4/14/1992           | \$ 140,000,000        | \$ 140,000,000                      |
| 6 | 1992 One-A & B | 12/17/1992          | \$ 71,835,000         | \$ 71,835,000                       |
| 7 | 1993 Two-A & B | 3/30/1993           | \$ 38,000,000         | \$ 38,000,000                       |
| 8 | 1993 I         | 9/28/1993           | \$ 150,000,000        | \$ 150,000,000                      |
|   |                |                     | <b>Total:</b>         | \$ 448,895,000                      |

In **Table 1**, the total outstanding amount available to NMEAF to fund loans under the 9.5 percent floor calculation, as of September 30, 1993, was \$448,895,000. The amounts for Bonds 1 and 4 are not included in this total, because they were paid off and retired before September 30, 1993, by Bonds 7 and 6, respectively.

Using the Bond Genealogy prepared by NMEAF (see Appendix A), we determined that, from October 1, 1993, through October 9, 2003, NMEAF issued—

- Twenty-four tax-exempt bonds, totaling \$688,185,000, which NMEAF used either to pay off its pre-1993 bonds or to pay off bonds that refunded those subsequent bonds (for example, bonds NMEAF used to refund prior bonds that paid off the pre-1993 bonds); and
- Nineteen tax-exempt bonds, totaling \$333,890,000, and one taxable bond, for \$10 million, which NMEAF used to finance loans it did not consider eligible for the 9.5 percent floor calculation.

For the period October 1, 1994, through March 31, 2004, NMEAF received \$60.9 million in special allowance payments under the 9.5 percent floor calculation.

### AUDIT RESULTS

NMEAF's policy of using tax-exempt bonds issued after October 1, 1993, either to pay off its pre-1993 bonds or to pay off bonds that refunded those subsequent bonds, did not result in NMEAF's increasing the amount of loans it claimed as eligible for the 9.5 percent floor calculation beyond the amount outstanding as of September 30, 1993. However special allowance payments to NMEAF under the 9.5 percent floor calculation for October 1, 1994, through December 31, 2003, were not all made in compliance with requirements in the HEA, regulations, and other guidance issued by the Department. As a result of NMEAF's practices for identifying loans eligible for the 9.5 percent floor calculation, NMEAF billed for and was overpaid special allowance for loans (1) that were pledged or transferred to a new funding source after the prior obligation was retired; (2) that were not funded by pre-1993 obligations; and (3) for which the funding source had been incorrectly categorized.

**FINDING NO. 1— AFTER LOANS WERE TRANSFERRED AS SECURITY FOR NEW OBLIGATIONS AND PRIOR OBLIGATIONS WERE RETIRED, NMEAF CONTINUED TO BILL FOR PAYMENTS USING THE 9.5 PERCENT FLOOR CALCULATION.**

When issuing a tax-exempt obligation to refund a prior obligation, NMEAF's practice was to use the funds from the new obligation to pay off and retire the prior obligation. Loans made or purchased with the proceeds of the prior obligation were pledged or transferred as security for the new obligation. (See Appendix A.)

All of NMEAF's pre-1993 bonds were paid off and retired using this method. When billing the Department for special allowance payments, NMEAF considers a loan eligible for the 9.5 percent calculation if the loan is funded by one of the pre-1993 bonds, or the proceeds of tax-exempt refundings of such obligations.

The publication of final regulations by the Department, on December 18, 1992 (57 FR 60280), established criteria for determining when a loan's eligibility for the 9.5 percent floor calculation terminates. Under 34 C.F.R. § 682.302(e)(2), a loan is not eligible for the 9.5 percent floor calculation—

- (i) After the loan is pledged or otherwise transferred in consideration of funds derived from sources other than [a tax-exempt obligation subject to the 9.5 percent floor calculation]; and
- (ii) If the authority retains a legal or equitable interest in the loan—
  - (A) The prior tax-exempt obligation is retired; or
  - (B) The prior tax-exempt obligation is defeased by means of obligations that the Authority certifies in writing to the Secretary bear a yield that does not exceed the yield permitted under Internal Revenue Service regulations, 26 CFR 1.103–14, with regard to investments of proceeds of a tax-exempt refunding obligation.

As stated in the Background section, the Omnibus Budget Reconciliation Act of 1993 limited the eligibility of tax-exempt obligations subject to the 9.5 percent calculation to those that were originally issued before October 1, 1993. In a Dear Colleague Letter issued in March 1996 (96-L-186), the Department explained the application of 34 C.F.R. § 682.302(e) for determining the eligibility of certain loans for the 9.5 percent floor calculation:

Under the regulations, if a loan made or acquired with the proceeds of a tax-exempt obligation is refinanced with the proceeds of a taxable obligation, the loan remains subject to the tax-exempt special allowance provisions if the authority retains legal interest in the loan. If, however, the original tax-exempt obligation is retired or defeased, special allowance is paid based on the rules applicable to the new funding source (taxable or tax-exempt).

\* \* \* \* \*

Adjustments to ED 799 billings and current billings for any loans covered by this policy should be made using the applicable tax-exempt special allowance codes for the periods that the holder retains legal interest in the loan and the original tax-exempt obligation has not been retired or defeased.

In final regulations published on October 29, 1999 (64 FR 58622), and effective on July 1, 2000, the Department incorporated the changes made by the Omnibus Budget Reconciliation Act of 1993, limiting the application of the 9.5 percent floor calculation to tax-exempt obligations originally issued before October 1, 1993. This change to the regulations confirmed the criteria, in 34 C.F.R. § 682.302(e), for terminating a loan's eligibility for the 9.5 percent floor calculation: loans eligible for the 9.5 percent floor calculation after enactment of the Omnibus Budget Reconciliation Act of 1993 become ineligible when they are transferred in consideration of funds derived from sources other than a tax-exempt obligation subject to the 9.5 percent floor calculation and the prior tax-exempt obligation is retired or defeased.

The Department summarized the application of 34 C.F.R. § 682.302(e) in its response to a report issued by the United States Government Accountability Office in September 2004 (*Federal Family Education Loan Program: Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, GAO-04-1070):

In general, under the Department's regulations, loans that are eligible for the special 9.5 percent subsidy retain that eligibility as long as the tax-exempt bond whose proceeds were used to make or purchase the loans remains open. In other words, absent a change in the law, unless and until the original financing instrument is retired or defeased, the loans it supports qualify for the special subsidy.

Under the Department's regulatory criteria, loans become ineligible for the 9.5 percent floor calculation on the date they are pledged or transferred as security for a new obligation and the original financing tax-exempt obligation is retired. In its special allowance payment billing, NMEAF continued to identify loans as eligible for the 9.5 percent floor calculation after the date the loans became ineligible.

All of NMEAF's pre-1993 obligations were paid off and retired no later than December 9, 2002. As a result, all previously eligible loans that were pledged or transferred as security for new obligations—including loans funded directly by new obligations—became ineligible to receive a special allowance payment using the 9.5 percent floor calculation.

The following table shows retirement dates for NMEAF's pre-1993 bonds, listed in Table 1, that were outstanding on September 30, 1993:

**Table 2**

| # | Bond Issued . . . | Retired on . . . |
|---|-------------------|------------------|
| 2 | 4/13/1987         | 3/1/1995         |
| 3 | 7/28/1988         | 8/23/1994        |
| 5 | 4/14/1992         | 4/1/2002         |
| 6 | 12/17/1992        | 12/9/2002        |
| 7 | 3/30/1993         | 12/3/2001        |
| 8 | 9/28/1993         | 3/1/1995         |

NMEAF received a cumulative total of \$18,612,649 in special allowance payments, under the 9.5 percent floor calculation, for the five quarters covering the period October 1, 2002, through December 31, 2003. This payment amount was based on an average quarterly loan balance, reported by NMEAF, of about \$304.5 million. We re-calculated NMEAF's average quarterly loan balance, removing the loans that are ineligible under the criteria we describe above, and found that NMEAF's eligible loan balance was overstated, on average, by about \$301.3 million for each quarter. The average quarterly balance eligible for the 9.5 percent floor calculation was about \$3.2 million. (See Appendix B.)

We did not determine the overpayments attributed to the ineligible loans. However, we calculated that NMEAF may have been potentially overpaid \$18.4 million in special allowance

for those five quarters, assuming that the overpayments were proportional to the overstated eligible loan balances. (See **Table 3**.)

**Table 3**

| <b>Quarter Ending</b> | <b>Balance Claimed</b> | <b>Special Allowance Paid</b> | <b>Revised Balance</b> | <b>Revised Payment</b> | <b>Potential Amount Overpaid</b> |
|-----------------------|------------------------|-------------------------------|------------------------|------------------------|----------------------------------|
| 12/31/02              | \$286,119,485          | \$3,556,257                   | \$6,745,739            | \$83,845               | \$3,472,412                      |
| 3/31/03               | \$299,105,216          | \$3,401,772                   | \$2,763,660            | \$31,432               | \$3,370,340                      |
| 6/30/03               | \$308,246,554          | \$3,536,669                   | \$2,491,967            | \$28,592               | \$3,508,077                      |
| 9/30/03               | \$314,111,557          | \$4,042,674                   | \$2,177,994            | \$28,031               | \$4,014,643                      |
| 12/31/03              | \$315,134,264          | \$4,075,277                   | \$1,924,461            | \$24,887               | \$4,050,390                      |
| <b>Total</b>          |                        | \$18,612,649                  |                        | \$196,787              | <b>\$18,415,862</b>              |

In **Table 3**, the column(s) headed—

- **Balance Claimed** and **Special Allowance Paid** contain the actual balance of the loans NMEAF reported as eligible for the 9.5 percent floor calculation on its quarterly special allowance billing request and the actual amount of the Department’s special allowance payment to NMEAF.
- **Revised Balance** is our determination of the loan balance eligible for payments using the 9.5 percent floor. To identify these amounts, we included the balances, during each quarter, attributable to loans that (1) had not been pledged or transferred as security for a new obligation or (2) were funded by a pre-1993 obligation that had not been retired or defeased. (See Appendix B.)
- **Revised Payment** is our calculation of the amount of the Special Allowance Paid that is proportional to the revised balance. To calculate the Revised Payment, we determined the percentage of the Balance Claimed represented by the Revised Balance, and we multiplied the Special Allowance Paid by that percentage: (Revised Balance / Balance Claimed) X Special Allowance Paid.
- **Potential Amount Overpaid** is the Special Allowance Paid minus the Revised Payment.

### **Recommendations:**

We recommend that the COO for FSA—

- 1.1 Instruct NMEAF to include only eligible loans in the amounts it identifies for payment under the 9.5 percent floor calculation;
- 1.2 Determine and require NMEAF to return special allowance overpayments it received for the five quarters covering the period October 1, 2002, through December 31, 2003, for which we calculated an \$18.4 million potential overpayment; and

- 1.3 Determine and require NMEAF to return all other overpayments it received for special allowance after October 1, 1999.<sup>4</sup>

Liability calculations for this finding and for other findings in this report should be consolidated to ensure that NMEAF is not required to return an overpayment attributable to the same loans under two or more findings.

#### **NMEAF Comments:**

NMEAF strongly objects to this finding and its recommendations.<sup>5</sup> NMEAF provides the following reasons for its non-concurrence:

1. **Meaning of “Originally.”** In general, under the HEA, loans are eligible for the 9.5 percent calculation if they are funded by obligations “originally issued” before October 1, 1993, and loans are ineligible for the 9.5 percent calculation if they are funded by obligations “originally issued” on or after October 1, 1993. The OIG misinterprets the word “originally,” as that word is used in Section 438(b)(2)(B)(iv) of the HEA, and in related regulations and guidance issued by the Department.

When Congress was drafting the Omnibus Budget Reconciliation Act of 1993, lenders approached their representatives with concerns about the impact of the loss of special allowance payments under the 9.5 percent calculation. To address their concerns, Congress included the word “originally” in Section 438(b)(2)(B)(iv) of the HEA, to enable refundings of tax-exempt bond issues and transfers of loans. For example, with the addition of the word “originally”, an obligation issued in 1995, if used to refinance a pre-1993 obligation, would be considered an obligation that was “originally issued” on the same date that the pre-1993 obligation was issued.

NMEAF acknowledges that it is not providing documentation to support its interpretation of the word “originally,” stating, “We can understand that the Office of the Inspector General might not be willing to accept our word on this but we assume that the circumstances described should be verifiable from pre-introduction drafts of the legislation.” As additional support for its position, NMEAF cites the substantially contemporaneous statements of the Department of Education in Dear Colleague Letters

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<sup>4</sup> Here and elsewhere in this report, we limit our recommendations for return of overpayments to those for billings after October 1, 1999, to provide for record retention requirements. Under 34 C.F.R. § 682.414(a)(4)(iii), a lender is required to keep loan records for three years after the loan is paid off by the borrower or five years if the loan is paid off by anyone else. Under 34 C.F.R. § 682.414(a)(4)(iv), a lender is required to keep a copy of its audit report for no less than 5 years after the audit report is issued. The rules for lenders’ record retention do not describe any other retention periods, including the retention of data to support billings for special allowance payments. Since the reports for these billings would not be included in borrowers’ files, and are not “loan records,” we have limited our recommendations to a five-year period.

<sup>5</sup> NMEAF’s response to our draft report includes separate comments from NMEAF and from its counsel. Our summaries of NMEAF’s comments do not distinguish between NMEAF’s comments and its counsel’s comments. Both are identified as “NMEAF’s comments.”

issued from November 1993 through June 1995, “all of which reiterate how floor treatment will apply to loans refinanced by post October 1, 1993 tax exempt obligations.”

2. **Criteria.** If the position taken in Finding No. 1 were accurate, all the regulations and guidance issued by the Department after the Omnibus Budget Reconciliation Act of 1993 would have to be ignored. For example, the OIG’s report ignores the applicable statute, regulations, and Departmental guidance on the treatment of refunding bonds. NMEAF cites Dear Colleague Letter 93-L-161 (November 1993) and Dear Colleague Letter 93-L-163(LD) (December 1993), which state, “Refinancing of obligations which were originally issued prior to October 1, 1993, does not alter the eligibility of loans made or purchased with funds obtained from the proceeds of the original financing to receive the minimum special allowance.”

NMEAF also cites Dear Colleague Letter 95-L-181(LD) (June 1995), which states—

Tax-exempt loans made or purchased with funds obtained by the holder from the issuance, *or refinancing*, of obligations originally issued prior to October 1, 1993 (“old money”) will continue to be calculated by taking the greater of one-half the annual special allowance rate using 3.5% in the formula, or using the floor of 9.5% less the applicable interest rate. [Italics added.]

The guidance in these letters, and in other Departmental guidance, allows an extended eligibility for the 9.5 percent floor calculation, beyond the retirement of the original bond.

Further, NMEAF suggests that 34 C.F.R. § 682.302(e), as cited in OIG’s report, did not apply to NMEAF’s billing for special allowance payments until July 1, 2000. The Department’s regulations to implement the provisions of the Omnibus Budget Reconciliation Act of 1993, which established an October 1, 1993, cutoff date for loans’ eligibility for the 9.5 percent floor, were not issued until October 29, 1999 (64 FR 58622) and were not effective until July 1, 2000.

3. **Private Letter.** The Department has issued clear guidance contradicting the position reflected in this audit report. On October 14, 1993, attorneys for the Alabama Higher Education Corporation sent an inquiry to the Department about the continued eligibility of certain bonds for special allowance payments under the 9.5 percent floor calculation. The Acting Chief of the Department’s Loan Branch, Division of Policy Development, Policy, Training, and Analysis Service responded on November 24, 1993.

The response agreed that loans funded by the bonds in question would continue to be treated as if they were funded by the pre-1993 bond, stating—

You indicated that the Alabama Higher Education Loan Corporation (the Corporation) intends to issue “tax-exempt” refunding bonds to redeem or otherwise retire the three original obligations, specified in your letter, each of which was issued prior to October 1, 1993. Based on the facts presented in your letter, we concur that the special allowance rates will continue to be determined

pursuant to §§438(b)(2)(B)(i) and (ii) of the Higher Education Act of 1965, as amended.

Also, an internal e-mail was sent by policy staff at the Department to regional Department staff, on July 17, 2002, which supports NMEAF's position. The e-mail confirmed that the refunding bonds continued to maintain the eligibility for the 9.5 % floor treatment.

4. **GAO Report to Congressional Requesters.** The OIG's report cites a paragraph of the Department's response to a report issued by GAO in September 2004: *Federal Family Education Loan Program: Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, GAO-04-1070. However, the OIG does not include other pertinent statements in the Department's response to GAO's report that support NMEAF's practices.

In the second paragraph of its response to GAO's report, the Department acknowledges the three strategies described in the report that may be used by "lenders and loan holders to maintain and even increase their 9.5 percent loan portfolios." The Department's response does not indicate that it considers GAO's descriptions of the strategies to be inaccurate.

GAO describes one of these three strategies as follows:

Lenders can issue a new bond, called a refunding bond, to repay an outstanding pre 10/1/93 tax-exempt bond that financed 9.5% loans. Consequently the refunding bond finances the 9.5% loans and may have a later maturity date than the original bond, allowing lenders to maintain their 9.5% loan volume for a longer time.

Under this strategy, the bond originally issued before October 1, 1993, is not retired or defeased, it is refunded. As such, the OIG's conclusion that NMEAF has incorrectly billed the Department for special allowance payments under the 9.5 percent calculation is not supported by GAO's report or the Department's response to that report.

5. **Taxpayer-Teacher Protection Act of 2004.** During the recent development and enactment of the Taxpayer-Teacher Protection Act of 2004 (Pub.L.108-409), discussion in the House and Senate acknowledged lenders' ability to extend eligibility for the 9.5 percent floor calculation by refunding pre-1993 obligations. NMEAF quotes statements made by a number of Senators and Congressmen during the drafting of this legislation, and NMEAF states—

. . . there was an agreement that recycling of 9.5% floor loans in pre-October 1, 1993 tax exempt obligations and tax exempt refundings of such obligations would continue unabated (even though some of the members thought it should not but conceded the legislation before them permitted its continuance).

NMEAF concludes that, other than the misclassified amount it identified for the OIG during its audit (see Finding No. 3), it has been billing the Department correctly for special allowance payments under the 9.5 percent floor calculation.

**OIG Response:**

Other than revising certain criteria in Finding No. 1, to reflect our response to a portion of NMEAF's comment number 2, we have not changed our finding or recommendations based on NMEAF's comments. Our responses to each of NMEAF's comments on Finding No. 1 are provided below:

1. **Meaning of "Originally."** The word "originally," as it is used in Section 438(b)(2)(B)(iv) of the HEA, is not defined in the HEA, supporting regulations, or any sub-regulatory guidance issued by the Department. NMEAF provides no documentation to support its interpretation of this term or its view of the legislative history.

The purpose of the provision in the Omnibus Budget Reconciliation Act of 1993, to limit eligibility for the 9.5 percent floor calculation to obligations issued before October 1, 1993, is reflected in the following publications:

- The Conference Report for the Omnibus Budget Reconciliation Act of 1993 (H.R. Rep. 103-213), which states, "The conference agreement lowers the guaranteed special allowance for secondary markets from a minimum of 9.5 percent to the special allowance for other lenders."
- Dear Colleague Letter 93-L-161 (November 1993), which states, "The minimum special allowance rate 'floor' on new loans made or purchased, in whole or in part, with funds derived from tax-exempt obligations has been repealed."

As such, NMEAF's interpretation of "originally" is contrary to the stated purpose of this provision, which was to eliminate the 9.5 percent floor and reduce the amount paid to the lender. NMEAF's interpretation of "originally" would not provide for lower special allowance payments to lenders because it would continue special allowance payments under the 9.5 percent floor calculation.

As for the support for NMEAF's position derived from the "substantially contemporaneous statements" of the Department in its Dear Colleague Letters, we can find no indication in those letters that the Department interpreted the term "originally" in the manner proposed by NMEAF, or that it used such an interpretation as a basis for the policy reflected in those letters.

2. **Criteria.** NMEAF states that our report ignores the HEA, regulations, and other guidance issued by the Department. Specifically, NMEAF states that we ignore Dear Colleague Letters that allow continued eligibility for the 9.5 percent floor calculation based on the refinancing of obligations issued before October 1, 1993, and that we ignore the July 1, 2000, effective date of the 1999 regulations.

Our report does not disagree with NMEAF's position on the continued eligibility of a loan after it has been transferred as security for a refinancing obligation. However, the guidance cited by NMEAF does not support its assertion that a refunding bond's eligibility for the 9.5 percent floor calculation is extended beyond the retirement of the original bond. If a loan's original pre-1993 funding source has been retired, the criteria in 34 C.F.R. § 682.302(e)(2)—and all other official guidance issued by the Department on the status of loans after the pre-1993 obligation has been retired—provide that the loan is no longer eligible for payments under the 9.5 percent floor calculation.

NMEAF is correct in its assertion that the Department's regulations to implement the October 1, 1993, cutoff date for a loan's eligibility for the 9.5 percent floor were not effective until July 1, 2000. We have revised our report's discussion of the criteria to reflect the date that these regulations were effective. However, we do not agree with NMEAF's suggestion that the requirements in 34 C.F.R. § 682.302(e), for termination of a loan's eligibility for the 9.5 percent special allowance calculation, did not apply to special allowance billing before July 1, 2000.

The requirements in 34 C.F.R. § 682.302(e) were not changed by the final rule that was effective July 1, 2000. Both before and after that date, 34 C.F.R. § 682.302(e) provided that a loan is ineligible for the 9.5 percent special allowance calculation if it is (1) transferred in consideration of funds derived from sources other than a tax-exempt obligation subject to the 9.5 percent floor calculation and (2) the prior tax-exempt obligation is retired or defeased. The change to the regulations in 2000 was a change to the definition of an eligible obligation, limiting eligibility to those obligations originally issued before October 1, 1993. This regulatory change incorporated into regulations a statutory definition that was effective since the enactment of the Omnibus Budget Reconciliation Act of 1993, and confirmed the applicability of 34 C.F.R. § 682.302(e) to loans affected by the 1993 change.

3. **Private Letter.** In its comments, NMEAF refers to private letter guidance sent on November 24, 1993, by the Acting Chief of the Department's Loan Branch, Division of Policy Development, Policy, Training, and Analysis Service to attorneys for the Alabama Higher Education Corporation. The guidance in this private letter cannot be used as criteria for NMEAF's practices, because—
  - A private letter issued to one lender cannot be used to justify the actions of another; and
  - There is no indication that NMEAF was aware of or relied on this letter when it initiated its billing practices.

As to the internal e-mail, sent by the Department's policy staff to regional staff on July 17, 2002, NMEAF has not provided the e-mail in question, so we cannot determine whether it supports NMEAF's position.

4. **GAO Report to Congressional Requesters.** GAO's report provides the results of its study of special allowance payments made under the 9.5 percent calculation and describes strategies used by lenders to slow the decrease in, maintain, or increase their 9.5 percent loan volume. GAO's description of the refunding strategy used by lenders does not address the application of criteria for termination of a loan's eligibility for the 9.5 percent floor calculation in 34 C.F.R. § 682.302(e).

The comments that the Department provided to GAO confirm that certain refunding transactions will result in loss of eligibility for the 9.5 percent floor calculation. NMEAF's refunding practice falls into the category identified by the Department, in its comments to GAO, of loans that are ineligible for continued 9.5 percent payments.

5. **Taxpayer-Teacher Protection Act of 2004.** NMEAF quotes statements made by a number of Senators and Congressmen during the debate on the Taxpayer-Teacher Protection Act of 2004. However, none of these statements addresses the legality of refunding practices, including the practice used by NMEAF. As a result, the statements NMEAF provides do not support its position.

Though NMEAF's comments dispute the criteria for a loan's eligibility for the 9.5 percent floor, they do not explain how its loans qualify for the 9.5 percent floor under current criteria, and they do not dispute our understanding of its loan records, policies, or practices for determining the eligibility of its loans when billing under the 9.5 percent floor. Our agreement, in part, with one of NMEAF's comments (discussed above, in comment number 2), does not change our finding or recommendation, other than some revisions we made to our discussion of the criteria.

**FINDING NO. 2 – NMEAF RECEIVED SPECIAL ALLOWANCE PAYMENTS, UNDER THE 9.5 PERCENT FLOOR CALCULATION, FOR LOANS FUNDED BY OBLIGATIONS THAT WERE ISSUED AFTER OCTOBER 1, 1993.**

NMEAF's loan records do not indicate that all its loans billed under the 9.5 percent floor calculation were made or purchased with funds received from eligible sources. We judgmentally selected 70 student loans from loan balances for which NMEAF billed special allowance payments under the 9.5 percent floor calculation. Of these 70 loans, 66 were ineligible for the special allowance payments NMEAF received.

Under 34 C.F.R. § 682.302(c)(3)(i) a loan is eligible for the 9.5 percent floor calculation if it is—

... a loan made or guaranteed on or after October 1, 1980 that was made or purchased with funds obtained by the holder from—

(A) The proceeds of tax-exempt obligations originally issued prior to October 1, 1993, the income from which is exempt from taxation under the Internal Revenue Code of 1986 (26 U.S.C.);

(B) Collections or payments by a guarantor on a loan that was made or purchased with funds obtained by the holder from obligations described in paragraph (c)(3)(i)(A) of this section;

(C) Interest benefits or special allowance payments on a loan that was made or purchased with funds obtained by the holder from obligations described in paragraph (c)(3)(i)(A) of this section;

(D) The sale of a loan that was made or purchased with funds obtained by the holders from obligations described in paragraph (c)(3)(i)(A) of this section; or

(E) The investment of the proceeds of obligations described in paragraph (c)(3)(i)(A) of this section.

The 70 loans we examined were selected from loans that NMEAF identified as eligible for the 9.5 percent floor calculation, in its billing reports for the quarters ended December 31, 2002 (38 loans selected) and December 31, 2003 (32 loans selected). We identified the applicable billing categories with the largest balances, and from them, in general, we selected loans with large balances. Of the 70 loans, 66 were either made or purchased well after October 1, 1993, and funded from proceeds of tax-exempt obligations issued after October 1, 1993. These 66 loans were not eligible for special allowance payments using the 9.5 percent floor calculation because NMEAF's records did not show that these loans had ever been funded by pre-1993 bonds or by any other eligible funding source described in 34 C.F.R. § 682.302(c)(3)(i).

The 70 loans we selected had an outstanding balance of \$1,142,614. The 66 loans that were ineligible for payments under the 9.5 percent floor calculation had an outstanding balance of \$1,056,402. Though we did not calculate the amount of special allowance payments attributable to the 70 loans, we used our review of those loans to calculate, informally, the cumulative total of special allowance payments that, under the criteria, would have been paid to NMEAF, for all loans, for the five quarters beginning October 1, 2002, and ending December 31, 2003. This calculation indicates that NMEAF might have received special allowance overpayments of about \$17.2 million for those five quarters.<sup>6</sup> (See Appendix C.)

### **Recommendations:**

We recommend that the COO for FSA—

- 2.1 Instruct NMEAF to include only eligible loans, funded by eligible sources listed in 34 C.F.R. § 682.302(c)(3)(i), in the amounts it identifies for payment under the 9.5 percent floor calculation; and
- 2.2 Calculate and require NMEAF to return all special allowance overpayments it received after October 1, 1999.

Liability calculations for this finding and for other findings in this report should be consolidated to ensure that NMEAF is not required to return an overpayment attributable to the same loans under two or more findings.

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<sup>6</sup> The method we used to select the 70 loans does not allow us to calculate a statistically valid estimate of special allowance overpayments. Our determination of a potential overpayment, based on our judgmental sample, is intended only for use as a general indicator of the potential effect of NMEAF's practices for funding loans and documenting their eligibility for special allowance payments under the 9.5 percent floor calculation. The calculation is based on an assumption that the judgmental sample is nevertheless reflective of NMEAF's practices.

**NMEAF's Comments:**

NMEAF strongly objects to this finding and its recommendations. NMEAF states that Finding No. 2 is based on the same improper criteria as Finding No. 1, "that a tax-exempt refunding bond cannot extend the 9.5% floor eligibility." NMEAF has provided, in its response to Finding No. 1, its rationale for the continued eligibility of tax-exempt refunding bonds for special allowance payments under the 9.5 percent floor calculation. Since NMEAF has shown that "a tax-exempt refunding bond issue can extend the eligibility for the 9.5% floor treatment, [it has also shown that] loans residing in and securing such bond issue are eligible for the 9.5% floor treatment."

**OIG Response:**

NMEAF identifies its comments on our Finding No. 1 as its response to Finding No. 2, but those comments do not fully address the condition or criteria we describe in Finding No. 2. The criteria used for Finding No. 2 are in 34 C.F.R. § 682.302(c)(3)(i), which provides a detailed list of the funding sources that may be used to identify a loan as eligible for the 9.5 percent floor. As we describe in our report, NMEAF's loan records do not document that all loans receiving payments under the 9.5 percent floor calculation were made or purchased with funds obtained from listed, eligible sources.

If NMEAF's objection to Finding No. 2 is based on a belief that Dear Colleague Letters 93-L-161, 93-L-163(LD), and 95-L-181(LD) consider a refunding bond to be the same as a pre-1993 bond, its belief does not appear to be supported by those letters. Dear Colleague Letters 93-L-161 and 93-L-163(LD) state—

Refinancing of obligations which were originally issued prior to October 1, 1993, does not alter the eligibility of loans made or purchased with funds obtained from the proceeds of the original financing to receive the minimum special allowance.

It is clear that this guidance does not conflict with the criteria we cite in 34 C.F.R. § 682.302(c)(3)(i): it only applies to refinanced loans if they were "made or purchased with funds obtained from the proceeds of the original financing."

Dear Colleague Letter 95-L-181(LD) states—

Tax-exempt loans made or purchased with funds obtained by the holder from the issuance, or refinancing, of obligations originally issued prior to October 1, 1993 ("old money") will continue to be calculated by taking the greater of one-half the annual special allowance rate using 3.5% in the formula, or using the floor of 9.5% less the applicable interest rate.

Though the language in this letter seems to consider a refinancing bond to be the same as a pre-1993 bond, for purposes of determining the eligibility of a loan for the 9.5 percent floor calculation, the letter's consistency with other guidance issued by the Department (this letter states that its guidance "will continue" prior policies) makes this interpretation questionable, and

34 C.F.R. § 682.302(c)(1), which provides a detailed list of the funding sources that may be used to identify a loan as eligible for the 9.5 percent floor, make this interpretation unsupported.

**FINDING NO. 3 – NMEAF INCORRECTLY CATEGORIZED A \$4.7 MILLION LOAN BALANCE AS ELIGIBLE FOR THE 9.5 PERCENT FLOOR CALCULATION.**

While researching one of our questions, NMEAF discovered that it had assigned an incorrect bond identification (ID) number to a loan balance of \$4.7 million. NMEAF assigns a bond ID number to each of its loans to identify each loan's funding source. A loan's funding source determines whether NMEAF considers the loan to be eligible for special allowance payments under the 9.5 percent floor calculation. NMEAF assigned bond ID number 131 to the \$4.7 million when the correct bond ID number was 132.

NMEAF considered loans funded by bond ID number 131 to be eligible for special allowance payments using the 9.5 percent floor calculation. NMEAF did not consider loans funded by bond ID number 132 to be eligible for such payments. The loans funded by bond ID number 132 also fail to meet the criteria described in Finding Nos. 1 and 2 of this report.

As a result of its error, NMEAF incorrectly billed \$4.7 million as eligible for special allowance payments under the 9.5 percent floor calculation. Because it would be difficult to calculate an adjustment based on actual outstanding loan balances for each quarter, NMEAF calculated the amount of the overpayment as if the \$4.7 million had been incorrectly billed for each quarter since February 1998. Using this assumption, NMEAF determined that the amount of the overpayment was \$688,767. NMEAF stated that the overpayment was corrected by an adjustment it made to its special allowance billing for the quarter ending on June 30, 2004.

**Recommendations:**

We recommend that the COO for FSA—

- 3.1 Verify the accuracy of NMEAF's calculation of a \$688,767 downward adjustment to its billing for special allowance is appropriate for this finding, and
- 3.2 Review FSA's records to ensure that NMEAF made the downward adjustment to its special allowance payments, reimbursing the Department for the overpayment.

Liability calculations for this finding and for other findings in this report should be consolidated to ensure that NMEAF is not required to return an overpayment attributable to the same loans under two or more findings.

**NMEAF's Comments:**

NMEAF concurs with Finding No. 3. NMEAF states that the Department has reviewed the method used by NMEAF to identify the error and for calculating the amount of the adjustment, and the Department has reported to NMEAF that the appropriate adjustment has been made.

**OBJECTIVE, SCOPE, AND METHODOLOGY**

The objective of our audit was to determine whether NMEAF's use of tax-exempt obligations to finance student loans, billed at the 9.5 percent special allowance rate, is in compliance with requirements in the HEA, regulations, and other guidance issued by the Department. Specifically, the objective of our audit was to determine whether—

- Tax-exempt bonds issued after September 30, 1993, qualify for financing student loans that are eligible for the 9.5 percent special allowance floor rate; and
- Increases in the amount of loans subject to the 9.5 percent special allowance floor are correct.

Our audit covered special allowance billings and the tax-exempt obligations issued and used to finance student loans during the period October 1, 1994, through March 31, 2004. To accomplish our audit objective, we—

- Interviewed staff at the Department and reviewed the HEA, regulations, and other Departmental guidance on the eligibility of loans for special allowance payments under the 9.5 percent floor calculation.
- Obtained and reviewed reports of recent reviews of lenders by the Department and the Government Accountability Office.
- Obtained and reviewed the Department's data related to billings for the 9.5 percent special allowance rate.
- Obtained from the Department the amount of 9.5 percent special allowance payments to NMEAF and the amount of outstanding loan balances included in NMEAF's quarterly reports/billings for the period October 1, 1994, through March 31, 2004.
- Reviewed NMEAF's Single Audit reports for the years ended June 30, 2002 and 2003. Our review included (1) discussions with the external auditor who conducted the Single Audit for the year ended June 30, 2003, and (2) a review of the external auditor's working papers related to internal controls, computer systems, and testing of loans included in the special allowance section of NMEAF's quarterly billings. In addition, we interviewed NMEAF's Director of Internal Audit and reviewed selected documents and reports related to the computerized loan database system and testing of the quarterly reports prepared from NMEAF's student loan database.
- Interviewed staff at NMEAF to gain an understanding of the process NMEAF used to issue tax-exempt obligations and reviewed NMEAF's policies, procedures, and practices for (1) determining the eligibility of loans for special allowance payments under the 9.5 percent floor calculation and (2) preparing the special allowance section of the quarterly reports that contain loans claimed for the 9.5 percent special allowance rate. Our review did not include an assessment to determine whether these policies, procedures, and practices were adequate

to provide reasonable assurance that NMEAF included only loans eligible for the 9.5 percent special allowance rate in its quarterly billings.

- Obtained and reviewed the Bond Genealogy, prepared by NMEAF, of all taxable and tax-exempt bonds that NMEAF issued from 1985 through 2003.
- Examined transcripts and other documents related to tax-exempt obligations issued by NMEAF that were used to fund loans it reported as eligible for the 9.5 percent floor calculation. Our audit did not include a determination of whether NMEAF's obligations qualified for tax-exempt status or whether those obligations met any other criteria that are not included in the HEA or the Department's regulations or other guidance.
- Examined NMEAF's system for maintaining loan records to document its loans' eligibility for the 9.5 percent special allowance rate.
- Reviewed the eligibility of 70 loans judgmentally selected from the loans NMEAF claimed for the 9.5 percent allowance rate for the quarters ended December 31, 2002 (38 loans), and December 31, 2003 (32 loans). We generally selected loans from the special allowance categories with the reported largest outstanding loan balance.

To achieve our audit's objective, we relied, in part, on data NMEAF used to bill the Department for special allowance payments. NMEAF used a servicing system created by Idaho Financial Associates to maintain data and to complete its billing reports. To assess the reliability of NMEAF's data, we compared the information for loans included on the quarterly reports for December 31, 2002, and December 31, 2003, to NMEAF's computerized loan database and then to the actual loan source documents for selected loans. Based on our assessment, we determined that NMEAF's computer-processed data was sufficiently reliable for the purposes of achieving our audit objectives.

We conducted our audit in accordance with generally accepted government auditing standards appropriate to the scope described above. From June through October 2004, we conducted our work at NMEAF's offices in Albuquerque, New Mexico, and our offices in Chicago, Illinois; Kansas City, Missouri; and St. Paul, Minnesota. We discussed the results of our audit with NMEAF officials on November 4, 2004.

**NMEAF Bond Genealogy**

The following table was prepared by NMEAF’s Assistant Controller of Bonds and Trusts. In the table—

- “IFA” means “Idaho Financial Associates,” which is the creator of the student loan servicing system used by NMEAF.
- “O/S” means “Outstanding”.
- A “9.5 Refund” or “Refunding” bond is a bond that NMEAF used either to pay off its pre-1993 bonds or pay off bonds that refunded those subsequent bonds (for example, bonds NMEAF used to refund prior bonds that paid off the pre-1993 bonds). NMEAF considers a loan financed by a “9.5 Refund” or “Refunding” bond to be eligible for the 9.5 percent floor calculation.
- A “Non-floor”, “New”, or “NF” bond is a bond that provides new money. NMEAF does not consider a loan financed by a “Non-floor”, “New”, or “NF” bond to be eligible for the 9.5 percent floor calculation.

**Comments**

|   |  |
|---|--|
|   | \$53,940,000 o/s & refunded \$38m by '93-Two |
|   | \$5,255,000 o/s & refunded by '95-IV         |
|   | \$43,805,000 o/s & refunded by '94-Three     |
|   | \$71,835,000 o/s & refunded by '92-One       |
|   | Refunded 1988-B Bonds                        |
|   | Refunded \$38m of 1985 Bonds                 |
|   | Refunded by 1994-II & 1995-IV Bonds          |
|   | Refunded o/s portion of 1988 Bonds           |
|   | Refunded \$75m of 93-I Bonds                 |
| - | Refunded \$75m of 93-I Bonds                 |
| - | Refunded o/s portion of 1987 Bonds           |
|   | NEW, Non-floor                               |
|   | Refunded portion of 92-1, 93-2 & 94-3        |
|   | NEW, Non-floor                               |
|   | Refunded portion of 1992 Bonds               |
|   | NEW, Non-floor                               |
|   | Refunded portion of 1992 Bonds               |

**Comments**

NEW, Non-floor  
 Refunded portion of 1992 Bonds

Refunded portion of 92-1, 93-2, 94-3 & 94-II  
 NEW, Non-floor

Refunded portion of 92, 92-1, 93-2, 94-3, 94-II, 95-IV & 95-A (9.5-floor)

Refunded portion of 94-II & 95-IV

Refunded portion of 95-A (Non-floor)

NEW, Non-floor

TAXABLE, Non-floor

Refunded portion of 92, 92-1, 93-2, 94-3, 94-II, 95-IV & 95-A (9.5-floor)

NEW, Non-floor

Refunded portion of 95-A (Non-floor)

Refunded by 1999 Bonds

NEW, Non-floor

Refunded portion of 92, 92-1, 93-2, 94-3, 94-II, 95-IV & 95-A (9.5-floor)

Refunded portion of 95-A (Non-floor) & 95A-ALF

NEW, Non-floor

Refunded by 2000 Bonds

NEW, Non-floor

Refunded portion of 92-1, 93-2, 94-3, 95-IV & 95-A (9.5-floor)

Refunded portion of 92, 94-II & 95-IV

Refunded portion of 95-A (Non-floor) & 95A-ALF

NEW, Non-floor

Refunded portion of 92, 92-1, 94-3 & 95-IV; 95-A & 98 (9.5 floor)

Refunded portion of 95-A & 96-B (Non-floor) & 95A-ALF

NEW, Non-floor

Refunded final portion of 1992 Bonds

Refunded portion of 93-2; 95-A, 96-B & 98A-1 (9.5 Floor)

Refunded portion of 92 & 95-IV; 96A-1, 98A-1, 2000A-2&3 (9.5 Floor)

Refunded portion of 94-II & 95-IV; 2000A-3 (9.5 Floor)

NEW, Non-floor

Refunded portion of 92-1 & 94-3

Refunded portion of 94-II & 95-IV; 96B-1, 98A-1 & 98B-1 (9.5 Floor)

Refunded portion of 95-A (Non-floor) & 95A-ALF

NEW, Non-floor

**Comments**

Refunded portion of 98A-2, 99A-2, 2000A-3,  
2001A-1 (9.5 Floor)

Refunded portion of 94-3; 95-A (9.5 Floor)

**Note (1):** The Bond Genealogy, as provided to us by NMEAF, incorrectly labeled the \$6,715,000 of Bond Issue 2001B-1 as bond ID# 163 when it should have been Bond ID# 160/161.

**Analysis of Loan Balance Distribution**

For the five quarters beginning on October 1, 2002, and ending on December 31, 2003, we analyzed the loan balances that were identified by NMEAF as eligible for special allowance payments using the 9.5 percent calculation, and we identified the portions of those balances attributable to each of NMEAF’s tax-exempt obligations.

The results of our analysis were used to estimate NMEAF’s eligible loan balance for Finding No. 1. Our estimate includes only the amounts attributable to loans that (1) were not pledged or transferred as security for a new obligation or (2) could have been funded, originally, by an obligation that had not been retired. As identified in the table below, our estimate is the sum of the amounts attributable to—

|  |  |
|--|--|
| <p>1. <b>Pre-1993 Obligations</b>, because the loans that continue to be associated with those obligations had not been pledged or transferred as security for a new obligation.</p>   | \$12,545,612   |
| <p>2. <b>Bond 170</b>, for the quarter ending December 31, 2002, since loans associated with that bond could have been funded, originally, by an open, tax-exempt obligation that was issued before October 1, 1993 (Bond 040). Bond 170 paid off the final outstanding balance of Bond 040, which was retired on December 9, 2002. We have not determined the portion of Bond 170 that was used to pay off the remaining obligation for Bond 040, so we have calculated our estimate of the revised balance by using the maximum loan balance that could have been funded, originally, during that quarter by Bond 040.</p> | + \$3,558,209  |
|  | <p><b><i>Revised Balance is</i></b> \$16,103,821</p> |

**Note (1)** The average quarterly balance eligible for the 9.5 percent floor calculation was about \$3.2 million. (\$16,103,821 divided by 5 quarters). —

**Quarter  
Ending  
12/31/03**

**1. Pre-1993 Obligations.** 

|  |             |
|--|-------------|
|  | \$1,315     |
|  | \$826       |
|  | \$1,343,975 |
|  | \$578,345   |

|   | <b>Quarter<br/>Ending<br/>12/31/03</b> |
|---|--|
|   | \$1,563,409                            |
|   | \$11,194,907                           |
| - | \$14,810,907                           |
| - |  |
|   | \$4,697,725                            |
|   |  |
|   | \$1,695,531                            |
|   |  |
|   | \$6,544,105                            |
|   |  |
|   | \$11,726,248                           |
|   |  |
|   | \$2,657,674                            |
|   |  |
|   | \$23,524,627                           |
|   |  |
|   | \$50,652,454                           |
|   | \$26,484,751                           |
|   |  |
|   | \$10,271,718                           |
|   | \$5,822,748                            |
|   | \$68,148,369                           |
|   |  |
|   | \$2,489,067                            |
|   | \$3,000,430                            |
|   | \$67,925,131                           |

 **2. Bond 170**

Special Allowance Payments to NMEAF

APPENDIX B

| Bond Issue | Original Issue Date | IFA Bond ID | Quarter Ending 12/31/02 | Quarter Ending 3/31/03 | Quarter Ending 6/30/03 | Quarter Ending 9/30/03 | Quarter Ending 12/31/03 |
|------------|---------------------|-------------|-------------------------|------------------------|------------------------|------------------------|-------------------------|
| 2003A-1    | 10/9/2003           | 183         |                         |                        |                        |                        |                         |

**Totals:** \$286,129,486 \$299,105,315 \$308,246,553 \$314,111,557 \$315,134,259

**Note (2):** The Bond Genealogy, as provided to us by NMEAF, incorrectly labeled the \$6,715,000 of Bond Issue 2001B-1 as bond ID# 163 when it should have been Bond ID# 160/161.

### **Potential Overpayment in Finding No. 2**

As described in Finding No. 2, we judgmentally selected 70 student loans for which NMEAF received special allowance payments under the 9.5 percent floor calculation. Our sample was selected from the loans included in NMEAF's billing reports for the quarters ended December 31, 2002 (38 loans), and December 31, 2003 (32 loans). We identified the applicable categories in those billing reports that had the largest balances, and from those categories, selected loans with large balances.

We determined that 66 of the 70 selected loans were ineligible for the 9.5 percent floor calculation, because the records for the 66 loans did not show that they had been funded with the proceeds of a pre-1993 obligation. The 70 loans in our sample had an outstanding balance of \$1,142,614 and the 66 loans we determined were ineligible had an outstanding loan amount of \$1,056,402.

Based on our review of these 70 loans, we calculated, informally, that there might have been an overpayment to NMEAF of about \$17.2 million, for the five quarters from October 1, 2002, through December 31, 2003. However, since the method we used to select the 70 loans in our judgmental sample does not allow us to calculate a statistically valid estimate of special allowance overpayments to NMEAF, our identification of a potential overpayment is intended only for use as a general indicator of the potential effect of NMEAF's practices for funding loans and for documenting loans' eligibility for special allowance payments under the 9.5 percent floor calculation. Our informal calculation is based on an assumption that the judgmental sample is nevertheless reflective of NMEAF's practices.

The method we used to determine the potential overpayment is shown in the table below:

| <b>Quarter Ending</b> | <b>Balance Claimed</b> | <b>Special Allowance Paid</b> | <b>Revised Balance</b> | <b>Revised Payment</b> | <b>Potential Overpayment</b> |
|-----------------------|------------------------|-------------------------------|------------------------|------------------------|------------------------------|
| 12/31/02              | \$286,119,485          | \$3,556,257                   | \$21,588,159           | \$268,325              | \$3,287,932                  |
| 3/31/03               | \$299,105,216          | \$3,401,772                   | \$22,567,953           | \$256,669              | \$3,145,103                  |
| 6/30/03               | \$308,246,554          | \$3,536,669                   | \$23,257,681           | \$266,847              | \$3,269,822                  |
| 9/30/03               | \$314,111,557          | \$4,042,674                   | \$23,700,205           | \$305,026              | \$3,737,648                  |
| 12/31/03              | \$315,134,264          | \$4,075,277                   | \$23,777,369           | \$307,486              | \$3,767,791                  |
| <b>Total</b>          |                        | \$18,612,649                  |                        | \$1,404,353            | <b>\$17,208,296</b>          |

In this table, the column(s) headed—

- **Balance Claimed** and **Special Allowance Paid** contain the actual balance of the loans NMEAF reported as eligible for the 9.5 percent floor calculation on its quarterly special allowance billing request and the actual amount of the Department’s special allowance payment to NMEAF.
- **Revised Balance** was calculated by dividing the amounts outstanding for the 70 loans (\$1,142,614) into the amounts outstanding for the 66 ineligible loans (\$1,056,402), to identify a potential percentage of ineligible dollars (92.455%). The Balance Claimed was then multiplied by the complement of this percentage (7.545%), which is used to identify the potential percentage of eligible dollars.
- **Revised Payment** was calculated by multiplying the Special Allowance Paid by the potential percentage of eligible dollars in our sample (7.545%).
- **Potential Overpayment** is the Special Allowance Paid minus the Revised Payment.
-



Mexico Educational Assistance Foundation

## Appendix D

### *NMEAF Response to Draft Audit Report*

January 13, 2005

Mr. Richard J. Dowd  
Regional Inspector General for Audit  
U.S. Department of Education  
Office of Inspector General  
111 North Canal Street, Suite 940  
Chicago, Illinois 60606-7204

Dear Mr. Dowd:

As I explained in my correspondence dated December 21, 2004, the New Mexico Educational Assistance Foundation (NMEAF) strongly objects to findings #1 and #2, as well as the recommendations in the Draft Audit Report (Control Number ED-OIG/A05-E0017), which NMEAF received via electronic mail on December 16, 2004 and via hard-copy on December 22, 2004. In the remainder of this correspondence we will detail our position as to why tax-exempt refunding bonds extend the eligibility of the 9.5% floor treatment for special allowance calculations. We have intentionally not addressed the issue of the transferring of loans from a 9.5% floor eligible tax-exempt bond to taxable financings and the extension of the 9.5% floor with these loans since we do not claim the 9.5% floor on such loans.

#### Finding #3

NMEAF concurs with Finding #3, since prior to the completion of their on site visit we pointed out to your staff the incorrect classification of a portion of the 1998 bond issue as being eligible for the 9.5% floor special allowance. NMEAF staff has calculated the amount of "9.5% floor" special allowance received on the loans in the \$4.7 million portion of the bond issue, and has submitted the \$688,767 adjustment with its LaRS billing for the quarter ending June 30, 2004. The U.S. Department of Education auditors from the Dallas Regional Office have reviewed the identification of the calculation errors, and the calculation and adjustment methodology. Their report to NMEAF is that they found no issue with the calculation and the adjustment that has already been made.

#### Finding #1

The OIG staff continues to ignore the applicable statute, regulations, and Department guidance on the treatment of refunding bonds. For the position taken by the OIG in Finding #1 to be accurate, all regulations and guidance issued by the Department after the signing of the Omnibus Budget Reconciliation Act of 1993 would have to be ignored. The attached correspondence dated January 11, 2005 from Mr. John Keohane, Esq. (our bond counsel), along with the attached Appendix and supporting documentation, clearly identifies the legal status of loans being funded by tax-exempt bonds originally issued

prior to October 1993. As his analysis indicates, the treatment of tax-exempt refunding bonds issued to refund tax-exempt bonds originally issued prior to October 1993 extends the eligibility for the 9.5% floor treatment in relation to the special allowance calculation. For this not to be the case, one would need to ignore the insertion of the word "originally" in the draft language proposed in S 1134 and HR 2264 that was included in the final language in the Omnibus Budget Reconciliation Act of 1993. When this issue was being considered in 1993, several secondary markets that had 9.5% floor eligible bonds outstanding pointed out that the bonds would mature long before the loans that were being held in the bond issue. In addition, some states had limitations on the term of the bond issues that were shorter than allowed in federal statute. Congress recognized the problem, and inserted the word "originally" in the final language to specifically enable refundings of these tax-exempt bond issues and transfer of the loans.

Realizing the potential ramifications of this new statutory language and its interpretation, especially in light of the new regulations that had just been issued by the Department implementing the reauthorization changes of 1988, legal counsel for the Alabama Higher Education Loan Corporation requested a clarification from the Department's policy staff in August 1993. The enclosed letter clearly outlines the refunding bonds being contemplated by the Alabama Higher Education Loan Corporation, and Pam Moran's response clearly indicates a position that the loans securing the refunding bonds would continue to be eligible for the "9.5% floor" treatment. This position by the policy staff of the Department was again reinforced in Dear Colleague Letters #93-L-161, 95-L-181, and 96-L-186. In particular, 93-L-161 states that if the tax-exempt status of the refunding bond does not change, the bond issue and loans contained therein remain eligible for the 9.5% floor treatment.

This position was further solidified when the auditors from the Dallas Regional Office began to see these 9.5% floor refunding bond issues at the various secondary markets. They requested a clarification from the policy staff at the Department, and received written confirmation from Mr. George Harris dated July 17, 2002 that indeed, the refunding bonds continued to maintain the eligibility for the 9.5% floor treatment.

If we look further at the response of the Assistant Secretary for Postsecondary Education to the GAO report titled "Federal Family Education Loan Program – Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments", we see that the reference included in the draft report leaves out some important references. The response referenced indicated in the second paragraph that the GAO described three strategies employed by lenders and loan holders to maintain and even increase their 9.5% loan portfolios. Nowhere in the correspondence does the Assistant Secretary indicate the three strategies described by the GAO are inaccurate. In fact, the second strategy indicated in the report states "Lenders can issue a new bond, called a refunding bond, to repay an outstanding pre-10/1/93 tax-exempt bond that financed 9.5% loans. Consequently, the refunding bond finances the 9.5% loans and may have a later maturity date than the original bond, allowing lenders to maintain their 9.5% loan volume for a longer time." This does not allow for the conclusion reached by the OIG in its Draft Audit Report since the bond originally issued prior to 10/1/93 is not retired or defeased, it

is refunded. To conclude otherwise is not supported by the GAO findings or the Assistant Secretary's correspondence.

Congress entered the discussion when it proposed and passed HR 5186. All of the discussion on the House and Senate floors detailed in Mr. Keohane's letter clearly indicates that Congress recognized the ability for lenders to extend eligibility for the 9.5% floor by refunding the bonds originally issued prior to October 1, 1993 with a tax-exempt refunding bond. This ability was cited time and again as a major reason for the legislation. When the President signed HR 5186 on November 21, 2004, this ability to extend the term of the 9.5% floor bonds by any type of refunding was terminated as of September 30, 2004, but clearly existed before this time.

Finding #2

Finding #2 is based on the same faulty/specious logic, as Finding #1, that being that a tax-exempt refunding bond cannot extend the 9.5% floor eligibility. The analysis of the 70 loans in this finding concluded that a majority of the loans sampled were improperly billed for the 9.5% floor special allowance since they resided in a tax-exempt refunding bond that was issued after October 1993. Since I have clearly outlined the argument regarding the eligibility of the tax-exempt refunding bonds for the 9.5% floor treatment in the detail under Finding #1, it would be of little import to outline the same argument again. Suffice it to say that if a tax-exempt refunding bond issue can extend the eligibility for the 9.5% floor treatment, loans residing in and securing such bond issue are eligible for the 9.5% floor treatment.

Recommendations

NMEAF strongly objects to the recommendations identified in the Draft Audit Report. Our objection centers on the position that, except for the loans misclassified as 9.5% floor eligible in error, NMEAF has been billing the Department correctly for the 9.5% floor loans. There are no further instructions required by the COO, and there are no adjustments to be calculated.

In closing, we assert that the OIG staff has ignored the statutory construct, applicable regulations, and Departmental guidance to arrive at Finding #1, #2, and its recommendations. This, even after NMEAF provided reference to the applicable regulations and guidance in a letter from our bond counsel and during our exit interview. To continue to take this position in the face of the facts and legal documentation goes beyond the point of being a misunderstanding to being reckless.

If you have any questions regarding our response or our bond counsel's letter with attached Appendix, please feel free to contact me at 505.761.2010 or via e-mail at [farbere@nmstudentloans.org](mailto:farbere@nmstudentloans.org).

Sincerely,



Elwood G. "Woody" Farber  
President

CC: Ms. Sally Stroup  
Ms. Terri Shaw  
Mr. John Keohane, Esq.  
Mr. Reginald Storment, Esq.



Appendix D

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January 11, 2005

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*PRIVILEGED AND CONFIDENTIAL*

Mr. Elwood Farber  
President  
New Mexico Educational Assistance Foundation  
7400 Tiburon  
Albuquerque, NM 87109

Re: New Mexico Education Assistance Foundation  
U.S. Department of Education  
Inspector General  
Draft Audit Report - ED - OIG/AO5-E0017  
December 2004

Dear Mr. Farber:

We are writing in response to your request that as your counsel we review and comment upon the above captioned draft report of the U.S. Department of Education's Office of Inspector General entitled "Audit of Special Allowance Payments to New Mexico Educational Assistance Foundation". In particular you have directed our attention to Findings No. 1 and No. 2 of such draft report. Finding No. 3 is a finding discovered by the Foundation and reported by the Foundation to the Office of the Inspector General.

In the course of our review, we have reviewed an exception report as to 9.5% Special Allowance (what we understand to be in the nature of a pre-draft draft) by the Office of the Inspector General, to which the Foundation responded earlier by your letter and our letter of August 26, 2004 to you (a copy of which we understand was delivered by you to the Office of the Inspector General).

As noted in our letter of August 26, 2004, it is our understanding that (except for the instance described in finding No. 3) at no time did the Foundation bill the 9.5% floor rate on any loan which was not a loan made or purchased with funds from the proceeds of tax exempt obligations issued prior to October 1, 1993 or from tax exempt refundings of such obligations.



Mr. Elwood Farber  
January 11, 2005  
Page 2

For the reasons set forth below and in the accompanying Appendix, we advise you that we believe the Foundation's actions as referenced in the prior paragraph are wholly consistent with the provisions of 20 USC §1087-1 (b)(2)(B) (i) through (iv) and to the extent the Draft Audit Report takes exception to such actions the Office of the Inspector General is in error.

The major error is that it does not apply the statute, i.e., 20 USC §1087-1(b)(2)(B)(iv), to determine which loans do not receive the 9.5% floor rate:

loans which are financed with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993....

The Office of the Inspector General ignores the word "originally" or treats it as redundant. Indeed, in their reading there is no difference if the provision read "originally issued" or "issued" and in doing so the Office violates one of the main rules of statutory construction, i.e., to give each word effect. No less a body than the Supreme Court noted that in statutory construction it was its duty to give effect, if possible, to every clause and word of a statute. United States v. Menasche, 348 US 528, 538-539 (citing to Montclair v. Ramsdell, 107 U.S. 147, 152. See also "...a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void or insignificant" Duncan v. Walker, 533 U.S. 167, 121 S. Ct. 2120, 2125 (2001). In our earlier letter to the Foundation (which we understand was forwarded to the Office of the Inspector General) we noted our participation in discussions in 1993 with representatives of the Congress in which the need to permit refundings was specifically addressed and the word "originally" was inserted for the purpose of having the 9.5% floor apply to loans financed by the tax exempt refundings. We can understand that the Office of the Inspector General might not be willing to accept our word on this but we assume that the circumstances described should be verifiable from pre-introduction drafts of the legislation.

Additionally, if the Office of the Inspector General is unwilling or unable to accept our representation that tax-exempt refundings were specifically discussed and intended to be eligible for the 9.5% floor rate, why will it not accept the substantially contemporaneous statements of the Department of Education set forth in the November 1993 Dear Colleague Letter (93-L-161), the December 1993 Dear Colleague Letter (93-L-163(LD)) or the June 1995 Dear Colleague Letter (95-L-181(LD)), all of which reiterate how floor treatment will apply to loans refinanced by post October 1, 1993 tax exempt obligations as described in the attached Appendix?



Mr. Elwood Farber  
January 11, 2005  
Page 3

Or failing that, how does the Office of the Inspector General account for the correspondence between counsel for the Alabama Higher Education Loan Corporation and the Department (October-November, 1993) in which the Department clearly agreed that a post October 1, 1993 tax exempt refunding of pre-October 1, 1993 tax exempt obligations would continue to qualify loans financed by the refunding issue for 9.5% floor treatment?

We do acknowledge that the Office of the Inspector General does attempt to apply to the 1993 amendments provisions of the pre-existing 1992 regulations without attempting to determine whether the 1993 amendment provisions changed the circumstances addressed by the 1992 regulations and further the Office of the Inspector General applies to the 1993 amendment provisions of the 1996 Dear Colleague Letter which specifically states that it does not apply to statutory amendments subsequent to 1992. As Sutherland on Statutory Construction (Statutes and Statutory Construction – Sixth Edition – 2000 Revision) notes under “Administrative Regulations,” §31:6 (page 726): “No deference to a former interpretation by an administrative agency can control where the interpretation is in conflict with a subsequently enacted legislative mandate.” The Supreme Court has addressed this issue in relation to Treasury regulations: “Treasury regulations and interpretations long continued without substantial change, *applying to unamended or substantially reenacted statutes*, are deemed to have received congressional approval and have the effect of law”, U.S. v. Cleveland Indians Baseball Co., 532 U.S. 200, 121 S. Ct. 1433 at 1445 (2002) (emphasis added), citing to Cottage Savings Assn. v. Commissioner, 499 U.S. 554, 561, 111 S. Ct. 1503 (1991) citing to U.S. v. Correll, 389 U.S. at 305-6, 88 S. Ct. 445 (1967). The Supreme Court application clearly supports the position in Sutherland with respect to an amended statute such as we have here.

Additionally, the Office of the Inspector General does not determine but rather assumes that the 1992 regulations are valid even though the effect of such regulations are to apply the one-half special allowance rate established pursuant to 20 USC §1087-1(b)(2)(B)(i) with respect to loans made or purchased with funds obtained by the holder from the issuance of obligations the income from which is exempt from taxation under Title 26 to those obtained from the issuance of obligations other than those the income from which is exempt from taxation under Title 26.

That the Department may have thought it had good financial reasons (an anticipation of rising interest rates) for making this change (as discussed on page 34 of the GAO Report referenced in the Appendix hereto) does not change the fact that the Department was not authorized to go beyond or change the statute. The Department may not by regulation amend a statute or add to a statute something which is not there. California Cosmetology Coalition v. Riley, 110 F3d 1454, 1460 (9th Cir. 1997).



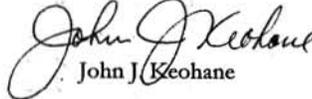
Mr. Elwood Farber  
January 11, 2005  
Page 4

As noted in the Appendix, during the discussion on HR 5186, in both the House and Senate, there was agreement that recycling of 9.5% floor loans in pre-October 1, 1993 tax exempt obligations and tax exempt refundings of such obligations would continue unabated (even though some of the members thought it should not but conceded the legislation before them permitted its continuance).

Based on the above, we again state the draft audit report is in serious error and does not comport with the applicable provisions of the Higher Education Act.

We assume you will be delivering a copy of this letter to the Inspector General.

Very truly yours,

  
John J. Keohane

**Privileged and Confidential****APPENDIX ON 9 1/2% FLOOR**

Student loans made or insured on or after October 1, 1980 "which were made or purchased with funds obtained by the holder from the issuance of obligations, the income from which is exempt from taxation under Title 26" have, pursuant to the provisions of 20 USC §1087-1(b)(2)(B)(ii), generally been entitled to an effective rate of return of not less than 9 1/2%\* (the so-called "floor"). Amendments of this provision in 1992 simplified the formula but did not change the floor.

In 1993, as part of the Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, the Congress determined to terminate the floor provision prospectively for loans "financed by funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993, the income from which is excluded from gross income under the Internal Revenue Code of 1986" 20 USC §1087-1(b)(2)(B)(iv).

Prior to the introduction of the 1993 amendments representatives of the tax exempt student loan bond issuers, either non-profits or state agencies, and their counsel, had discussions with Congressional representatives about the proposal during which it was noted that bonds then outstanding that had been issued (due to the prevailing interest rate market) for periods insufficient to amortize the student loans would have to be refunded and if the proposed amendment did not take such refundings into consideration, bond defaults were likely. To meet this concern, the word "originally" was inserted prior to "issued" to "grand-father" tax exempt refundings which relate back to the date of original issuance under the Tax Code.

The Office of the Inspector General ("OIG") of the United States Department of Education (the "Department") has recently taken and attempted to enforce an interpretation of the impact of 20 USC §1087-1(b)(2)(B)(iv) which is directly counter to the history of such legislation (a matter which should be verifiable by the OIG), contemporaneous and subsequent interpretations of such provisions by the Department, recently stated interpretations by members of the Congress and the rules of statutory construction.

**Department Interpretations****November 1993 Dear Colleague Letter (93-L-161)**

The stated purpose of such letter was to provide the student loan community with information on the major changes mandated by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66) signed into law on August 10, 1993. In its cover letter, the Department noted: While some changes are self-implementing and supersede current regulations, other changes will require that new regulations be published."

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\* Loans made or insured on or after October 1, 1980 from exempt obligations received only half the standard special allowance payment. See also Federal Register/Vol. 57, December 18, 1992, 34 CFR §682.302.



On page 13 of such letter under the caption "Special allowance payments - §438(b)(2)" it is stated:

The minimum special allowance rate "floor" on new loans made or purchased, in whole or in part, with funds derived from tax-exempt obligations has been repealed. Accordingly, loans made or purchased with funds obtained by the holder from the issuance of obligations *originally issued on or after October 1, 1993* [or other related sources] no longer qualify to receive the minimum special allowance. Refinancing of obligations which were originally issued prior to October 1, 1993, does not alter the eligibility of loans made or purchased with funds obtained from the proceeds of the original financing to receive the minimum special allowance. [Both "originally" and "on or after October 1, 1993" in the second prior sentence are italicized in the Dear Colleague Letter.]

**Response to Alabama Higher Education Loan Corporation**

On October 13, 1993, counsel to the Alabama Higher Education Loan Corporation (the "Corporation") sought guidance from the Department as to whether certain eligible loans financed "from the issuance of tax-exempt obligations originally issued prior to October 1, 1993" would be eligible for the special allowance rate based on Section 438(b)(2)(B)(i) and (ii) of the Higher Education Act [20 USC §1087-1(b)(2)(B)(i) and (ii)] since, the Corporation posited "they would not be eligible for the full special allowance rate (without a floor) provided for in Section 438(b)(2)(B)(iv) of the Higher Education Act [20 USC §1087-1(b)(2)(B)(iv)]" upon their refunding and retirement by the issuance of post-October 1, 1993 tax exempt obligations.

On November 24, 1993, Pamela A. Moran, Acting Chief, Loans Branch, Division of Policy Development, Policy, Training, and Analysis Service of the Department, responded:

you indicated that the Alabama Higher Education Loan Corporation...intends to issue "tax-exempt" refunding bonds to redeem or otherwise retire the three original obligations, specified in your letter, each of which was issued prior to October 1, 1993. Based on the facts presented in your letter, we concur that the special allowance rates will continue to be determined pursuant to §§438(b)(2)(B)(i) and (ii) of the Higher Education Act of 1965, as amended."

*Neither the request nor the response cites to the pre-1993 regulations.*

**December 1993 Dear Colleague Letter (93-L-163(LD))**

This letter contained information and provided guidance on the changes made by the Omnibus Budget Reconciliation Act that affected the Lender's Interest and Special Allowance Request and Report. Part IV thereof, under the caption "Special Allowance" used language substantially the same as that used in the November 1993 Dear Colleague Letter cited above:

The minimum special allowance rate "floor" on new loans made or purchase, in whole or in part, with funds derived from tax-exempt obligations has been repealed. Accordingly, loans made or purchase with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993 [or certain funds derived therefrom] no longer qualify to receive the minimum special allowance. Refinancing of obligations which were originally issued prior to October 1, 1993, does not alter the eligibility of loans made or purchased with funds obtained from the proceeds of the original financing to receive the minimum special allowance.

*This guidance did not cite to the pre-1993 regulations.*

**June 1995 Dear Colleague Letter (95-L-181(LD))**

This letter provided instructions for reporting the changes required by the Omnibus Budget Reconciliation Act of 1993. In such letter the Department distinguished between "new money" and "old money".

A new special allowance category (SH) has been added for loans made or purchased with funds obtained by the holder for (sic) the issuance of obligations originally issued on or after October 1, 1993 ("new money")...

Tax exempt loans made or purchased with funds obtained by the holder from the issuance, *or refinancing*, of obligations originally issued prior to October 1, 1993 ("old money") will continue to be calculated by taking the greater of one-half the annual special allowance rate using 3.5% in the formula, or using the floor of 9.5% less the applicable interest rate. (*italics added*)

*This guidance did not cite to the pre-1993 regulations.*



**March 1996 Dear Colleague Letter (96-L-186)**

The subject of this letter was stated as “[c]larification and interpretive guidance on certain provisions in the Federal Family Education Loan (FFEL) Program regulations published on December 18, 1992. It is the response to question 30 thereof which has given rise to the “glitch” or “loop hole” in the Higher Education Act which was the intended target of the provisions of H.R. 5186 recently enacted.

What this Dear Colleague Letter by its own terms *does not do* is attempt to clarify or interpret any of the provisions of the Omnibus Budget Reconciliation Act of 1993 and specifically not any of the provisions of the floor. As stated in its preamble, the letter only covers changes made by statutes enacted prior to 1993.

The question and answer are as follows:

30. Section 682.302(e), which pertains to eligibility for special allowance for loans made or acquired with obligations on which the interest is exempt from taxation (tax-exempt obligations), has been revised in the 1992 regulations. What is the significance of the change and which is the effective date of the change?

Section 682.302(e) was revised to reflect a shift in the Department’s policy regarding loans made or acquired with the proceeds of tax-exempt obligations. The regulations in effect prior to December 18, 1992 stated that a lender was paid special allowance on a loan made or acquired with the proceeds of a tax-exempt obligation based on the rules applicable to loans financed with taxable obligations and the prior tax-exempt obligation was retired or defeased. The regulations were silent as to the method of calculating the applicable special allowance rate for a loan made or acquired with a tax-exempt obligation that was subsequently refinanced with the proceeds of a taxable obligation, but the prior tax-exempt obligation remained outstanding. The Department’s prior guidance stated that the current funding source defined the applicable special allowance provisions – if a loan was financed with the proceeds of a tax-exempt obligation, the tax-exempt special allowance rule applied. If the loan was financed with the proceeds of a taxable obligation, the taxable special allowance rules applied.

In the December 18, 1992 regulations, the Department changed this policy. Under the regulations, if a loan made or acquired with the proceeds of a tax-exempt obligation is refinanced with the proceeds of a taxable obligation, the loan remains subject to the tax-exempt special allowance provisions if the authority retains



legal interest in the loan. If, however, the original tax-exempt obligation is retired or defeased, special allowance is paid based on the rules applicable to the new funding source (taxable or tax-exempt).

This change is effective as of the effective date of the 1992 regulations, February 1, 1993, and applies to all loans transferred from a tax-exempt obligation to a taxable obligation on or after that date.

Adjustments to ED 799 billings and current billings for any loans covered by this policy should be made issuing the applicable tax-exempt special allowance codes for the periods that the holder retains legal interest in the loan and the original tax-exempt obligation has not been retired or defeased.

Since the analysis in the answer was based on the Higher Education Act as it predated the 1993 amendments, it did not incorporate such amendments or the guidance in any of the above referenced Department documents.

**August 3, 1999 Proposed Rule**

On August 3, 1999, the Department published a notice of proposed rulemaking purportedly to implement changes made to the Higher Education Act of 1965 by the Higher Education Amendments of 1998, but included in such proposal was the first rulemaking with respect to the implementation of 20 USC §1087-1(b)(2)(B)(iv).

See: Federal Register/Vol. 64, No. 148, Tuesday, August 3, 1999/Proposed Rules, p. 42176.

Under its Proposed Regulatory Changes, the Department stated:

[T]hese proposed regulations also reflect the changes made to the HEA relating to the special allowance calculation for loans made or purchased with the proceeds of the tax-exempt funds. More specifically, these proposed regulations specify which loans qualify for the minimum (or floor) special allowance rate and are subject to the 50 percent limitation on the maximum special allowance rate. 42179

The proposed rule contemplated amending Section 682.302 of the regulations by adding a provision (c)(3)(i)(A) thereto providing that loans funded from:



[t]he proceeds of tax-exempt obligations originally issued prior to October 1, 1993, the income from which is exempt from taxation under the Internal Revenue Code of 19867 [p. 42190]

would qualify for the minimum (or floor) special allowance rate and are subject to the 50 percent limitation on the maximum special allowance rate. [p. 42190] The proposal continued in (c)(4) thereof to make clear that:

[l]oans made or purchased with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993...do not qualify for the minimum special allowance rate specified in paragraph (c)(3)(iii) of this section, and are not subject to the 50 percent limitation on the maximum rate otherwise applicable to loans made with tax-exempt funds. [p. 42190]

#### **October 29, 1999 Final Rules**

On October 29, 1999, the Department published its final rules on 34 CFR Part 682, see Federal Register/Vol. 64, No. 209/Friday, October 29, 1999/Rules and Regulations, p. 58622, with the provisions of Section 682.302 as to the floor/non-floor as set forth in the Proposed Rules.

#### **September 2004 United States Government Accountability Office Report**

In response to a request from Members of the House of Representatives, the United States Government Accountability Office ("GAO") on September 20, 2004 issued its report entitled: "Federal Family Education Loan Program – Statutory and Regulatory Changes Could Avert Billion in Unnecessary Federal Subsidy Payments" (the "GAO Report").

The GAO Report notes: "[t]he primary factor influencing the increase in special allowance payments has been the sharp decline in interest rates paid by borrowers relative to the minimum 9.5 percent guaranteed yield for lenders". GAO Report, p. 3. Increasing floor loan volume was also a factor and the GAO refers to the methods of increasing such volume as "recycling, refunding and transferring", GAO Report, p.4, which the GAO explains as follows:

First, after paying costs associated with a pre-October 1, 1993 tax-exempt bond (such as payments of interest and principal to bond investors), lenders can reinvest, or recycle, any remaining money earned from 9.5 percent loans to make or purchase additional loans that, under the law, are also guaranteed a minimum 9.5 percent lender yield. Using this method, lenders are able to slow the decrease in, maintain, or slightly increase their 9.5 loan volume.

Second, lenders can issue a new bond, called a refunding bond, to repay the principal, interest, and other costs of an outstanding pre-



October 1, 1993 tax-exempt bond. Based on how the HEA has been interpreted, 9.5 percent loans originally financed with a pre-October 1, 1993 tax-exempt bond, but subsequently financed by a refunding bond, continue to carry the government guaranteed minimum yield for lenders of 9.5 percent. Moreover, the refunding bond may have a later maturity, or payoff, date than the original bond. Using this method, lenders can maintain their 9.5 per cent loan volume.

Third, under Education regulations, a lender can significantly increase its 9.5 percent loan volume by issuing a taxable bond and using the proceeds to purchase 9.5 percent loans financed by a pre-October 1, 1993 tax-exempt bond. The lender then uses the cash available from the pre-October 1, 1993 tax-exempt bond to make or but additional loans, which are guaranteed the minimum 9.5 percent yield. Under regulations issued in 1992, the loans transferred to the taxable bond continue to be guaranteed the minimum 9.5 percent lender yield, so long as the original bond is not retired or defeased. (At the time the regulation was promulgated, Education anticipated that interest rates would rise, resulting in a higher lender yield for loans financed with taxable bonds than for loans financed with tax-exempt bonds. Education believed that if the 1992 regulation was not promulgated, lenders would have had an incentive to transfer loans from tax-exempt bonds to taxable bonds in order to obtain a higher yield, thus resulting in higher special allowance payments for the government.)

#### H.R. 5186

#### House of Representatives

H.R. 5186 "An Act to reduce certain special allowance payments and provide additional teacher loan forgiveness on Federal student loans", passed the House of Representatives on October 7, 2004 and the Senate on October [9], 2004 and was signed into law by the President on October 30, 2004 as P.L. 108-409.

Mr. Boehner of Ohio, Chairman of the Education and the Workforce Committee, described what H.R. 5186 would not do:

Now there are some who say this bill does not go far enough. They contend it should shut down subsidies retroactively. Congressional Record, October 6, 2004, H 8321.



Mr. Miller of California, Ranking Member of the Education and the Workforce Committee, addressed a similar theme:

But tragically tonight we only answer a part of that call because we do not deal with those provisions in this program that continue these unconscionable profits at the 9.5 percent loans due to the recycling. We are going to stop this loophole for this year, and we ought to stop the recycling. This is not retroactive. Congressional Record, October 6, 2004, H 8322.

Mr. McKeon of California, Chairman of the Subcommittee on 21st Century Competitiveness of the Education and Workforce Committee stated:

The bill before us is the first step to permanently ending the 9.5 percent special allowance subsidy.... Prospective changes like those in the bill before us will ensure the loophole is shut down without jeopardizing student benefits. The GAO recently recommended Congress put an end to the excess loan provider benefits with prospective changes. That is because the GAO recognizes that retroactive changes would harm students by reducing borrower benefits. Congressional Record, October 6, 2004, H 8322.

Mr. Kildee of Michigan (one of the requesters of the GAO Report) stated:

However, it is important that Members understand that this bill has two major deficiencies. First of all, it does not completely close the loophole which lenders have been exploiting. It keeps on "recycling". Congressional Record, October 6, 2004, H 8323.

Mr. Van Hollen of Maryland (the other requester of the GAO Report) stated:

. . . I introduced an earlier bill...that would close the 9.5 percent loophole permanently, completely, immediately and prospectively, not retroactively...Unfortunately, we have not had an opportunity in committee or on this floor to deal with that bill that would address the problem fully and permanently . . . . But when we take a look at the bill, it has two very serious problems . . . .Secondly, it does leave a big part of the loophole in place. It would continue to permit lenders to make 9.5 percent eligible loans using the proceeds from existing 9.5 percent-eligible loans through a scheme or process called recycling. Congressional Record, October 6, 2004, H 8324.

Ms. Jackson-Lee of Texas:



The bill continues a current lender practice typically referred to as "recycling". Recycling involves lenders using the interest payments from student borrowers and the excessive subsidies paid by the Federal government to make new loans which also receive a guaranteed 9.5 percent rate of return. Congressional Record, October 6, 2004, H 8325

Mr. Holt of New Jersey:

Let me just review what this bill does. I rise in support of H.R. 5186. It is an improvement over the current law. But it fails to address the problem. It ignores the Government Accountability Officer's recommendation to immediately stop lenders from issuing new loans at 9.5 percent. Congressional Record, October 6, 2004, H 8325

Mr. Miller of California:

But what happens with this legislation is, while hiding behind a legitimate claim by nonprofits, they keep open that recycling loophole that is overwhelmingly used, according to the General Accountability Office, by for-profit lenders. Nothing to do with retroactivity, because we stop this practice in the future, and we can stop recycling in the future. Congressional Record, October 6, 2004 H 8326

Mr. Boehner of Ohio:

And while I know that people want to go all the way and shut it down and be really tough, what about those nonprofit student aid organizations around the country who have these loans, who use those excessive profits to help low-income students and mostly minority students from all over the country? Congressional Record, October 6, 2004

#### Senate

Mr. Kennedy of Massachusetts:

Mr. President, this bill deserves to pass, but it's only a down-payment on the real reform needed to close a flagrant loophole in the student loan program...because it does not close all of the notorious 9.5 percent student loan loophole.... Sadly, under this Republican bill, the abuse will continue. New loans will be



made to students that taxpayers will subsidize at a 9.5 percent interest rate.

In 1993, Congress passed legislation intended to phase-out of existence the 9.5 percent bank guaranty. But two key loopholes have kept that subsidy alive and well. The legislation before the Senate closes one.

The first loophole – the one that isn't closed by this legislation – allows for what is called 9.5 percent loan “recycling”. Congressional Record, October 9, 2004, S10920

Mr. Reed of Rhode Island:

[A] grandfather clause was enacted for outstanding 9.5 percent return, tax-exempt bond generated student loan funds. Rather than end the 9.5 percent loans, this grandfather clause has worked as a loophole. Owners of 9.5 percent guaranteed loans continually recycle proceeds from tax-exempt bonds originally issued before 1993 – creating in effect a revolving loan fund – and the Federal Government continues to guarantee a 9.5 percent rate of return . . . . Regrettably, the bill before us today does not contain such a comprehensive and permanent fix. This more limited effort provides only a temporary 1-year solution and it continues to allow “recycling” of loans, as opposed to the bonds. . . . Congressional Record, October 9, 2004, S 10921.

Mrs. Murray of Washington:

[T]he Gregg bill does not fully close the loophole. This subsidy would still live on. My bill says that lenders cannot create new loans at 9.5 percent. No new subsidies-period. . . . But the Republican bill is not a real fix. It does not stop these gimmicks entirely. In many cases, lenders could keep writing new loans at 9.5 percent for decades. Congressional Record, October 9, 2004, S 10921.

## EXHIBITS TO APPENDIX

| <u>Name of Exhibit</u>                                 | <u>Page Reference</u> |
|--|-----------------------|
| November 1993 DCL<br>(93-L-161).....                   | 1-2                   |
| Response to Alabama<br>Education Loan Corporation..... | 2                     |
| December 1993 DCL<br>(93-L-163 LD).....                | 3                     |
| June 1995 DCL<br>(95-L-181 LD).....                    | 3                     |
| March 1996 DCL<br>(96-L-186).....                      | 4-5                   |
| August 3, 1999<br>Proposed Rule.....                   | 5                     |
| October 29, 1999<br>Final Rule.....                    | 6                     |
| September 2004<br>GAO Report.....                      | 6-7                   |
| HR 5186.....   | 7-10                  |

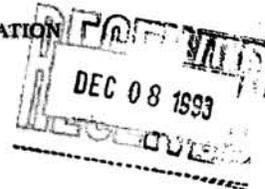
**OIG Note:**

Only the first three of the exhibits listed above are included in this Appendix D. Due to their length, we have not included the remaining six exhibits, which are readily available on the internet:

- Four exhibits are available on the Department's Information for Financial Aid Professionals (IFAP) Library, at <http://ifap.ed.gov/IFAPWebApp/index.jsp>.
- + June 1995 DCL (95-L-181 LD) and March 1996 DCL (96-L-186) are available under Archived Publications, Dear Partner/Colleague Letters, Lender Letters ("L" Type).
- + August 3, 1999, Proposed Rule, and October 29, 1999, Final Rule, are available under Archived Publications, Federal Registers, 1999 Publication Year.
- The Taxpayer-Teacher Protection Act of 2004 (Pub. L. 108-409), the signed law resulting from HR 5186, is available at <http://thomas.loc.gov/bss/d108/d108laws.html>.
- The GAO Report, "Federal Family Education Loan Program: Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments" (September 2004, GAO-04-1070) is available at <http://www.gao.gov>.



UNITED STATES DEPARTMENT OF EDUCATION  
OFFICE OF POSTSECONDARY EDUCATION  
NOVEMBER 1993



93-L-161  
93-G-246  
93-S-71

**SUMMARY:** This letter contains information about the major changes made to the Federal Family Education Loan Program by the Omnibus Budget Reconciliation Act (Pub. L. 103-66).

Dear Colleague:

The Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66) was signed into law by President Clinton on August 10, 1993. Numerous changes affecting the Federal Family Education Loan (FFEL) Program under Title IV, Part B of the Higher Education Act of 1965, as amended (HEA), were made by this legislation. The new law also established requirements for the transition of the FFEL Program to the Federal Direct Student Loan (FDSL) Program.

The purpose of this letter is to provide the student loan community with information on the major program changes mandated by the new law. While some changes are self-implementing and supersede current regulations, other changes will require that new regulations be published. As further detailed instructions on the various provisions are developed, the Office of Postsecondary Education will provide additional guidance.

We appreciate your assistance and cooperation as we work to implement these statutory changes.

Sincerely,

A handwritten signature in black ink, appearing to read "William L. Moran". The signature is fluid and cursive.

William L. Moran  
Acting Deputy Assistant Secretary  
for Student Financial Assistance

100 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202

Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.

| <b><u>TABLE OF CONTENTS</u></b>                         | <b><u>PAGE</u></b> |
|---|--------------------|
| <b>GUARANTY AGENCY PROVISIONS</b>                       |                    |
| Administrative cost allowance                           | 1                  |
| Advance fund payments                                   | 1                  |
| Assignment of guaranty agency loans                     | 1                  |
| Income-contingent repayment after default               | 1                  |
| Insurance claims paid to lenders                        | 2                  |
| Insurance premium                                       | 2                  |
| Lender-of-last-resort requirements                      | 2                  |
| Lender referral services                                | 3                  |
| Preservation and recovery of reserves                   | 4                  |
| Reinsurance fees paid by guaranty agencies to ED        | 5                  |
| Reinsurance paid by ED to guaranty agencies             | 5                  |
| Reserve requirements and transition to the FDSL Program | 5                  |
| Secretary's equitable share                             | 6                  |
| Supplemental preclaims payments                         | 6                  |
| <b>FEDERAL CONSOLIDATION LOANS</b>                      |                    |
| Eligible borrower                                       | 7                  |
| Income-sensitive repayment                              | 7                  |
| Lender fees paid to ED                                  | 7                  |
| Repayment provisions                                    | 8                  |
| Terms and conditions                                    | 8                  |
| <b>FEDERAL PLUS LOANS</b>                               |                    |
| Multiple disbursement requirement                       | 9                  |
| Variable interest rate beginning July 1, 1994           | 9                  |
| Variable interest rate beginning July 1, 1998           | 9                  |

| <b><u>TABLE OF CONTENTS</u></b>                     | <b><u>PAGE</u></b> |
|---|--------------------|
| <b>FEDERAL STAFFORD LOANS</b>                       |                    |
| Unsubsidized Federal Stafford Loan limits           | 10                 |
| Unsubsidized Federal Stafford Loan repayment period | 10                 |
| Unsubsidized Federal Stafford Loan origination fee  | 11                 |
| Variable interest rate beginning July 1, 1994       | 11                 |
| Variable interest rate beginning July 1, 1995       | 11                 |
| Variable interest rate beginning July 1, 1998       | 11                 |
| <b>OTHER CHANGES</b>                                |                    |
| Cohort default rate                                 | 12                 |
| Elimination of Federal SLS Program                  | 12                 |
| Loan fees from lenders                              | 12                 |
| Loan fees from Sallie Mae                           | 12                 |
| Origination fees                                    | 13                 |
| Special allowance payments                          | 13                 |
| State share of default costs                        | 13                 |

## GUARANTY AGENCIES

The following changes (in alphabetical order) are the major provisions of Pub. L. 103-66 that have direct implications for guaranty agencies:

### **Administrative cost allowance** **§428(f)**

The statutory authority for paying an administrative cost allowance to a guaranty agency pursuant to §428(f) of the HEA does not exist *after fiscal year 1993*, and guaranty agencies should not submit further applications for such payments. However, §458(a) of the HEA authorizes the Secretary to use administrative funds authorized by that section for various activities, including providing "... transition support (including administrative costs) for the expenses of guaranty agencies in servicing outstanding loans in their portfolios and in guaranteeing new loans ...." Additional information about this change was provided in "Dear Guaranty Agency Director" Letter 93-G-245 (October 1993).

### **Advance fund payments** **§422(c)(7)**

The HEA now clarifies the Secretary's authority to make emergency advances to a guaranty agency. Effective *August 10, 1993*, the Secretary may advance funds under this provision, on terms and conditions specified by the Secretary, to a guaranty agency to ensure that the agency is able --

1. To continue to fulfill its lender-of-last-resort obligations during the transition from the FFEL Program to the FDSL Program; or
2. To meet its immediate cash needs, including the uninterrupted payment of claims, while the Secretary is seeking to terminate the agency's agreement or assuming the agency's functions.

### **Assignment of guaranty agency loans** **§428(c)(8)**

The HEA has been amended to give the Secretary authority effective *August 10, 1993*, to direct a guaranty agency to promptly assign loans to the Secretary if the Secretary determines:

1. An assignment is required to protect the federal fiscal interest; or
2. It is necessary for an orderly transition from the FFEL Program to the FDSL Program.

### **Income-contingent repayment after default** **§428(b)(1)(D), §428(m)**

Effective for loans first disbursed *on or after July 1, 1994*, a guaranty agency must ensure that, prior to the disbursement of a loan, the borrower's promissory note or other written evidence of the loan contains a notice informing the borrower that if the borrower defaults and the loan is assigned to the Secretary, the borrower may be required to repay the loan

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## **PAGE 1 - GUARANTY AGENCY PROVISIONS**

in accordance with an income-contingent repayment schedule. The common application/promissory note approved by the Department for use in the Federal Stafford and Federal SLS Programs already contains a statement that would comply with this statutory requirement.

Before the enactment of Pub. L. 103-66, borrowers who defaulted on their loans could be subject to income-contingent repayment only after the Secretary published a finding that this method of repayment would be effective. The finding requirement has been eliminated by Pub. L. 103-66. Effective *July 1, 1994*, in accordance with §428(m) of the HEA, the Secretary must require at least 10 percent of borrowers who have defaulted on FFEL Program loans that are assigned to the Secretary to repay those loans under an income-contingent repayment plan. The terms and conditions of income-contingent repayment shall be established by the Secretary, and will be the same as, or similar to, the income-contingent repayment plan used in the FDSL Program.

**Insurance claims paid to lenders**

**§428(b)(1)(G)**

Effective for loans first disbursed *on or after October 1, 1993*, a guaranty agency's default insurance must insure not less than 98 percent (down from 100 percent) of the unpaid principal balance of loans insured under its program. Exceptions to this requirement are provided for subsidized Federal Stafford loans made pursuant to a lender-of-last-resort program and claims paid to a lender or servicer (as agent for a lender) designated as exceptional under §428I of the HEA. These loans must be insured at no less than 100 percent of the unpaid principal balance. An agency may continue to pay 100 percent of the amount of all non-default claims.

The Secretary has determined that Congress intended to bar guaranty agencies from paying lenders more than 98 percent of the unpaid principal and accrued interest on default claims filed on loans made on or after October 1, 1993. The Secretary believes, therefore, that a guaranty agency may not use its reserve fund to guarantee more than 98 percent of the unpaid principal and interest on a defaulted loan. See §422(g) of the HEA.

**Insurance premium**

**§428(b)(1)(H)**

The maximum insurance premium that a guaranty agency may charge a lender has been reduced from 3 percent to 1 percent of the principal amount of the loan. This change will become effective for loans first disbursed *on or after July 1, 1994* for periods of enrollment that either include that date or begin after that date.

**Lender-of-last-resort requirements**

**§428(j)**

1. Effective *August 10, 1993*, the HEA requires a guaranty agency to respond to a student within 60 days after the student submits an original complete application to the agency for a loan through the agency's lender-of-last-resort (LLR) program. In addition, a guaranty agency cannot subject a student applying for an LLR loan to additional eligibility requirements or requests for additional information beyond what is required to obtain a subsidized Federal Stafford Loan, nor can the student be required to receive more than two rejections from eligible lenders prior to requesting assistance from the LLR program. However, a guaranty agency may

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**PAGE 2 - GUARANTY AGENCY PROVISIONS**

provide loan counseling specifically designed to benefit a student applying for an LLR loan. In doing so, the agency may not require a student applying for an LLR loan to provide information that is not required from other students to be considered eligible for a loan.

2. Under prior law, a guaranty agency was not required to provide LLR services to students attending certain categories of schools. *See* former §428(j)(3) of the HEA. Effective *August 10, 1993*, Pub. L. 103-66 deleted that exception so that a student attending any eligible school may apply for assistance through the LLR program.
3. Effective *August 10, 1993*, if the Secretary determines that eligible students are unable to obtain loans through a guaranty agency's LLR program, the Secretary is authorized to advance funds to that agency or another guaranty agency pursuant to §422(c)(7) of the HEA, so that a guaranty agency can make such loans as directed by the Secretary. A guaranty agency making LLR loans with funds advanced by the Secretary shall be paid a fee, in an amount established by the Secretary, in lieu of interest and special allowance subsidies. The guaranty agency will be required to assign these loans to the Secretary on demand. Upon such assignment, the portion of the advance represented by the loans assigned shall be considered repaid by the agency.
4. Section 439(q) of the HEA has been amended to require Sallie Mae to make LLR loans upon the request of the Secretary, if the Secretary determines that eligible borrowers in a geographic area, or who are attending specific schools, are seeking and unable to obtain loans. *Beginning not later than 90 days after the enactment of Pub. L. 103-66 (November 8, 1993)*, Sallie Mae, or its designated agent, must make LLR loans, if requested.

#### Lender referral services

#### §428(e)

1. Effective *August 10, 1993*, the Secretary may enter into agreements with guaranty agencies that meet standards established by the Secretary to provide lender referral services in geographic areas specified by the Secretary. A student will be eligible to apply for lender referral services through a guaranty agency that has an agreement with the Secretary to provide such services if the student --
  - a. Is either a resident of, or is accepted for enrollment in, or is attending, an eligible institution located in a geographic area for which the Secretary determines that loans are not available to all eligible students.
  - b. Has sought, and was unable to find a lender willing to make an FFEL Program loan.
2. The Secretary is required to publish in the *Federal Register* whatever standards, criteria, and procedures the Secretary determines are reasonable and necessary to provide lender referral services and ensure loan access to student and parent borrowers during the transition from the FFEL Program to the FDSL Program. The HEA exempts the publication of these standards, criteria, and procedures from §431 of the General Education Provisions Act.

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### PAGE 3 - GUARANTY AGENCY PROVISIONS

3. The Secretary shall pay a lender referral fee to each guaranty agency with whom the Secretary has a lender referral agreement, in an amount equal to 0.5 percent of the principal amount of a loan made as a result of the agency's referral service.

**Preservation and recovery of reserves**

**§422(g)**

1. The HEA clarifies that guaranty agency reserve funds and any assets purchased with such reserve funds, regardless of who holds or controls the reserves or assets, are considered to be the property of the United States, to be used in the operation of the FFEL Program or the FDSL Program.
2. The Secretary is specifically permitted to direct a guaranty agency to suspend or cease activities under any contract entered into or on behalf of a guaranty agency *after January 1, 1993*, if the Secretary determines that the contract is a misuse or improper expenditure of the reserve fund (or assets) or such contract provides unnecessary or improper benefits to the agency's officers or directors. Violation of any direction issued by the Secretary under this provision may result in criminal penalties under §490 of the HEA.
3. Any contract with respect to the administration of the agency's reserve fund, or the administration of any assets purchased or acquired with the agency's reserve fund, that is entered into or extended by the agency or any other party on behalf of or with the concurrence of the agency, *on or after August 10, 1993*, shall provide that the contract may be terminated by the Secretary upon 30 days notice to the contracting parties if the Secretary determines that such contract includes an impermissible transfer of the reserve fund or assets, or is otherwise inconsistent with the terms or purposes of §422 of the HEA.
4. Effective *August 10, 1993*, the Secretary is authorized to require the return of all of a guaranty agency's reserve fund if the Secretary determines that such return is in the best interests of the operation of the FFEL or FDSL Programs or to ensure the proper maintenance of the agency's funds or assets or the orderly termination of the agency's operations and the liquidation of its assets. The Secretary also has the authority to require a guaranty agency to return to the Secretary any portion of the agency's reserve fund that the Secretary determines is unnecessary for paying the program expenses and contingent liabilities of the agency.

In addition, the Secretary may direct a guaranty agency to require the return, to the Secretary or the guaranty agency, of any reserve funds or assets held by, or under the control of any other entity, if the Secretary determines those funds or assets are needed to pay the program expenses and contingent liabilities of the guaranty agency, or which are required for the orderly termination of the guaranty agency's operations and the liquidation of its assets. The determinations of the Secretary discussed in this paragraph (unlike those in paragraph #2) must be made based on standards prescribed by regulations to be developed through negotiated rulemaking and that include procedures for administrative due process. Further information about negotiated rulemaking will be provided in a later communication from the Department.

**Reinsurance fees paid by guaranty agencies to ED §428(c)(9)**

This fee (either 0.25 or 0.5 percent of loan principal guaranteed each fiscal year) has been eliminated by Pub. L. 103-66, effective for loans guaranteed *on or after October 1, 1993*.

**Reinsurance paid by ED to guaranty agencies §428(c)(1)**

On loans made prior to October 1, 1993, the Secretary reimburses a guaranty agency for either 100, 90, or 80 percent of the amount of a default claim paid to a lender. These reinsurance percentages have been reduced to 98, 88, and 78 percent, respectively, for reinsurance requests submitted for loans for which the first disbursement is made *on or after October 1, 1993*, with two exceptions:

1. Loans transferred from an insolvent guaranty agency pursuant to a plan approved by the Secretary will be reinsured at 100, 90, and 80 percent, respectively.
2. Lender-of-last-resort claims will receive 100 percent reinsurance. Lender-of-last-resort loans are subsidized Federal Stafford Loans made:
  - a. By lenders pursuant to a guaranty agency's lender-of-last-resort program approved by the Secretary;
  - b. By a guaranty agency with funds from its reserve fund or with funds advanced by the Secretary;
  - By Sallie Mae pursuant to §439(q); and
  - d. Through a lender referral program pursuant to §428(e) that serves the role of a lender-of-last-resort program.

**Reserve requirements and transition to the FDSL Program §428(c)(9)**

Effective *August 10, 1993*, to ensure an orderly transition from the FFEL Program to the FDSL Program, the Secretary has been given the following additional powers to assist a guaranty agency or terminate the agency's reinsurance agreement:

1. If the Secretary determines that the federal fiscal interest can be protected best by terminating a guaranty agency's agreement, the agency, upon the request of the Secretary, must submit a management plan to the Secretary within 30 working days, describing the means by which the Secretary and the agency shall work together to ensure the orderly termination of the agency's operations and the liquidation of its assets.
2. Notwithstanding any other provision of federal or state law, if the Secretary has terminated, or is seeking to terminate a guaranty agency's reinsurance agreement, or if the Secretary has assumed the agency's functions, no state court may issue any order affecting the Secretary's actions with respect to such guaranty agency.

No state law applies to the Secretary's actions in terminating the agency's operations.

3. If the Secretary assumes the functions of a guaranty agency, the Secretary's liability for any outstanding liabilities of the agency (other than outstanding loan guarantees) shall not exceed the fair market value of the reserves of the agency, minus any necessary liquidation or administrative costs.

#### Secretary's equitable share

§428(c)(6)

1. Prior to October 1, 1993, a guaranty agency could retain the complement of its reinsurance percentage on the loan (either 10 or 20 percent) plus 30 percent of the amount collected on a defaulted loan for the administrative costs of collection, preclaims assistance, supplemental preclaims assistance, and monitoring the enrollment and repayment status of borrowers. This amount has been reduced to the complement of the reinsurance percentage on the loan (either 2, 12, or 22 percent) plus 27 percent of any borrower payments received by the agency *on or after October 1, 1993* on defaulted loans.
2. To illustrate this change, we provide the following example: For a \$1,000 eligible default claim subject to 98 percent insurance, the guaranty agency would pay the lender \$980. If the agency's reinsurance request to the Secretary was subject to 98 percent reinsurance, the Secretary would make a reinsurance payment to the agency for \$960.40 (98 percent of \$980). The debtor now owes \$1,000 to the guarantor. If the debtor makes a \$1,000 payment, the agency would retain \$20 of the debtor's payment as the 2 percent complement of the reinsurance percentage (98 percent) applicable to the loan, *plus 27 percent (\$270) of the debtor's payment for a total of \$290*. The remaining \$710 would be paid to the Secretary.

#### Supplemental preclaims payments

§428(l)(2)

Formerly, a guaranty agency was paid \$50 for each successful performance of supplemental preclaims assistance that averted a default. The determination of a successful performance (a default claim is not filed by the lender within 150 days after the loan became 120 days delinquent) has not changed. However, the agency's compensation for these efforts has been changed to equal one percent of the total unpaid principal and accrued interest on the loan as of the date the lender transmitted its request for supplemental preclaims assistance to the guaranty agency. This change will apply to loans for which successful supplemental preclaims assistance is initiated *on or after October 1, 1993*.

### FEDERAL CONSOLIDATION LOANS

The following changes (in alphabetical order) are the major provisions of Pub. L. 103-66 that primarily affect the Federal Consolidation Loan Program:

#### **Eligible borrower**

**§428C(a)**

Pub. L. 103-66 deleted the requirement that the borrower must consolidate at least \$7,500 in eligible student loans. The requirement that at least \$5,000 in FFEL Program loans must be discharged to qualify for a 15-year repayment period on the Federal Consolidation Loan has also been deleted. In addition, the Secretary is no longer prohibited from requiring lenders, holders, or guarantors of Federal Consolidation Loans to receive, maintain, or to make reports with respect to preexisting records relating to any eligible student loan discharged by the Federal Consolidation Loan. These changes take effect for Federal Consolidation Loans disbursed *on or after July 1, 1994*.

#### **Income-sensitive repayment**

**§428C(b)**

If a borrower certifies to a lender that, *on or after July 1, 1994*, he or she has sought, but has been unable to obtain a Federal Consolidation Loan with an income-sensitive repayment schedule from the holders of the loans that the borrower wishes to consolidate, then any other Federal Consolidation Loan lender may make a Federal Consolidation Loan to that borrower. Regulations prescribing the rules to be used for establishing income-sensitive repayment schedules for all FFEL Program loans (except Federal PLUS Loans) are currently being developed through negotiated rulemaking. A notice of proposed rulemaking for public comment is expected to be published in the fall of 1993.

#### **Lender fees paid to ED**

**§428C(f)**

1. Each holder of a Federal Consolidation Loan that is disbursed *on or after October 1, 1993*, shall, on a monthly basis, pay to the Secretary, an interest payment rebate fee equal to an annualized rate of 1.05 percent of the unpaid principal and accrued interest on the loan. This fee is in addition to the loan fee charged by the Secretary pursuant to §438(d) of the HEA (0.5 percent of the principal amount of the loan).
2. The holder of the loan should calculate the amount of the fee due each month by multiplying the unpaid principal and accrued interest of each such loan held by the lender at the end of each month by 0.0875 percent. While the Department is developing a new form and system to accommodate the payment of fees on a monthly basis, an interim procedure has been established for holders to pay this fee. Upon receipt of this letter, the holder of any Federal Consolidation Loan that was disbursed during October or November 1993 should remit a combined payment for those months in the form of a check marked "Consolidation Loan fee"

made payable to the U.S. Department of Education. A cover letter should accompany the check, identifying the holder, the months that the fee applies to, and the amount of the unpaid principal and accrued interest. Payment must be mailed so that it is received no later than December 31, 1993 at the following address: U.S. Department of Education, Interest Payment Processing, P.O. Box 4138, Greenville, Texas 75403-4138.

3. Beginning with December 1993 and for each month thereafter during the interim period, holders should send a monthly check in the amount of the fee owed to the same address so that it is received by the end of the following month (e.g., by January 31 for the month of December). These checks should also be marked "Consolidation Loan fee" and made payable to the U.S. Department of Education. A cover letter should accompany the check, identifying the holder, the month that the fee applies to, and the amount of the unpaid principal and accrued interest.

#### Repayment provisions

§428C(c)

1. The interest rate on a Federal Consolidation Loan disbursed *on or after July 1, 1994* shall be the weighted average of the interest rates on the loans consolidated, rounded upward to the nearest whole percent. These loans will *not* have a minimum interest rate of 9 percent.
2. If the amount of the Federal Consolidation Loan is less than \$7,500, the borrower's repayment schedule may not exceed 10 years. This change applies to Federal Consolidation Loans disbursed *on or after July 1, 1994*.

#### Terms and conditions

§428C(b)

1. The provision entitling a Federal Consolidation Loan borrower to an interest subsidized deferment has been deleted, except for a borrower who receives a Federal Consolidation Loan that discharges *only* subsidized Federal Stafford Loans. This change is effective for Federal Consolidation Loans made based on applications received by an eligible lender *on or after August 10, 1993*. Any borrower who is currently eligible for interest subsidies on a Federal Consolidation Loan will remain eligible for those benefits.
2. A borrower may also obtain a Direct Federal Consolidation Loan from the Secretary *on or after July 1, 1994*, if the Secretary determines that the Department of Education has the necessary origination and servicing arrangements in place for such loans. In order for a borrower who does not have an FDSL Program loan to obtain a Direct Federal Consolidation Loan from the Secretary, the borrower must certify that he or she has been unable to obtain a Federal Consolidation Loan or a Federal Consolidation Loan with income-sensitive repayment terms from an FFEL Program lender.

**FEDERAL PLUS LOANS**

The following changes (in alphabetical order) are the major provisions of Pub. L. 103-66 that primarily affect the Federal PLUS Loan Program:

**Multiple disbursement requirement §428B(c)**

Any Federal PLUS Loan for which the first disbursement is scheduled to be made *on or after October 1, 1993* will be required to be disbursed in multiple installments under the same procedures that control multiple disbursement of Federal Stafford and Federal SLS Loans. Until the completion of the Federal PLUS Loan common application/promissory note, which will contain a section for the school to specify disbursement dates, the lender may make Federal PLUS Loan disbursements based on the same schedule normally provided by the school for the disbursement of Federal Stafford and Federal SLS Loans, unless the school provides the lender with an alternative disbursement schedule.

**Variable interest rate beginning July 1, 1994 §427A(c)**

The variable interest rate on a Federal PLUS Loan for which the first disbursement is made *on or after July 1, 1994* shall be determined on June 1 of each year and shall apply to the 12-month period beginning July 1 and ending on June 30. The Secretary shall determine the interest rate by adding 3.1 percent to the bond equivalent rate of 52-week Treasury bills auctioned at the final auction held prior to such June 1, except that the interest rate shall not exceed 9 percent.

**Variable interest rate beginning July 1, 1998 §427A(h)**

The variable interest rate on a Federal PLUS Loan for which the first disbursement is made *on or after July 1, 1998* shall be determined on June 1 of each year and shall apply to the 12-month period beginning July 1 and ending on June 30. The Secretary shall determine the interest rate by adding 2.1 percent to the bond equivalent rate of the securities with a comparable maturity, as established by the Secretary after consultation with the Secretary of the Treasury, except that the interest rate shall not exceed 9 percent.

### FEDERAL STAFFORD LOANS

The following changes (in alphabetical order) are the major provisions of Pub. L. 103-66 that primarily affect the Federal Stafford Loan Program:

#### **Unsubsidized Federal Stafford Loan limits §428H(d)**

The annual and aggregate limits for unsubsidized Federal Stafford Loans made to a dependent undergraduate student shall be the same as the annual and aggregate subsidized Federal Stafford Loan limits applicable to such student, less the amount of any subsidized Federal Stafford Loan received by the student. This change will become effective for loans first disbursed *on or after July 1, 1994* for periods of enrollment that either include that date or begin after that date.

2. For any other student, the loan limits shall be (1) the annual and aggregate subsidized Federal Stafford Loan limits applicable to such student, less the amount of any subsidized Federal Stafford Loan received by the student *plus* (2) the annual and aggregate loan limits in §428H(d) of the HEA. For example, a first-year independent undergraduate student who qualified for, and received a \$1,000 subsidized Federal Stafford Loan, could borrow up to an additional \$5,625 unsubsidized Federal Stafford Loan [\$1,625 remaining under §428(b)(1) of the HEA plus \$4,000 under §428H(d)(2)]. This change will become effective for loans first disbursed *on or after July 1, 1994* for periods of enrollment that either include that date or begin after that date.

#### **Unsubsidized Federal Stafford Loan repayment period §428H(e)**

1. The borrower's repayment period for an unsubsidized Federal Stafford Loan begins on the date the first payment of principal is due from the borrower. This change will become effective for loans first disbursed *on or after July 1, 1994* for periods of enrollment that either include that date or begin after that date.
2. The amount of the borrower's periodic payment and the length of the repayment schedule shall be established by assuming an interest rate equal to the applicable rate of interest at the time the repayment of principal is scheduled to begin. At the option of the lender, the promissory note or other written evidence of the loan may require that the amount of the periodic payment will be adjusted annually, or the length of the repayment period will be adjusted to accommodate variable interest rate changes. The Secretary will revise the common application/promissory note to accommodate this option. This change will become effective for loans first disbursed *on or after July 1, 1994* for periods of enrollment that either include that date or begin after that date.

**Unsubsidized Federal Stafford Loan origination fee §428H(f)**

Before the enactment of Pub. L. 103-66, the lender was required to charge the borrower a 6.5 percent "origination fee/insurance premium." This fee has been renamed as simply the "origination fee," and the amount has been reduced to 3 percent of the principal amount of a loan first disbursed *on or after July 1, 1994* for a period of enrollment that either includes that date or begins after that date. In addition, the guaranty agency may charge the borrower an insurance premium that does not exceed 1 percent of the principal amount of the loan, in accordance with §428H(l), effective for loans first disbursed *on or after July 1, 1994* for periods of enrollment that either include that date or begin after that date.

**Variable interest rate beginning July 1, 1994 §427A(f)**

The variable interest rate on a Federal Stafford Loan shall be determined on June 1 of each year and shall apply to the 12-month period beginning July 1 and ending on June 30. The Secretary shall determine the interest rate by adding 3.1 percent to the bond equivalent rate of 91-day Treasury bills auctioned at the final auction held prior to such June 1, except that the interest rate shall not exceed 8.25 percent. This change will become effective for loans first disbursed *on or after July 1, 1994* for periods of enrollment that either include that date or begin after that date.

**Variable interest rate beginning July 1, 1995 §427A(g)**

During the borrower's in-school, grace, and deferment periods, the variable interest rate on a Federal Stafford Loan shall be determined on June 1 of each year and shall apply to the 12-month period beginning July 1 and ending on June 30. The Secretary shall determine the interest rate by adding 2.5 percent to the bond equivalent rate of 91-day Treasury bills auctioned at the final auction held prior to such June 1, except that the interest rate shall not exceed 8.25 percent. This change will become effective for loans first disbursed *on or after July 1, 1995* for periods of enrollment that either include that date or begin after that date.

**Variable interest rate beginning July 1, 1998 §427A(h)**

The variable interest rate on a Federal Stafford Loan shall be determined on June 1 of each year and shall apply to the 12-month period beginning July 1 and ending on June 30. The Secretary shall determine the interest rate by adding 1 percent to the bond equivalent rate of the securities with a comparable maturity, as established by the Secretary after consultation with the Secretary of the Treasury, except that the interest rate shall not exceed 8.25 percent. This change will become effective for loans first disbursed *on or after July 1, 1998* for periods of enrollment that either include that date or begin after that date.

**OTHER CHANGES**

The following changes (in alphabetical order) are the major provisions of Pub. L. 103-66 that have not been discussed in the earlier sections of this letter:

**Cohort default rate** §435(m)

The definition of a school's cohort default rate has been modified to include the portion of a Federal Consolidation Loan that repaid the borrower's Federal Stafford or Federal SLS Loans made for attendance at the school. This change will be effective *July 1, 1994*. Guaranty agencies must ensure that a school is notified, in accordance with §428(c)(2)(H), whenever preclaims assistance is requested on a Federal Consolidation Loan that repaid a Federal Stafford or Federal SLS Loan made to a student who received the loan for attendance at the school.

**Elimination of Federal SLS Program** §428A

The Federal SLS Program has been merged into the unsubsidized component of the Federal Stafford Loan Program, and will no longer exist as a separate program. No new Federal SLS Loans may be made for a period of enrollment beginning *on or after July 1, 1994*. All conditions and benefits applicable to existing Federal SLS Loans will continue for those loans. Also, to the extent that current unsubsidized Federal Stafford Loans have different conditions and benefits than under the merged program, those loans retain those different conditions and benefits.

**Loan fees from lenders** §438(d)

Pub. L. 103-66 requires the Secretary to charge a fee to lenders equal to 0.5 percent of the principal amount of any FFEL Program loan made *on or after October 1, 1993*. The Secretary will collect this fee by offsetting the amount of the quarterly interest and special allowance payments due the lender.

**Loan fees from Sallie Mae** §439(h)(7)

With the exception of Federal Consolidation Loans and lender-of-last-resort loans it makes pursuant to §439(q), the Student Loan Marketing Association shall pay a monthly fee to the Secretary, equal to an annualized rate of 0.3 percent of the principal amount of each loan it acquires *on or after August 10, 1993*. If the Secretary determines that Sallie Mae has substantially failed to comply with its lender-of-last-resort obligations under §439(q), the fee increases to 1 percent.

**Origination fees****§438(c)**

The amount of origination fee that a lender may charge a borrower (except a Federal Consolidation Loan borrower) has been reduced from 5 percent to 3 percent of the principal amount of the loan. This change will become effective for loans first disbursed *on or after July 1, 1994* for periods of enrollment that either include that date or begin after that date.

**Special allowance payments****§438(b)(2)**

1. The minimum special allowance rate "floor" on new loans made or purchased, in whole or in part, with funds derived from tax-exempt obligations has been repealed. Accordingly, loans made or purchased with funds obtained by the holder from the issuance of obligations *originally* issued *on or after October 1, 1993*, or with funds derived from default reimbursements, collections, interest, or other income related to eligible loans made or purchased with such tax-exempt funds, no longer qualify to receive the minimum special allowance. Refinancing of obligations which were originally issued prior to October 1, 1993, does not alter the eligibility of loans made or purchased with funds obtained from the proceeds of the original financing to receive the minimum special allowance.
2. The special allowance rate on a Federal Stafford Loan during the borrower's in-school, grace, and deferment periods shall be determined by substituting "2.5 percent" for "3.10 percent" in the calculation described in §438(b)(2)(A). This change will become effective for loans first disbursed *on or after July 1, 1995* for periods of enrollment that either include that date or begin after that date.
3. The special allowance rate on a Federal Stafford Loan during the borrower's in-school, grace, and deferment periods shall be computed according to the formula described in §438(b)(2)(F) of the HEA. This change will become effective for loans first disbursed *on or after July 1, 1998* for periods of enrollment that either include that date or begin after that date.

**State share of default costs****§428(n)**

*Beginning in fiscal year 1995*, if a school with a cohort default rate exceeding 20 percent for the most recent fiscal year for which rates are calculated is located within a particular state, that state will be required to pay a fee to the Secretary to partially offset the Secretary's default costs related to that school.

2. For fiscal year 1995, the state's share of default costs will be calculated by multiplying the new loan volume for FY 1995 for all schools in the state by 12.5 percent, and then multiplying that result by the sum of the amounts calculated under paragraph #3 for each school in the state with a cohort default rate that exceeds 20 percent for the most recent fiscal year for which rates are calculated. That result is then divided by the amount of loan volume attributable to current and

former students of schools in that state entering repayment for purposes of calculating the most recent fiscal year cohort default rate.

3. The amount by which a school exceeds the 20 percent default standard shall be the amount of loan volume in default for the most recent fiscal year cohort default rate for the school *minus* 20 percent of the amount of loan volume attributable to current and former students of the school entering repayment for purposes of calculating the most recent fiscal year cohort default rate.
4. As an example of the above calculations, assume there are four schools located in a state, and each has \$10 million in new loan volume for fiscal year 1995, and each had \$10 million entering repayment for purposes of the most recent fiscal year cohort default rate. If only one of the schools had a default rate that exceeded 20 percent (for this example, assume 40 percent), the state would owe the Secretary \$250,000 based on the following calculation:  
$$\begin{array}{r} \$40 \text{ million} \times 0.125 \times \frac{\$2 \text{ million}}{\$40 \text{ million}} \end{array}$$
5. The 12.5 percent factor used for fiscal year 1995 increases to 20 percent in fiscal year 1996, and 50 percent for each fiscal year thereafter. Using the example in paragraph #4, this would result in a \$400,000 fee owed to the Secretary in FY 1996, and \$1 million owed for FY 1997.
6. A state may charge an FFEL participating school located in the state a fee based on the school's cohort default rate and the amount of the state's payment owed to the Secretary. The state's fee structure for charging schools must be approved by the Secretary, and must include a process by which a school could be exempt from such fee if the school could demonstrate, to the satisfaction of the state and the Secretary, that exceptional mitigating circumstances contributed to the school's cohort default rate.
7. Additional details concerning this requirement will be provided at a later date.

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**PAGE 14 - OTHER CHANGES**



UNITED STATES DEPARTMENT OF EDUCATION  
OFFICE OF POSTSECONDARY EDUCATION

NOV 24 1993

Mr. David M. Reicher, Esq.  
Foley & Lardner  
777 East Wisconsin Avenue  
Milwaukee, Wisconsin 53202-5367

Dear Mr. Reicher:

Thank you for your letter of October 14 regarding the statutory special allowance rates that would be applicable to the refunding of three outstanding "tax-exempt" bond issues.

You indicated that the Alabama Higher Education Loan Corporation (the Corporation) intends to issue "tax-exempt" refunding bonds to redeem or otherwise retire the three original obligations, specified in your letter, each of which was issued prior to October 1, 1993. Based on the facts presented in your letter, we concur that the special allowance rates will continue to be determined pursuant to §§438(b)(2)(B)(i) and (ii) of the Higher Education Act of 1965, as amended.

Please do not hesitate to contact me should you have further questions.

Sincerely,

A handwritten signature in cursive script that reads "Pamela A. Moran".

Pamela A. Moran  
Acting Chief, Loans Branch  
Division of Policy Development  
Policy, Training, and Analysis Service

400 MARYLAND AVE., S.W. WASHINGTON, D.C. 20202

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October 14, 1993

Mr. Ralph Madden  
Program Specialist  
FFELP Loans Branch  
Division of Policy and Program Development  
Policy, Training, and Analysis Service  
United States Department of Education  
7th and D Street, S.W.  
ROB-3, Room 4310  
Mailstop 5343  
Washington, D.C. 20202

Re: Payment of Special Allowance on Eligible Loans  
Financed by Refunding Obligations

Dear Mr. Madden:

We have been requested by Alabama Higher Education Loan Corporation (the "Corporation") to obtain written confirmation from the Department of Education (the "Department") of the Corporation's understanding of the special allowance rate that will apply to certain eligible loans. In particular, the Corporation wishes to confirm that, following the refunding transaction described below, the special allowance rate for these eligible loans will be determined under clauses (i) and (ii) of Section 438(b)(2)(B) of the Higher Education Act of 1965, as amended (the "Higher Education Act"). In considering your response to this letter, you may assume that all loans will be "eligible loans" as defined in Section 438(b)(5) of the Higher Education Act.

The Corporation intends to refund three outstanding bond issues, the income from which is exempt from taxation under the Internal Revenue Code of 1986, as amended (the "Code", which term includes its predecessor, the Internal Revenue Code of 1954, as amended) (the "Original Obligations"). The Original Obligations, each issued prior to October 1, 1993, include:

United States Department of Education  
October 14, 1993  
Page 2

1. Approximately \$12,765,000 outstanding principal amount of Student Loan Revenue Bonds, 1986 Series A and B originally issued on April 8, 1986 in the aggregate principal amount of \$63,500,000;
2. Approximately \$19,615,000 outstanding principal amount of Student Loan Revenue Bonds, 1987 Series A originally issued on March 5, 1987 in the aggregate principal amount of \$40,000,000; and
3. Approximately \$34,450,000 outstanding principal amount of Weekly Adjustable/Fixed Rate Student Loan Revenue Bonds, Series 1992-B, originally issued on June 25, 1992 in the aggregate principal amount of \$35,000,000.

The Corporation intends to issue refunding bonds, the income from which will be excluded from gross income under the Code (the "Refunding Bonds"), in early December 1993 and to immediately apply the proceeds to redeem or to otherwise retire the Original Obligations within 90 days. Upon the issuance of the Refunding Bonds and the deposit of the proceeds thereof under the trust indentures for each of the Original Obligations, eligible loans and certain cash and proceeds currently held under those indentures will be transferred to the trustee (the "Trustee") under the indenture for the Refunding Bonds. In considering your response to this letter, you may assume that the Trustee will be an "eligible lender" under the Higher Education Act and the holder of the loans.

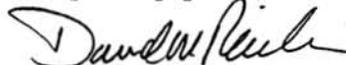
The Corporation believes that the special allowance rate applicable to eligible loans transferred to the Trustee, or made or purchased by the Trustee with funds transferred to the Trustee, from the indentures relating to the Original Obligations should be the rate based on Section 438(b)(2)(B)(i) and (ii) of the Higher Education Act. This rate, which includes the minimum floor, also should apply to eligible loans which are made or purchased by the Trustee with funds obtained by the Trustee from collections or default reimbursements on, or interest or other income pertaining to, eligible loans described in or made or purchased with funds described in the preceding sentence or from income on the investment of such funds.

Because the eligible loans described herein were or will be financed with funds obtained by the holder from the issuance of tax-exempt obligations originally issued prior to October 1, 1993, they would not be eligible for the full special allowance rate (without a floor) provided for in Section 438(b)(2)(B)(iv) of the Higher Education Act.

United States Department of Education  
October 14, 1993  
Page 3

The Corporation intends to sell the Refunding Bonds in the first or second week of December 1993, and therefore, we respectfully request your expeditious response. Please do not hesitate to call me with any legal or factual questions that you may have in responding to this letter. I would also appreciate discussing the matter with you if the Department disagrees with the Corporation's conclusion regarding the applicable special allowance rate.

Very truly yours,



David M. Reicher

cc: Tom Roberson

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Subject 93-G-248; Tax Exempt-Omnibus Act Changes-Interest &amp; Special

December 1993

93-L-163(LD)  
93-G-248  
Tax-Exempt

Summary: This letter contains information and provides guidance on the changes made by the Omnibus Budget Reconciliation Act that affect the Lender's Interest and Special Allowance Request and Report.

Dear Colleague:

The Omnibus Budget Reconciliation Act was signed into law by President Clinton on August 10, 1993. This act amended the Higher Education Act of 1965. There are several changes that affect reporting on the Lender's Interest and Special Allowance Request and Report (ED Form 799). This letter provides instructions for reporting the changes required by the new legislation. Also included in this letter are instructions for reporting the Federal Consolidation Loan Interest Rebate Fee (Consolidation Loan Fee) effective October 1, 1993. (An ED Form 799 with updated instructions is scheduled to be distributed for the March 1994 quarter.)

Although several changes had effective dates of October 1, 1993, the Department requests that lenders delay reporting new information until the March 1994 quarter. At that time all activity for the quarter ending September 30, 1993 should be reported as adjustments. The changes are presented below.

## PART II - ORIGINATION FEES

There will be a fee charged to lenders equal to 0.5 percent of the principal amount of any FFEL Program loan made on or after October 1, 1993.

- 1) Lender fees for current quarter should be reported in Part II, Column C as:

LN - New loans made (including those then sold);  
LS - Loans made and sold in the current quarter if the

purchase  
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owes the lender fees and;  
LB - Loans bought from another lender in the current quarter, if you owe the lender fees.

- 2) Lender fee adjustments to previously reported quarters should be reported in Part II, Column C as:

LI - Net increases in loans made or bought as reported for a previous quarter if you owe the lender fees and;  
LD - Net decreases in the loans made or bought as reported for a previous quarter if the fees are to be credited to you.

c.c.

The amount of origination fee that a lender may charge a borrower (except a Federal Consolidation Loan borrower) will be reduced from 5 percent to 3 percent of the principal amount of the loan, effective for loans first disbursed on or after July 1, 1994 for a period of enrollment that either includes that date or begins after that date. Lenders will continue to report this information in Part II of the ED Form 799.

The 6.5 percent "origination fee/insurance premium" for Federal Unsubsidized Stafford loans will be renamed as simply the "origination fee" and the amount due will be reduced to 3 percent of the principal amount of a loan first disbursed on or after July 1, 1994 for a period of enrollment that either includes that date or begins after that date. Lenders will continue to report this information in Part II of the ED Form 799.

#### PART III - INTEREST BENEFITS

Lenders can now report loans that are subject to the 1992 excess interest rule for the current quarter using "EC".

Enter "EC" in Part III, Column C for current quarter reporting.

Lenders can report loan adjustments that are subject to the 1992 excess interest rule using "EI" or "ED".

Enter "EI" in Part III, Column C for adjustments that result in a net increase in the interest due.

Enter "ED" in Part III, Column C for adjustments that result in a net decrease in interest due.

#### IV - SPECIAL ALLOWANCE

The minimum special allowance rate "floor" on new loans made or purchased, in whole or in part, with funds derived from tax-exempt obligations has been repealed. Accordingly, loans made or purchased with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993, or with funds derived from default reimbursements, collections, interest, or other income related to eligible loans made or purchased with such tax-exempt funds, no longer qualify to receive the minimum special allowance. Refinancing of obligations which were originally issued prior to October 1, 1993, does not alter the eligibility of loans made or purchased with funds obtained from the proceeds of the original financing to receive the minimum special allowance.

Enter "XF" in Part IV, Column C for tax-exempt loans that are not subject to the floor.

Federal Stafford Loans - Variable interest rates beginning July 1, 1994

The variable interest rate on a Federal Stafford Loan shall be determined on June 1 of each year and shall apply to the 12-month period beginning July 1 and ending on June 30. The Secretary shall determine the interest rate by adding 3.1 percent to the bond equivalent rate of 91-day Treasury bills auctioned at the final auction held prior to such June 1, except that the interest rate shall not exceed 8.25 percent. This change will become effective for loans first disbursed on or after July 1, 1994 for periods of enrollment that either include that date or begin after that date.

EL:

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Enter SG in Part IV, Column C and "EVAR" in Column E, for loans disbursed on or after July 1, 1994.

Enter XG in Part IV, Column C and "EVAR" in Column E, for loans disbursed on or after July 1, 1994 with tax-exempt funds.

Federal PLUS Loans - Variable interest rate beginning July 1, 1994

The variable interest rate on a Federal PLUS Loan shall be determined on June 1 of each year and shall apply to the 12-month period beginning July 1 and ending June 30. The Secretary shall determine the interest rate by adding 3.1 percent to the bond equivalent rate of 52-week Treasury bills auctioned at the final auction held prior to such June 1, except that the interest rate shall not exceed 9 percent. This change will become effective for loans first disbursed on or after July 1, 1994 for periods of enrollment that either include that date or begin after that date.

Enter SG in Part IV, Column C and "EVAR" in Column E for loans disbursed on or after July 1, 1994.

Enter XG in Part IV, Column C and "EVAR" in Column E, for loans disbursed on or after July 1, 1994 with tax-exempt funds.

#### ART V - CHANGES IN GUARANTEED LOAN PRINCIPAL FOR THE QUARTER

here are no changes at this time.

#### VI - GUARANTEED LOAN PORTFOLIO ANALYSIS FOR END OF QUARTER

here are no changes at this time

#### CHANGES

##### Federal Consolidation Loans - Consolidation Loan Rebate Fee

Each holder of a Federal Consolidation Loan that is disbursed on or after October 1, 1993, shall, on a monthly basis, pay to the Secretary, an interest payment rebate equal to an annualized rate of 1.05 percent of the unpaid principal and accrued interest on the loan. This fee is in addition to the lender fee charged by the Secretary.

The interim procedures described below will exist while the Department is developing a new form and system to accommodate the payment of fees on a monthly basis. Upon receipt of this letter, the holder of a Federal Consolidation Loan that was disbursed during October, November, or December 1993 should remit a combined payment for those months.

- 1 The holder of the loan should calculate the amount of the fee due each month by multiplying the unpaid principal and accrued interest of such loan held by the lender at the end of each month by 0.0875 percent.

TEL

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- 2) The lender's check should be made payable to the U.S. Department of Education and clearly marked "Consolidation Loan Fee." In addition, please include a cover letter identifying the lender, the lender number, the month that the fee applies to, and the amount of the unpaid principal and accrued interest.
- 3) Beginning with January 1994 and for each month thereafter during the interim period, holders should send a monthly check in the amount of the fee owed to the address below so that it is received by the end of the following month (e.g. by February 30 for the month of January).

U.S. Department of Education  
Interest Payment Processing  
P.O. Box 4138  
Greenville, Texas 75403-4138

If you have any questions regarding this letter, please contact the Disbursement Branch at (202) 708-9776.

Sincerely,

William L. Moran  
Acting Deputy Assistant Secretary  
for Student Financial Assistance