Special Allowance Payments to Sallie Mae’s Subsidiary, Nellie Mae, for Loans Funded by Tax-Exempt Obligations

FINAL AUDIT REPORT

ED-OIG/A03I0006
August 2009

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U.S. Department of Education
Office of Inspector General
Philadelphia, PA
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August 3, 2009

Mark L. Heleen
Executive Vice President and General Counsel
Sallie Mae, Inc.
12061 Bluemont Way
Reston, VA 20190

Dear Mr. Heleen:

Enclosed is our final audit report, Control Number ED-OIG/A03I0006, entitled Special Allowance Payments to Sallie Mae’s Subsidiary, Nellie Mae, 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:

William J. Taggart
Chief Operating Officer, Federal Student Aid
US Department of Education
Union Center Plaza III, Room 112G1
830 First Street, NE
Washington, DC 20002

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/
Bernard Tadley
Regional Inspector General for Audit

Enclosures
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXECUTIVE SUMMARY</td>
<td>1</td>
</tr>
<tr>
<td>BACKGROUND</td>
<td>3</td>
</tr>
<tr>
<td>AUDIT RESULTS</td>
<td>7</td>
</tr>
<tr>
<td><strong>FINDING – SLMA Billed Loans under the 9.5 Percent Floor</strong></td>
<td>7</td>
</tr>
<tr>
<td>Calculation after the Eligible Tax-Exempt Bond Matured and</td>
<td></td>
</tr>
<tr>
<td>after Its Loans Were Refinanced with Ineligible Funds</td>
<td></td>
</tr>
<tr>
<td>OBJECTIVES, SCOPE, AND METHODOLOGY</td>
<td>23</td>
</tr>
<tr>
<td>Enclosure: SLMA Comments</td>
<td>29</td>
</tr>
</tbody>
</table>
Acronyms/Abbreviations Used in this Report

ADB  Average Daily Balance
CFR  Code of Federal Regulations
DCL  Dear Colleague Letter
Department U.S. Department of Education
ECFC Education Credit Finance Corporation
GAO Government Accountability Office
GAS Government Auditing Standards, July 2007 Revision
FFEL Federal Family Education Loan
FSA Federal Student Aid
HEA Higher Education Act of 1965, as amended
HERA Higher Education Reconciliation Act of 2005
LaRS Lender’s Interest and Special Allowance Request and Report
LID Lender Identification Number
NLMA Nellie Mae
OIG Office of Inspector General
Pub. L. Public Law
SAP Special Allowance Payments
SLMA Sallie Mae, Inc.
TTPA Taxpayer-Teacher Protection Act of 2004
EXECUTIVE SUMMARY

The purpose of the audit was to determine if Nellie Mae (NLMA), a subsidiary of Sallie Mae, Inc. (SLMA), (1) billed loans under the 9.5 percent floor in compliance with the Taxpayer-Teacher Protection Act of 2004 (TTPA) and the Higher Education Reconciliation Act of 2005 (HERA) and (2) billed loans under the 9.5 percent floor after the eligible tax-exempt bonds from which the loans derived their eligibility matured or were retired. Our audit period covered October 1, 2003, through September 30, 2006.

Special allowance payments (SAP) 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 SAP 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 SAP for these loans may not be less than 9.5 percent, minus the interest the lender receives, divided by four. We refer to this calculation as the “9.5 percent floor.” When interest rates are low, the 9.5 percent floor provides a significantly greater return than lenders receive for other loans.

We found that SLMA’s billing for its NLMA subsidiary for SAP under the 9.5 percent floor, complied with the TTPA and HERA. However, SLMA’s billing for NLMA did not comply with other requirements for the 9.5 percent floor calculation. Specifically, SLMA continued to bill loans under the 9.5 percent floor after the eligible tax-exempt bonds, from which the loans derived their eligibility for the 9.5 percent floor, had matured and been retired, and after the loans were refinanced with funds derived from ineligible sources. We estimate that this noncompliance resulted in special allowance overpayments of about $22.3 million.

SLMA officials asserted that the date the last bond associated with an indenture matured determined the eligibility for the 9.5 percent floor calculation of loans financed by, or made eligible through, the bonds associated with that indenture. SLMA justified its practice based, in part, upon the position that, because all of the bonds associated with an indenture shared common characteristics, all of the bonds should be treated as a single obligation for purposes of applying the 9.5 percent floor calculation. This management control weakness resulted in noncompliance with regulations and special allowance overpayments.

We recommend that the Chief Operating Officer for Federal Student Aid (FSA) instruct SLMA to return to the U.S. Department of Education (Department), the special allowance overpayments we describe in our report, and disclose any other instances, at any of its subsidiaries (i.e., NLMA, Southwest Student Services Corporation, Student Loan Funding Resources, Student Loan Finance Association), of loans billed under the 9.5 percent floor calculation after the eligible tax-exempt bond issue matured and after the loans were refinanced with funds derived from an ineligible funding source.
A draft of this report was provided to SLMA for review and comment on March 10, 2009. In its comments, SLMA agreed with our conclusion that it complied with TTPA and HERA, but strongly disagreed with our finding and recommendations. SLMA confirmed that it treated loans it purchased from Nellie Mae that were made with the proceeds of the 1993 Bonds issued under the 1993 Trust Agreement as eligible for the 9.5 percent floor calculation until the last bond issued matured on July 1, 2005, but asserted that this practice was based on a reasonable application of the HEA, regulations, and clear legislative intent. SLMA provided no evidence to cause us to revise our finding or recommendations. The full text of SLMA’s comments on the draft report is included as an Enclosure to this report, except for 36 pages of Exhibit B that shows amortization tables supporting the two Eligible Loan Balance tables on page 56 of this report. The full Exhibit B will be made available upon request.
BACKGROUND

Sallie Mae Corporation

SLMA was founded in 1972 as a government-sponsored enterprise and was originally chartered as a secondary market that purchased student loans. In 2004, SLMA dissolved its charter, terminating its corporate ties to the federal government. SLMA's primary business was to originate and hold student loans by providing funding, delivery, and servicing support for education loans in the U.S. through its participation in the FFEL Program and through offering private education loans.

SLMA managed the largest portfolio of FFEL Program and private education loans in the student loan industry, serving nearly 10 million student and parent customers through ownership and management of $142.1 billion in student loans as of December 31, 2006, of which $119.5 billion or 84 percent were federally insured. SLMA served clients that included over 6,000 educational and financial institutions and state agencies. SLMA also marketed student loans, both federal and private, directly to consumers.

SLMA acquired several companies in the student loan industry that billed loans under the 9.5 percent floor. These include—

- Nellie Mae Corporation in July 1999,
- Student Loan Funding Resources in July 2000,
- Student Loan Finance Association in November 2003, and
- Southwest Student Services Corporation in October 2004.

On July 27, 1999, NLMA incorporated NM Education Loan Corporation. On July 22, 2002, NM Education Loan Corporation's name was changed to SLM Education Credit Management Corporation. On November 10, 2003, SLM Education Credit Management Corporation's name was changed to SLM Education Credit Finance Corporation (ECFC). SLMA was 100 percent owner of ECFC, and ECFC was the sole owner of both Nellie Mae Holding LLC and Nellie Mae Education Loan LLC.

Special Allowance Payments

A lender participating in the FFEL Program is entitled to a quarterly SAP for loans in its portfolio. 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 HEA. For example, for Stafford loans, the amount of the quarterly SAP is calculated in four steps:

1. Determining the average of the bond equivalent rates of 91-day Treasury bills auctioned during the quarter,

   1 The calculation used for other types of FFEL Program loans is slightly different.
2. Adding a specified percentage to this amount (the specified percentage varies based on the loan type, origination date, and other factors),
3. Subtracting the applicable interest rate for the loan, and
4. Dividing the resulting percentage by 4. (34 C.F.R. § 682.302(c))

According to Section 438(a) of the HEA, the purpose of SAP 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 . . . .

9.5 Percent Floor


In general, the quarterly SAP 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 SAP 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 the separate calculation as the “9.5 percent floor.”

When interest rates are low, the 9.5 percent floor calculation results in significantly greater SAP than the lender would otherwise receive. For example, for a FFEL Program Stafford loan made on January 15, 2000, currently in repayment, and with an average daily balance of $5,000—

- For the quarter ending December 31, 2003, 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.
- For the quarter ending December 31, 2006, a lender would receive $29.50 under the 9.5 percent floor calculation (payment rate of 0.59 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 0.145 percent), the lender would receive $7.25.

The Student Loan Reform Act of 1993, which was included in the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66), repealed 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. In this report, we refer to these obligations as “eligible tax-exempt” obligations or bond issues. Tax-exempt obligations that were originally issued on or after October 1, 1993, are referred to as “ineligible tax-exempt” obligations or bond issues. Other obligations are referred to as “taxable” obligations or bond issues.

2 All regulatory citations are to the version dated July 1, 2003, unless otherwise noted.
Taxpayer-Teacher Protection Act of 2004

The TTPA (Pub. L. 108-409), enacted on October 30, 2004, revised Section 438(b)(2)(B) of the HEA to make certain loans ineligible for the 9.5 percent floor calculation. Loans were ineligible for the 9.5 percent calculation if they were—

- Financed by a tax-exempt obligation that, after September 30, 2004, and before January 1, 2006, had matured or been retired or defeased;
- Refinanced after September 30, 2004, and before January 1, 2006, with a funding source other than the proceeds of an eligible tax-exempt obligation, as described in Section 438(b)(2)(B)(v)(I) of the HEA; or
- Sold or transferred to any other holder after September 30, 2004, and before January 1, 2006.

Higher Education Reconciliation Act of 2005

The HERA (Pub. L. 109-171), enacted on February 8, 2006, further revised Section 438(b)(2)(B) of the HEA. First, the HERA made the TTPA provisions permanent by removing the January 1, 2006, sunset date. Second, under the HERA, a loan is ineligible for the 9.5 percent floor calculation if it was—

- Made or purchased on or after February 8, 2006; or
- Not earning special allowance at the 9.5 percent floor rate on February 8, 2006.

The HERA provides an exception to these requirements for certain small lenders, but SLMA does not qualify for that exception.

Eligible Tax-Exempt Bonds

For the period October 1, 2003, through September 30, 2006, NLMA had three outstanding eligible tax-exempt obligations (bonds outstanding), totaling $159,800,000 (Table 1).

<table>
<thead>
<tr>
<th>Bond</th>
<th>Indenture</th>
<th>Issue Date</th>
<th>Bond Maturity</th>
<th>Indenture Maturity</th>
<th>Original Bond Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>$159,800,000</strong></td>
</tr>
</tbody>
</table>

On average, NLMA had total average daily balance (ADB) billings of about $399.3 million in 9.5 percent floor loans for each quarter. During this same period, the Department paid special allowance, totaling about $75.1 million (net) to NLMA for its 9.5 percent floor loans. Although ECFC did not have any bonds outstanding during this period, ECFC, on average, had total ADB
billings of about $221.4 million in 9.5 percent floor loans for each quarter ended September 30, 2004, through June 30, 2005. The Department paid special allowance (net), totaling about $14.5 million (net) to ECFC for its 9.5 percent floor loans. These amounts are provided below in Tables 2 (for NLMA) and 3 (for ECFC).

### Table 2 - NLMA’s Quarterly 9.5 Percent Floor Loan Balances and Net SAP Paid

<table>
<thead>
<tr>
<th>Quarterly Period Ending</th>
<th>Current Quarter ADB Billed</th>
<th>Net Adjustments to ADB</th>
<th>Total ADB Billed</th>
<th>SAP Paid (Net)</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2003</td>
<td>$1,121,419,999</td>
<td>($22,469,676)</td>
<td>$1,098,950,323</td>
<td>$17,473,409</td>
</tr>
<tr>
<td>March 31, 2004</td>
<td>$1,125,633,637</td>
<td>($19,523,037)</td>
<td>$1,106,110,600</td>
<td>$17,562,882</td>
</tr>
<tr>
<td>June 30, 2004</td>
<td>$952,198,680</td>
<td>$142,460,841</td>
<td>$1,094,659,521</td>
<td>$17,355,455</td>
</tr>
<tr>
<td>September 30, 2004</td>
<td>$380,389,990</td>
<td>($12,755,104)</td>
<td>$367,634,886</td>
<td>$5,851,323</td>
</tr>
<tr>
<td>December 31, 2004</td>
<td>$344,424,312</td>
<td>($9,969,300)</td>
<td>$334,455,012</td>
<td>$5,305,828</td>
</tr>
<tr>
<td>March 31, 2005</td>
<td>$312,379,041</td>
<td>$485,819</td>
<td>$312,864,860</td>
<td>$4,994,624</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>$58,055,685</td>
<td>$217,469,058</td>
<td>$275,524,743</td>
<td>$4,418,304</td>
</tr>
<tr>
<td>September 30, 2005</td>
<td>$51,413,978</td>
<td>($31,032)</td>
<td>$51,382,946</td>
<td>$582,964</td>
</tr>
<tr>
<td>December 31, 2005</td>
<td>$45,437,762</td>
<td>($4,465)</td>
<td>$45,393,297</td>
<td>$512,105</td>
</tr>
<tr>
<td>March 31, 2006</td>
<td>$39,330,356</td>
<td>$3,575</td>
<td>$39,333,931</td>
<td>$440,244</td>
</tr>
<tr>
<td>June 30, 2006</td>
<td>$35,384,756</td>
<td>$7,635</td>
<td>$35,392,391</td>
<td>$395,558</td>
</tr>
<tr>
<td>September 30, 2006</td>
<td>$29,494,247</td>
<td>$0</td>
<td>$29,494,247</td>
<td>$192,335</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td></td>
<td></td>
<td><strong>$75,085,031</strong></td>
<td></td>
</tr>
</tbody>
</table>

Net adjustments are reflected during the quarters for which the adjustments were applied.

Source: U.S. Department of Education, Datamart

### Table 3 - ECFC’s Quarterly 9.5 Percent Floor Loan Balances and Net SAP Paid

<table>
<thead>
<tr>
<th>Quarterly Period Ending</th>
<th>Current Quarter ADB Billed</th>
<th>Net Adjustments to ADB</th>
<th>Total ADB Billed</th>
<th>SAP Paid (Net)</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2003</td>
<td>$0</td>
<td>($17,137)</td>
<td>($17,137)</td>
<td>$0</td>
</tr>
<tr>
<td>March 31, 2004</td>
<td>$0</td>
<td>($15,204)</td>
<td>($15,204)</td>
<td>$0</td>
</tr>
<tr>
<td>June 30, 2004</td>
<td>$0</td>
<td>($18,766)</td>
<td>($18,766)</td>
<td>$0</td>
</tr>
<tr>
<td>September 30, 2004</td>
<td>$0</td>
<td>$353,718,924</td>
<td>$353,718,924</td>
<td>$5,858,826</td>
</tr>
<tr>
<td>December 31, 2004</td>
<td>$0</td>
<td>$204,754,549</td>
<td>$204,754,549</td>
<td>$3,335,806</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>$149,046,800</td>
<td>$0</td>
<td>$149,046,800</td>
<td>$2,404,179</td>
</tr>
<tr>
<td>September 30, 2005</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>December 31, 2005</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>March 31, 2006</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>June 30, 2006</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>September 30, 2006</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td></td>
<td></td>
<td><strong>$14,530,092</strong></td>
<td></td>
</tr>
</tbody>
</table>

Net adjustments are reflected during the quarters for which the adjustments were applied.

Source: U.S. Department of Education, Datamart
AUDIT RESULTS

The purpose of the audit was to determine if SLMA’s subsidiary, NLMA, (1) billed loans under the 9.5 percent floor in compliance with the TTPA and HERA, and (2) billed loans under the 9.5 percent floor, after the eligible tax-exempt bonds from which the loans derived their eligibility, had matured or been retired. Our audit period covered October 1, 2003, through September 30, 2006.

We found that SLMA’s billing for its NLMA subsidiary for SAP under the 9.5 percent floor complied with the TTPA and HERA. We also found that SLMA’s NLMA subsidiary continued to bill loans under the 9.5 percent floor after the eligible tax-exempt bonds, from which the loans derived their eligibility for the 9.5 percent floor, matured and after the loans were refinanced with funds derived from ineligible sources. As a result, SLMA’s billing activities for its NLMA subsidiary did not comply with laws, regulations, and guidance for the 9.5 percent floor calculation.

In its comments to the draft report, SLMA agreed with our conclusion that it complied with TTPA and HERA, but did not concur with our finding and recommendations. SLMA’s comments are summarized at the end of the finding. The full text of SLMA’s comments on the draft report is included as an Enclosure to this report.

FINDING – SLMA Billed Loans under the 9.5 Percent Floor Calculation after the Eligible Tax-Exempt Bond Matured and after Its Loans Were Refinanced with Ineligible Funds

SLMA continued to bill loans under the 9.5 percent floor calculation (1) after the eligible tax-exempt bond, from which the loans derived the 9.5 percent floor eligibility, matured and retired3 and (2) after the loans were refinanced with funds derived from an ineligible funding source. Although three of the bonds matured in 2002 and one matured in 2004 (Table 4), SLMA continued to bill loans that had been financed by these bonds under the 9.5 percent floor calculation until June 2005. The loans billed were ineligible to receive special allowance under the 9.5 percent floor calculation. We estimate that this noncompliance resulted in special allowance overpayments of about $22.3 million.

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3 Bonds 93B, 93F, 93G and 93H were retired (i.e. repaid) upon each bond’s respective maturity, as noted in Tables 4 and 5.
Table 4 – NLMA Bond Issues

<table>
<thead>
<tr>
<th>Bond</th>
<th>Original Bond Amount</th>
<th>Maturity Date</th>
<th>Bond Amount Outstanding at Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>93B</td>
<td>$48,905,000</td>
<td>June 1, 2002</td>
<td>$10,700,000</td>
</tr>
<tr>
<td>93F</td>
<td>$32,500,000</td>
<td>July 1, 2004</td>
<td>$32,500,000</td>
</tr>
<tr>
<td>93G</td>
<td>$107,000,000</td>
<td>August 1, 2002</td>
<td>$47,400,000</td>
</tr>
<tr>
<td>93H</td>
<td>$71,790,000</td>
<td>December 1, 2002</td>
<td>$14,370,000</td>
</tr>
</tbody>
</table>

Bonds 93B, 93F, 93G and 93H were issued under NLMA’s 93A Indenture, which consisted of eight bonds totaling $458,095,000. All eight bonds issued under the 93A Indenture were refunding bonds issued to refund obligations originally issued before October 1, 1993. The last outstanding bond issued under the indenture matured on July 1, 2005.4

Table 5 – Bonds Issued under NLMA’s 93A Indenture

<table>
<thead>
<tr>
<th>Bond or Supplement</th>
<th>Bond Name</th>
<th>Date Issued</th>
<th>Bond Maturity</th>
<th>Original Bond Issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Bond</td>
<td>93A</td>
<td>3/1/1993</td>
<td>7/1/2005</td>
<td>$103,300,000</td>
</tr>
<tr>
<td>First Supplement</td>
<td>93B</td>
<td>6/1/1993</td>
<td>6/1/2002</td>
<td>$48,905,000</td>
</tr>
<tr>
<td>Second Supplement</td>
<td>93C</td>
<td>7/1/1993</td>
<td>7/1/1998</td>
<td>$26,100,000</td>
</tr>
<tr>
<td>Second Supplement</td>
<td>93E</td>
<td>7/1/1993</td>
<td>7/1/1999</td>
<td>$58,340,000</td>
</tr>
<tr>
<td>Second Supplement</td>
<td>93F</td>
<td>7/1/1993</td>
<td>7/1/2004</td>
<td>$32,500,000</td>
</tr>
<tr>
<td>Third Supplement</td>
<td>93G</td>
<td>8/1/1993</td>
<td>8/1/2002</td>
<td>$107,000,000</td>
</tr>
<tr>
<td>Fourth Supplement</td>
<td>93H</td>
<td>11/15/1993</td>
<td>12/1/2002</td>
<td>$71,790,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>Total</strong> $458,095,000</td>
</tr>
</tbody>
</table>

SLMA’s treatment of 9.5 percent floor loans financed by bonds associated with the 93A Indenture was not consistent with NLMA’s practice prior to SLMA’s acquisition of NLMA in July 1999. According to SLMA officials, prior to SLMA assuming responsibility for NLMA’s bonds and 9.5 percent floor loans, NLMA’s practice was to cease billing loans under the 9.5 percent floor calculation upon the maturity of the applicable eligible tax-exempt bond. SLMA took the position that NLMA was mistaken when it ceased billing on a particular bond prior to

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4 A bond is a valid debt obligation of the issuer. An indenture is a formal agreement between the issuer of the bond and a trustee bank. Generally, the indenture creates a trust estate administered by the trustee for the benefit of the bondholders to ensure repayment of the bonds. Loans made or purchased with the bond proceeds and their associated payments and income are pledged by the issuer to the trust estate to ensure repayment of the bonds. (NLMA’s 93A Indenture did not include a pledge of collateral to secure the repayment of the bonds.) The indenture describes the terms and conditions of the bond, such as the type of obligation, bond amount, interest rate and maturity date. The indenture also specifies administrative tasks to be performed by the trustee, such as the handling of bond proceeds. A single bond or multiple bonds may be issued under an indenture or additional bonds may be issued under supplements to an indenture.
the maturity of the particular bond indenture (i.e., the date that the last bond in the indenture matures).

Pursuant to 34 C.F.R. § 682.302(e)(2), certain loans are ineligible for the 9.5 percent floor calculation:5

The Secretary pays a special allowance to an Authority at the rate prescribed in paragraph (c)(1) of this section [the usual special allowance rate] on a loan described in paragraph (c)(3)(i) of this section [a loan financed by an eligible tax-exempt obligation or related eligible financing sources]—

(i) After the loan is pledged or otherwise transferred in consideration of funds derived from sources other than those described in paragraph (c)(3)(i) of this section; 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 . . . .

On March 1, 1996, the Department issued Dear Colleague Letter (DCL) 96-L-186, *Clarification and interpretive guidance on certain provisions in the Federal Family Education Loan (FFEL) Program regulations published on December 18, 1992*. Item 30 of this DCL addressed the 9.5 percent floor calculation and stated—

Under the regulations, if a loan made or acquired with the proceeds of a [eligible] 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).

SLMA had a long-standing practice of continuing to bill loans under the 9.5 percent floor calculation until the last bond associated with the indenture matured. In this instance, SLMA treated loans made eligible for the 9.5 percent floor calculation by each of the bonds, issued under the 93A Indenture, as remaining eligible for the 9.5 percent floor calculation until Bond 93A matured on July 1, 2005.

SLMA explained that all of the individual bonds issued under the 93A Indenture shared common characteristics. For example, all of the bonds had identical terms and were payable from the same source of funds. SLMA considered it reasonable to treat all of the bonds issued under the 93A Indenture as a single “obligation,” and to consider that obligation to mature only when its last bond matured. SLMA argued that it would be arbitrary to identify a bond series (a group of bonds issued on the same date and maturing on the same date, as described in Table 5) as the “obligation,” because the 93A Indenture did not provide for such a distinction.

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5 After amendments were published in the Federal Register on December 18, 1992 (57 FR 60280), the text of 34 C.F.R. § 682.302(e) remained unchanged until September 8, 2006. We cite the text in effect prior to September 8, 2006.
We do not agree that SLMA’s position is a reasonable interpretation of the HEA or regulations. Though all of the bonds issued under the 93A Indenture do share some common characteristics, they cannot be considered identical. For purposes of determining an obligation’s eligibility for the 9.5 percent floor calculation, only the following characteristics are material:

- The tax treatment of income from the obligation. (HEA §438(b)(2)(B)(i))
- The date the obligation was originally issued. (HEA §438(b)(2)(B)(iv))
- If applicable, the date the obligation is refunded. (HEA §438(b)(2)(B)(iv))
- If the obligation is refunded, the tax treatment of income (i.e., tax-exempt or taxable) from refunding obligation(s). (34 C.F.R. §682.302(e)(2), effective September 8, 2006)
- The date the obligation matures, is retired or defeased. (HEA §438(b)(2)(B)(v))

Because bonds issued under the 93A Indenture have different maturity dates, it is unreasonable to ignore that characteristic and continue to bill under the 9.5 percent floor calculation: it is unreasonable to treat all bonds as eligible when it is clear from the maturity dates of the bond series that some of the bonds are no longer eligible.

In addition, the term “obligation,” as it is used in the HEA, regulations, and other guidance issued by the Department, plainly refers to a bond, not to the bond’s indenture:

- Pursuant to Section 438(b)(2)(B)(i) of the HEA, SAP is paid under the 9.5 percent floor for “loans which were made or purchased with funds obtained by the holder from the issuance of obligations.”
- Pursuant to 34 C.F.R. § 682.302(c)(3)(i), SAP is paid under the 9.5 percent floor for a loan “that was made or purchased with funds obtained by the holder from . . . [t]he proceeds of tax-exempt obligations.”
- Pursuant to DCL 96-L-186, guidance is provided for a loan “made or acquired with the proceeds of a [eligible] tax-exempt obligation [that] is refinanced with the proceeds of a taxable obligation.”

All of these requirements assume that the issuance of an “obligation” provides a lender with funds that can be used to make or purchase loans. The issuance of a bond does provide such funds; the issuance of an indenture does not. An indenture is a formal agreement between the issuer of a bond and a trustee bank, and its issuance does not provide a lender with funds that can be used to make or purchase loans.

Ineligible Loans Funded by Bond 93F

In July 2004, SLMA sold loans with a principal value of about $688.6 million from its NLMA subsidiary to its ECFC subsidiary, in consideration of funds derived from ineligible sources. The eligibility of these loans for the 9.5 percent floor was derived from Bond 93F.6 As a result of the sale, NLMA ceased billing the loans under the 9.5 percent floor calculation, and classified the loans as eligible for the usual special allowance rates, as Bond 93F was scheduled to mature on

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6 We did not perform audit procedures to confirm that these loans were in fact eligible for the 9.5 percent floor calculation.
July 1, 2004. According to SLMA officials, the sale was an erroneous early liquidation of Bond 93F.

At the time of the sale, SLMA determined that loans financed by, or made eligible through, Bond 93F would not be eligible for the 9.5 percent floor calculation after the bond matured on July 1, 2004. Upon maturity, Bond 93F was repaid and, as a result, retired. Upon the sale to ECFC, the loans were classified as being financed by holding tanks associated with ECFC. According to SLMA, holding tanks are funded with the proceeds of short-term borrowings and long-term notes. Holding tanks are not funded with eligible tax-exempt obligations and, therefore, are an ineligible funding source for loans billed under the 9.5 percent floor calculation. When Bond 93F was retired and the loans were transferred in consideration of an ineligible source (the holding tanks), the loans lost their eligibility for the 9.5 percent floor calculation.

In February 2005, SLMA recoded the loans held by ECFC (the loans that previously derived their eligibility for the 9.5 percent floor from Bond 93F) and resumed billing their SAP under the 9.5 percent floor for the quarters ended March 31, 2005, and June 30, 2005. SLMA adjusted prior billings for the quarters ended September 30, 2004, and December 31, 2004, to bill the loans under the 9.5 percent floor calculation.

The loans were billed under SLMA’s ECFC subsidiary as detailed in Table 6. On average, for each of the quarters ended from September 30, 2004, through June 30, 2005, SLMA billed an ADB of about $221 million under the 9.5 percent floor calculation for ineligible loans associated with Bond 93F. SLMA received about $14.5 million in improper SAP under the 9.5 percent floor calculation for these ineligible loans.

We estimated the payments SLMA would have received based on the average usual special allowance rates for the same quarters. Of the $14.5 million received for quarters ended September 30, 2004, through June 30, 2005, SLMA should have received an estimated $2.2 million under the usual rates, resulting in an estimated overpayment of about $12.3 million (Table 6).

<table>
<thead>
<tr>
<th>Quarter Ended</th>
<th>ECFC Current Quarter ADB Billed</th>
<th>ECFC Net Adjustments to ADB</th>
<th>Total ECFC ADB Billed</th>
<th>Estimated SAP at Usual Rates</th>
<th>9.5 Percent SAP Paid</th>
<th>Estimated Overpayment</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 30, 2004</td>
<td>$0</td>
<td>$353,732,135</td>
<td>$353,732,135</td>
<td>$429,659</td>
<td>$5,858,826</td>
<td>$5,429,167</td>
</tr>
<tr>
<td>December 31, 2004</td>
<td>$0</td>
<td>$204,767,175</td>
<td>$204,767,175</td>
<td>$510,871</td>
<td>$3,335,806</td>
<td>$2,824,935</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>$149,046,800</td>
<td>$0</td>
<td>$149,046,800</td>
<td>$644,926</td>
<td>$2,404,179</td>
<td>$1,759,253</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$2,189,599</strong></td>
<td><strong>$14,530,092</strong></td>
<td><strong>$12,340,492</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note - Details of our estimates are contained in the Objectives, Scope and Methodology section of this report, “Estimate of Ineligible 9.5 Percent SAP and Usual SAP on Loans Funded by Bond 93F.” For each quarter, the estimated overpayment is the difference between the special allowance paid under the 9.5 percent floor calculation and the estimated special allowance amount at the usual special allowance rates.
Ineligible Loans Funded by Bonds 93B, 93G and 93H

Upon the maturity of Bonds 93B, 93G, and 93H (in June, August, and December 2002, respectively), the loans financed by, or made eligible through, these bonds were treated by SLMA in a manner similar to the loans associated with Bond 93F. According to SLMA officials, loans funded by Bonds 93B, 93G, and 93H continued to be billed under the 9.5 percent floor calculation until July 1, 2005, which was the maturation date of the last bond (Bond 93A) associated with the 93A Indenture. According to SLMA officials, the loans associated with Bonds 93B, 93G, and 93H were transferred to and maintained in holding tanks, associated with NLMA, immediately after each bond matured. Holding tanks are not funded with eligible tax-exempt obligations and represent an ineligible funding source for loans billed under the 9.5 percent floor calculation. As a result, the loans associated with Bonds 93B, 93G, and 93H became ineligible for the 9.5 percent floor calculation when they were refinanced with the ineligible funds in the holding tanks and the bonds matured. Upon each bond’s respective maturity, Bonds 93B, 93G, and 93H were repaid and, as a result, retired.

Within four holding tanks, the loans were commingled with loans associated with other eligible bonds from the 93A Indenture (i.e., Bonds 93A, 93B, 93F, 93G and 93H). The four holding tanks, which commingled both eligible and ineligible loans funded by the bonds under the 93A Indenture, had special allowance billings under the 9.5 percent floor calculation for the audit period as detailed in Table 7.

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7 The loans were billed under LID 833691 for NLMA. SLMA’s internal systems associated these loans with holding tanks 4402/5402 and 4421/5421. These holding tanks were associated with the 93A Indenture.
Table 7 – NLMA Holding Tank Billings for Eligible and Ineligible Loans Associated with Bonds 93A, 93B, 93F, 93G, and 93H

<table>
<thead>
<tr>
<th>Quarter Ended</th>
<th>Average Daily Balance</th>
<th>Estimate of 9.5 Percent SAP Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2003</td>
<td>$818,752,786</td>
<td>$13,003,077</td>
</tr>
<tr>
<td>March 31, 2004</td>
<td>$802,965,117</td>
<td>$12,737,214</td>
</tr>
<tr>
<td>June 30, 2004</td>
<td>$792,198,634</td>
<td>$12,559,635</td>
</tr>
<tr>
<td>September 30, 2004</td>
<td>$225,306,698</td>
<td>$3,586,004</td>
</tr>
<tr>
<td>December 31, 2004</td>
<td>$216,111,835</td>
<td>$3,427,641</td>
</tr>
<tr>
<td>March 31, 2005</td>
<td>$170,380,802</td>
<td>$2,724,468</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>$123,819,876</td>
<td>$1,985,496</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$50,023,535</strong></td>
<td></td>
</tr>
</tbody>
</table>

Note: We estimated the amount of SAP paid under the 9.5 percent floor calculation (9.5 Percent SAP Paid) on the ADB associated with the branch codes for the four holding tanks (4402/5402 and 4421/5421). For each quarter, we divided the total ADB billed for the four holding tanks by NLMA’s total ADB billed under the 9.5 percent floor calculation. We then multiplied the resulting percentage by NLMA’s total SAP paid under the 9.5 percent floor calculation to estimate the amount of 9.5 percent SAP paid for each respective quarter on the ADBs associated with the four holding tanks.

SLMA was unable to quantify its 9.5 percent floor calculation billings specifically associated with Bonds 93B, 93G, and 93H, because the loans within the holding tanks were commingled with loans associated with other eligible bonds associated with the 93A Indenture. We could not easily identify the ineligible loans and the quarterly ineligible ADBs associated with these loans. Therefore, we estimated the ineligible quarterly ADBs associated with Bonds 93B, 93G, and 93H that were billed under the 9.5 percent floor calculation. We also estimated the amount of the overpayments attributed to these ineligible loans.

In Table 8, we estimated that, on average, for each of the quarters ended June 30, 2002, through June 30, 2005, SLMA billed an ADB of about $54 million under the 9.5 percent floor calculation for loans that were no longer eligible for the 9.5 percent floor calculation following the maturity of the associated eligible tax-exempt bond and after the loans were refinanced with funds derived from an ineligible funding source.

In Table 9, we estimated that SLMA would have received about $10.7 million in improper SAP under the 9.5 percent floor calculation for the estimated ineligible ADBs. We also estimated the payments SLMA would have received based on the average usual special allowance rates for the

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8 We estimated the quarterly ADBs for the ineligible loans associated with the three matured bonds by amortizing the loans' estimated outstanding amounts at the time each bond matured resulting in an estimated quarterly ADB through the July 1, 2005, maturation of Bond 93A (Table 8).
same quarters. Of the estimated $10.7 million in improper SAP under the 9.5 percent floor calculation for quarters ended June 30, 2002, through June 30, 2005, SLMA would have received an estimated $632,000 under the usual rates, resulting in an estimated overpayment of about $10 million.

Table 8 – Estimate of Ineligible ADB Billed for NLMA Bonds 93B, 93G and 93H

<table>
<thead>
<tr>
<th>Quarter Ended</th>
<th>Bond 93B</th>
<th>Bond 93G</th>
<th>Bond 93H</th>
<th>Quarterly Balances (Ineligible ADB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 2002</td>
<td>$3,566,667</td>
<td></td>
<td></td>
<td>$3,566,667</td>
</tr>
<tr>
<td>September 30, 2002</td>
<td>$10,490,196</td>
<td>$31,445,098</td>
<td></td>
<td>$41,935,294</td>
</tr>
<tr>
<td>December 31, 2002</td>
<td>$10,175,490</td>
<td>$46,005,882</td>
<td>$4,790,000</td>
<td>$60,971,372</td>
</tr>
<tr>
<td>March 31, 2003</td>
<td>$9,860,784</td>
<td>$44,611,765</td>
<td>$14,088,235</td>
<td>$68,560,784</td>
</tr>
<tr>
<td>June 30, 2003</td>
<td>$9,546,078</td>
<td>$43,217,647</td>
<td>$13,665,588</td>
<td>$66,429,314</td>
</tr>
<tr>
<td>September 30, 2003</td>
<td>$9,231,373</td>
<td>$41,823,529</td>
<td>$13,242,941</td>
<td>$64,297,843</td>
</tr>
<tr>
<td>December 31, 2003</td>
<td>$8,916,667</td>
<td>$40,429,412</td>
<td>$12,820,294</td>
<td>$62,166,373</td>
</tr>
<tr>
<td>March 31, 2004</td>
<td>$8,601,961</td>
<td>$39,035,294</td>
<td>$12,397,647</td>
<td>$60,034,902</td>
</tr>
<tr>
<td>June 30, 2004</td>
<td>$8,287,255</td>
<td>$37,641,177</td>
<td>$11,975,000</td>
<td>$57,903,431</td>
</tr>
<tr>
<td>September 30, 2004</td>
<td>$7,972,549</td>
<td>$36,247,059</td>
<td>$11,552,353</td>
<td>$55,771,961</td>
</tr>
<tr>
<td>December 31, 2004</td>
<td>$7,657,843</td>
<td>$34,852,941</td>
<td>$11,129,706</td>
<td>$53,640,490</td>
</tr>
<tr>
<td>March 31, 2005</td>
<td>$7,343,137</td>
<td>$33,458,824</td>
<td>$10,707,059</td>
<td>$51,509,020</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>$7,028,431</td>
<td>$32,064,706</td>
<td>$10,284,412</td>
<td>$49,377,549</td>
</tr>
</tbody>
</table>

Average ADB $53,551,154

Note – Details of our estimates are contained in the Objectives, Scope and Methodology section in this report, “Estimate of Loans Billed After Bonds 93B, 93G, and 93H Matured.” Our estimate did not include a consideration for any loans that may have been transferred to the holding tank(s) before each bond matured.
Table 9 – Estimated SAP Overpayment for Bonds 93B, 93G, and 93H

<table>
<thead>
<tr>
<th>Quarter Ended</th>
<th>Estimated NLMA Ineligible ADB Billed</th>
<th>Estimated SAP at Usual Rates</th>
<th>Estimated 9.5 Percent SAP Paid</th>
<th>Estimated Overpayment</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 2002</td>
<td>$3,566,667</td>
<td>$0</td>
<td>$34,534</td>
<td>$34,534</td>
</tr>
<tr>
<td>September 30, 2002</td>
<td>$41,935,294</td>
<td>$7,590</td>
<td>$603,320</td>
<td>$595,730</td>
</tr>
<tr>
<td>December 31, 2002</td>
<td>$60,971,372</td>
<td>$7,012</td>
<td>$871,757</td>
<td>$864,745</td>
</tr>
<tr>
<td>March 31, 2003</td>
<td>$68,560,784</td>
<td>$6,788</td>
<td>$977,831</td>
<td>$971,043</td>
</tr>
<tr>
<td>June 30, 2003</td>
<td>$66,429,314</td>
<td>$4,783</td>
<td>$948,382</td>
<td>$943,599</td>
</tr>
<tr>
<td>September 30, 2003</td>
<td>$64,297,843</td>
<td>$6,816</td>
<td>$1,023,225</td>
<td>$1,016,410</td>
</tr>
<tr>
<td>December 31, 2003</td>
<td>$62,166,373</td>
<td>$8,890</td>
<td>$987,299</td>
<td>$978,410</td>
</tr>
<tr>
<td>March 31, 2004</td>
<td>$60,034,902</td>
<td>$6,184</td>
<td>$952,317</td>
<td>$946,133</td>
</tr>
<tr>
<td>June 30, 2004</td>
<td>$57,903,431</td>
<td>$60,162</td>
<td>$918,010</td>
<td>$857,848</td>
</tr>
<tr>
<td>September 30, 2004</td>
<td>$55,771,961</td>
<td>$35,415</td>
<td>$887,672</td>
<td>$852,257</td>
</tr>
<tr>
<td>December 31, 2004</td>
<td>$53,640,490</td>
<td>$58,146</td>
<td>$850,765</td>
<td>$792,619</td>
</tr>
<tr>
<td>March 31, 2005</td>
<td>$51,509,020</td>
<td>$152,209</td>
<td>$823,653</td>
<td>$671,444</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>$49,377,549</td>
<td>$278,144</td>
<td>$791,787</td>
<td>$513,643</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$632,137</strong></td>
<td><strong>$10,670,551</strong></td>
<td><strong>$10,038,413</strong></td>
<td></td>
</tr>
</tbody>
</table>

Note - Details of our estimates are contained in the Objectives, Scope and Methodology section in this report, “Estimate of Ineligible 9.5 Percent SAP and Usual SAP on Loans Funded by Bonds 93B, 93G, and 93H.”

Recommendations

We recommend that the Chief Operating Officer for Federal Student Aid instruct SLMA to—

1.1 Adjust its special allowance billings for loans associated with Bond 93F that became ineligible for the 9.5 percent floor calculation, as described in the finding, and return all overpayments to the Department (for which we estimate to be about $12.3 million).

1.2 Identify the loans associated with Bonds 93B, 93G, and 93H that became ineligible for the 9.5 percent floor calculation, as described in the finding, and adjust its special allowance billings for the affected loans in the quarters ended June 30, 2002, through June 30, 2005, and return all overpayments to the Department (for which we estimate to be about $10 million).

1.3 Disclose any other instances, at any of its subsidiaries (e.g., NLMA, Southwest Student Services Corporation, Student Loan Funding Resources, Student Loan Finance Association), of loans billed under the 9.5 percent floor calculation after the eligible tax-exempt bond issue matured and after the loans were refinanced with funds derived from an ineligible funding source and, if necessary, adjust its special allowance billings for all affected loans and return all overpayments to the Department.


SLMA Comments and OIG Responses

Introduction and Summary of Arguments

• **SLMA Comment.** SLMA agreed with our conclusion that it complied with TTPA and HERA, but strongly disagreed with our finding and recommendations. In its comments, SLMA confirmed that it treated loans it purchased from Nellie Mae that were made with the proceeds of the 1993 Bonds issued under the 1993 Trust Agreement as eligible for the 9.5 percent floor calculation until the last bond issued matured on July 1, 2005, but asserted that this practice was based on a reasonable interpretation of the HEA, regulations, and clear legislative intent.

• **OIG Response.** We have made some minor revisions to our report, for clarity, but we have not made the substantive revisions requested in SLMA’s comments. We do not agree that SLMA’s practice was based on a reasonable application of the HEA, regulations, and Departmental guidance.

Definition of “Obligation”

• **SLMA Comment.** SLMA disagreed with our understanding of the term “obligation,” and stated “... the OIG adopted a new narrow legal interpretation of the term obligation. An interpretation that, to the best of our knowledge, does not appear in the [HEA] ... or in any legislative history and has never been published or communicated to the student lending community in any manner.”

• **OIG Response.** Our report does not advance a new or unusual definition of “obligation.” Our understanding of the term “obligation” is consistent with the term’s use in the HEA, regulations, and Departmental guidance. Though the HEA, regulations, and Departmental guidance do not include a specific definition of “obligation,” their context indicates that the term means the particular debt or borrowing that was the source of the funds used to acquire or maintain ownership of a loan: the term is used to tie the 9.5 percent floor rate on a loan to the source of the funds used to acquire that loan.

For example, 34 C.F.R. § 682.302(c)(3)(i)(A) states that a loan is eligible for the 9.5 percent rate if it “was made or purchased with funds obtained by the holder from ... [t]he proceeds of tax-exempt obligations originally issued prior to October 1, 1993 ...” As such, the “obligation” is the funding source for the eligible loan. Contrary to this usage, SLMA’s definition of “obligation” would tie the eligibility of a loan for the 9.5 percent rate to a group of bonds, none of which may have been its funding source. This is not a reasonable application of the HEA’s and regulations’ use of “obligation.”

Congressional Intent

• **SLMA Comment.** SLMA stated that the finding is not consistent with the intent of Congress because the OIG’s understanding of the requirements for the 9.5 percent floor—

  ... is inconsistent with the original federal legislative intent that the 9.5% rate act as a floor and thus a limitation on the yield lenders could obtain. Therefore, the federal government encouraged maximizing loans within the 9.5% floor. In the past, the Department insisted that lenders not be permitted to turn loans originally
financed through tax-exempt obligations, for which special allowance was one half the normal special allowance [i.e., subject to the 9.5% floor rate], into loans that yielded full special allowance [i.e., subject to the usual rates] by refinancing the loans through taxable financings. Sallie Mae’s interpretation is the only interpretation consistent with that Congressional intent.

SLMA also stated that the finding is not consistent with the history of requirements for the 9.5 percent floor, as reflected in an audit report issued by the Government Accountability Office (GAO) in 2004.\(^9\) SLMA stated, “The Department amended 34 C.F.R. § 682.302(e)(2) in 1992 to prevent holders from avoiding the Half-SAP cap through refinancing into non-floor eligible loans, by adding a provision that if the authority retained a legal interest in those loans and the original tax-exempt obligation remained outstanding, floor loan treatment must continue.”

- **OIG Response.** SLMA’s general appeal to “congressional intent” is unsupported by specific evidence and does not address the particular circumstances of SLMA’s billing activity. The structure of the HEA provisions evidences Congress’ intent was to align a loan’s special allowance payments with the tax-exempt status of the bonds that were used to make or purchase it. The Department described this intent specifically, in its preamble to final regulations it published in the Federal Register on February 8, 1985:

> The rule implements the Congressional intention in section 438(b)(2) of the HEA to reduce special allowances to parties whose lower cost of borrowing does not justify Federal subsidy at the rate paid commercial lenders. These regulations therefore tie the rate of special allowance to the source of the funds used to acquire or maintain the Authority’s interest in a loan, and more particularly, to the financing costs incurred in securing those funds. Congress recognized that a party raising loan acquisition funds by means of tax-exempt borrowings had a financing cost well below that incurred by parties using other sources of funds, and the 1980 amendments to section 438 of the HEA which reduced the special allowance to tax-exempt borrowers reflect a Congressional judgment of the subsidy appropriate to their reduced borrowing costs. (50 FR 5512, emphasis added)

SLMA’s definition of “obligation” is contrary to Congress’ intent to “tie the rate of special allowance to the source of the funds.” Its definition would continue special allowance payments on a loan at the 9.5 percent rate long after its funding source was retired. For example, if a lender made or purchased $200 million in loans with the proceeds of $200 million in eligible tax-exempt bonds, and if $100 million of those bonds were retired within five years, and the remaining bonds continued until a 30-year maturity, these initial retirements, in SLMA’s view, would have no impact on the special allowance payments on the loans. The entire $200 million in loans would continue to receive special allowance payments at the 9.5 percent rate, until the remaining $100 million in bonds were retired.

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In addition to the reasons cited in the report’s finding, ECFC’s billings at the 9.5 percent floor calculation were also ineligible for 9.5 percent floor treatment because they did not comply with § 438(b)(2)(B)(i) of the HEA. § 438(b)(2)(B)(i) authorizes payment under the 9.5 percent floor calculation only “... for holders of loans which were made or purchased with funds obtained by the holder from the issuance of [eligible tax-exempt] obligations ...” As such, if the entity that issued the eligible tax-exempt obligation and used the proceeds to finance 9.5 percent floor loans no longer has title to, or interest in the loans, following the change in ownership of the loans, the loans can only qualify for the 9.5 percent floor calculation if the new holder used an eligible tax-exempt funding source to acquire the loan. ECFC was not eligible to bill loans under the 9.5 percent floor calculation because (1) ECFC did not use an eligible tax-exempt funding source to acquire the loans – it used holding tank funds, (2) NLMA did not retain an ownership interest in the loans sold to ECFC, and (3) NLMA and ECFC presented themselves as distinct and separate holders of loans for special allowance purposes.

SLMA’s Interpretation was Reasonable
• **SLMA Comment.** SLMA stated, “... neither the statute nor regulations currently specifically define ‘obligation’ and the precise issue raised in the OIG’s audit is one of first impression.” In addition, “SLMA reasonably interpreted the term ‘obligation’ ... to include multiple bonds issued in the same calendar year under a single trust agreement where the bonds shared important characteristics.”

SLMA also stated “... the OIG should not use an audit to advance a particular construction of an undefined term in a statutory provision that has long perplexed lenders, Congress, the Department and the press.” In addition, “If the Department takes the new position that ‘obligation’ for purposes of Section 438(b) and [34 CFR 682.302] should be interpreted more narrowly as an individual tax-exempt bond, it should publish public guidance for industry participants.”

• **OIG Response.** As stated in our previous responses, our understanding of the term “obligation” is consistent with the HEA, regulations and Departmental guidance. SLMA provided no evidence that such a definition “has long perplexed lenders, Congress, the Department and the press.”

The OIG’s Estimate is Incorrect and Overstated
• **SLMA Comment.** SLMA declared that the estimate of a $10 million overpayment of special allowance for loans associated with Bonds 93B, 93G, and 93H is overstated, because it is “based on a flawed assumption of the average life of non-consolidated FFELP loans, and should be removed from any final audit report.” Our report assumes that—

  o The average life of a loan associated with Bonds 93B, 93G, and 93H was 8.5 years, but according to SLMA, the average life of these loans ranged from 3.7 years to 4.6 years; and
  o The loans were newly originated at the time of the bond maturity, but according to SLMA, the loans had been in repayment for several years.
In addition, SLMA noted that a significant percentage of the loans would have been consolidated before the end of their expected lives. The correction of these assumptions would reduce the alleged $10 million estimated SAP overpayment.

- **OIG Response.** We believe that our estimate is reasonable and accurate. Our choice of 8.5 years as the average life of a loan was not arbitrary; it was consistent with the assumption made by the Department in its guidance for identifying loans that qualify for the 9.5 percent floor rate (DCL FP-07-06). We assumed that the loans were newly originated at the time of the bond maturity, and SLMA has not provided evidence to the contrary. Pursuant to 34 C.F.R. § 682.414(a)(4)(ii)(L), SLMA is required to document the accuracy of its billing, and it has not provided evidence to contradict our assumption.

Regardless, our audit report does not recommend recovery of the estimated amount; instead, it recommends that SLMA be instructed to “[i]dentify the loans associated with Bonds 93B, 93G, and 93H that became ineligible” and to adjust its billing and return overpayments for those loans. The Department may consider additional information provided by SLMA, including information on the specific life of the loans in its portfolio, when determining the corrective action for this audit.

**The Issues Addressed Have No Application to Other Sallie Mae Subsidiaries**

- **SLMA Comment.** SLMA disagreed with our Recommendation 1.3. It stated “. . . none of Sallie Mae’s other subsidiaries with 9.5 percent floor loans: (1) issued tax-exempt bonds under similar indentures or trust agreements with similar structures; (2) issued general obligation or unsecured bonds; or (3) had similar trust structures that lacked a defined pool of loans.”

- **OIG Response.** We have not removed Recommendation 1.3. During the audit’s survey phase, we noted that, in addition to NLMA, both Southwest Student Services Corporation and Student Loan Funding Resources had indentures under which more than one eligible tax-exempt bond had been issued. Our audit did not review the tax-exempt obligations and 9.5 percent floor rate SAP billings of SLMA’s other subsidiaries, and the information provided with SLMA’s response was not sufficient to confirm that SLMA’s statements are accurate. The Department may consider additional information provided by SLMA when determining the corrective action for this audit.

**Sallie Mae’s Legal Interpretation is Not a Management Control Weakness**

- **SLMA Comment.** SLMA stated “A difference in legal interpretation of an undefined statutory provision is not a management weakness in internal controls.” SLMA cites three authorities:

  1. The Public Company Accounting Oversight Board’s (PCAOB) Auditing Standard No. 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,” does not include anything to suggest that a company’s process of formulating a legal interpretation of a statute constitutes an internal control.
Exchange Act Periodic Reports: Frequently Asked Questions (revised October 6, 2004)” concludes that “[t]he definition of the term ‘internal control over financial reporting’ does not encompass a registrant’s compliance with applicable laws and regulations . . . .”

3. An unspecified, prior version of the Office of Management and Budget’s (OMB) Circular A-123, “Management Accountability and Control,” which SLMA quotes as stating, “[I]nternal control does not encompass such matters as statutory development or interpretation.”

• **OIG Response.** The authorities on internal control that SLMA cited were not applicable to our audit. The PCAOB and SEC authorities cited pertain to internal controls over financial reporting. Our audit was a performance audit, not a financial audit. The OMB circular cited pertains to Federal agencies’ internal controls; SLMA is not a Federal agency. In addition, the current (December 21, 2004) OMB Circular A-123 does not contain the language cited by SLMA. As we state in the Objectives, Scope, and Methodology section of this report, our audit was conducted in compliance with standards issued by the Comptroller General of the United States, in *Government Auditing Standards*, July 2007 Revision (GAS). Section 1.30 of GAS states, “Internal control audit objectives relate to an assessment of the component of an organization’s system of internal control that is designed to provide reasonable assurance of . . . compliance with applicable laws and regulations.” As such, GAS does not exclude an entity’s ability to arrive at a reasonable understanding of statutory and regulatory requirements from its definition of “internal controls.”

Common Characteristics

• **SLMA Comment.** SLMA stated “. . . all of the 1993 bonds were governed by terms of the same 1993 Trust Agreement, were issued in the same calendar year, were payable from the same sources of funds and because they were unsecured, had no claim or security interest on a specific pool of loans.” In addition, “Per the terms of the 1993 trust Agreement, each 1993 Bond was treated collectively and on a parity basis with the other 1993 Bonds in terms of the bondholders’ right to payments, default provisions, and remedies.” Consequently, SLMA concluded that, for purposes of applying the 9.5 percent floor provisions, it was reasonable to treat all of the 1993 Bonds as a single obligation because they shared common characteristics.

SLMA also stated, “The OIG’s separate consideration of each series relies on arguing that each series is unique only because of its issue date. However, the 1993 Bonds were not organized in such a way. For example, within certain of the series there were multiple interim maturity dates reflecting the maturity of some, but not all of the 1993 Bonds of an individual series.” In addition, “The OIG’s Draft Report would rely on the final maturity date of a bond series to determine eligibility for the 9.5 percent floor rate and ignore any interim maturity dates within the series. Sallie Mae’s practice just as reasonably relies on the final maturity date of the 1993 Bonds of July 1, 2005 as the appropriate end date for the 9.5 percent floor rate.”

• **OIG Response.** Whether the 1993 bonds had the same terms for right to payment, events of default, remedies, amendments, proceeds, and loan servicing has no bearing on their eligibility for special allowance payments at the 9.5 percent rate. As we state
in the finding, it is unreasonable to ignore attributes of obligations that are material in
determining their eligibility for the 9.5 percent floor. SLMA’s comments did not
address this explanation of our position. In regards to the bonds’ interim maturity
dates, the interim maturities occurred prior to our audit period. As a result, our
finding does not address SLMA’s treatment of the interim maturities and their impact
on its 9.5 percent floor billings. Had we expanded the scope of our audit, other
matters may have come to our attention that we could have included in our report.

Other Statutory Guidance

• **SLMA Comment.** SLMA asserted, “In the absence of clear statutory, regulatory, or
  Dear Colleague Guidance it was reasonable for SLMA to look to other statutory
  guidance or definition. Treasury’s regulations that permit a series of bonds to be
treated as one obligation support Sallie Mae’s practice of treating the 1993 Bonds as a
single financial obligation. Under Treasury’s regulations governing student loan
bonds during the lifespan of the 1993 Bonds, Sallie Mae was permitted to calculate a
single yield for all of the 1993 Bonds because of their significant relationship to each
other under the 1993 Trust Agreement.” Furthermore, “The courts have consistently
held that undefined terms in a statute be placed beside other statutes relevant to the
subject and given a meaning and effect derived from the combined whole.” In
addition, “The original provision of the HEA that established the Half-SAP program
explicitly incorporated the Internal Revenue Code provisions to determine which
obligations are tax-exempt. To this day, the Internal Revenue Code provisions
establish and govern those obligations entitled to receive tax-exempt treatment.”

• **OIG Response.** SLMA’s response provided no evidence that it in fact relied on the Treasury
  regulations to determine its FFEL billing practices. Though the HEA, regulations, and
Departmental guidance do not include a specific definition of “obligation,” the meaning of
the term is neither ambiguous nor unclear as used for Title IV purposes. The tax rule cited
by SLMA offers no insight into the definition of “obligation” for purposes of the FFEL
Program, because that tax rule relates to a limited issue on tax-exempt qualification. Tax law
provides little support for SLMA’s argument that “obligation” means a group of bonds.
Section 150 of the Internal Revenue Code, which addresses whether student loan bonds can
qualify as tax-exempt, defines the term “obligation” as synonymous with “bond”: “The term
‘bond’ includes any obligation.” (26 U.S.C. § 150(a)(1))

Inconsistent Practices

• **SLMA Comment.** SLMA asserted that our report’s allegation of inconsistencies in SLMA’s
practices is not accurate. SLMA acknowledged inconsistencies with NLMA’s 9.5 percent
billing practices prior to its acquisition, and stated its billing procedure for 9.5 percent floor
special allowance payments did not change. Our audit report states that the result of the July
2004 sale of loans associated with Bond 93F ceased billing the loans under the 9.5 percent
floor rate and classified the loans as eligible for the usual special allowance rates. SLMA
stated, “This sentence mischaracterizes the events associated with the July 2004 sale of loans
associated with the 93F bond series”. In addition, “. . . the July 2004 sale was an erroneous
early liquidation of bond series 93F.”
• **OIG Response.** Our audit report does not state that SLMA applied its practices inconsistently; it states that SLMA’s practices were inconsistent with NLMA’s practices. Our report accurately states that as a result of the July 2004 sale to ECFC, NLMA ceased billing the loans under the 9.5 percent floor rate. SLMA’s comments do not propose any other results from this transaction, and an SLMA memorandum documenting the transaction, dated February 1, 2005, supports our statement: “The Half SAP flag was switched to Full SAP for these loans. . . . This was an isolated transaction that was being evaluated for the first time. Accordingly, this change did not arise from a control gap, but rather from adopting a legal conclusion on an issue that had not been previously researched.” However, we have revised our report to more clearly state that SLMA considered the sale to be an error.

**Eligible Loans**

• **SLMA Comment.** SLMA stated in several places that the draft audit report acknowledged “the loans that were refinanced with the proceeds of the 1993 Bonds qualified to be billed under the 9.5 percent special allowance floor rate.”

• **OIG Response.** Our audit report does not acknowledge that “the loans that were refinanced with the proceeds of the 1993 Bonds qualified to be billed under the 9.5 percent special allowance floor rate.” The objectives of our audit were limited to (1) the requirements of the TTPA and HERA, and (2) loans billed under the 9.5 percent floor after the eligible tax-exempt bonds from which the loans derived their eligibility matured or were retired. Our report makes no assertions about the eligibility of the loans under any other requirements.
OBJECTIVES, SCOPE, AND METHODOLOGY

The original purpose of the audit was to determine if SLMA billed for SAP, under the 9.5 percent floor calculation, in compliance with requirements in the HEA, regulations, and guidance issued by the Department. Our audit was to cover the period January 1, 2005, through December 31, 2006. Based on our initial audit work, the audit’s objective and period of review were revised. The revised objectives of the audit were to determine if SLMA’s subsidiary, NLMA, (1) billed loans under the 9.5 percent floor in compliance with the TTPA and HERA, and (2) billed loans under the 9.5 percent floor, after the eligible tax-exempt bonds from which the loans derived their eligibility, had matured or been retired. The revised audit period covered October 1, 2003, through September 30, 2006.

To achieve the audit objectives, we—

- Reviewed information on SLMA’s four subsidiaries with 9.5 percent floor billings and eligible tax-exempt obligations: Southwest Student Services Finance Corporation, Student Loan Finance Association, Student Loans Funding Resources, and NLMA.
- Reviewed the Department’s Datamart system for 9.5 percent floor billings for SLMA’s four subsidiaries (listed above) and ECFC.
- Reviewed NLMA’s current billings and billing adjustments applicable to the audit period, and identified the significant billing adjustments by the quarter the adjustments were entered by SLMA. Billing adjustments less than $500,000 were excluded from our analysis, resulting in the net applied significant billing adjustments displayed in Table 10.
- Reviewed applicable laws, regulations and guidance issued by the Department, including the HEA, TTPA, HERA, 34 C.F.R. Part 682, and Dear Colleague Letters.

<table>
<thead>
<tr>
<th></th>
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<tr>
<td>December 31, 2003</td>
<td>($21,175,628)</td>
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<td>March 31, 2004</td>
<td>($18,439,959)</td>
<td>$0</td>
</tr>
<tr>
<td>June 30, 2004</td>
<td>$142,497,264</td>
<td>$0</td>
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<tr>
<td>September 30, 2004</td>
<td>($12,759,720)</td>
<td>$353,732,135</td>
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<tr>
<td>December 31, 2004</td>
<td>($9,894,223)</td>
<td>$204,767,175</td>
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<tr>
<td>March 31, 2005</td>
<td>$0</td>
<td>$91,622,389</td>
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<tr>
<td>June 30, 2005</td>
<td>$217,480,127</td>
<td>$0</td>
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<td>September 30, 2005</td>
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<tr>
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<td>$0</td>
</tr>
<tr>
<td>September 30, 2006</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

\(^{10}\) We did not determine if SLMA's special allowance billings under the 9.5 percent floor calculation included only eligible first-generation and second-generation loans, as those terms are explained in DCL FP-07-01, issued on January 23, 2007, and in DCL FP-07-06, issued on April 27, 2007.

\(^{11}\) Adjustments are shown in their applied quarters, and not the quarters in which they were entered.

• Held discussions with SLMA officials, including the Vice President of Loan Accounting and Reporting, Director of Service Accounting, Deputy General Counsel, Senior Vice-President of Corporate Finance, Senior Director and Accountant for Financial Reconciliation, and SLMA’s Information Technology Group.

• Reviewed documentation provided by SLMA, including—
  - A written explanation, created and provided at our request, of SLMA’s position, understanding, policy, and implementation of SAP billing under the 9.5 percent floor calculation;
  - A written description of how SLMA’s CLASS loan servicing system identified loans eligible for the 9.5 percent floor calculation;
  - SLMA’s policies and procedures explaining SLMA’s administration of its 9.5 percent portfolio to reflect changes in laws and regulations applicable to 9.5 percent floor calculation loans;
  - SLMA’s internal systems coding to segregate and identify loans as 9.5 percent eligible using Lender Identification Number (LID) -Branch combinations;
  - Transaction documentation regarding the liquidation and subsequent recapture of loans funded by Bond 93F;
  - Bond Prospectus Cover Sheets, Internal Revenue Service Form 8038s, Information Return for Tax-Exempt Private Activity Bond Issues, and other bond documentation for SLMA’s tax-exempt obligations originally issued prior to October 1, 1993;
  - A listing of SLMA’s bonds funding 9.5 percent floor calculation loans, along with information related to each bond, including its taxable or tax-exempt status, the amount outstanding, and the average daily balance of 9.5 percent floor calculation loans funded in each quarter;
  - SLMA’s bond genealogy for outstanding bonds during the audit period;
  - A written description of holding tanks’ funding sources; and
  - An explanation of ECFC’s relationship to NLMA.

• Obtained from the Department’s Datamart system the amount of 9.5 percent floor SAP, the ADB, and ending principal balances included on NLMA’s and ECFC’s Lender’s Interest and Special Allowance Request and Report (LaRS) billings for the audit period.

**Initial Selection and Review of Loans for TTPA and HERA Compliance**

We judgmentally selected and reviewed 2 of the 12 quarterly special allowance billings during the audit period. We selected the quarter ending March 31, 2005 (because it was the first full quarter billed following the enactment of the TTPA) and the quarter ending June 30, 2006 (because it was the first full quarter billed following the enactment of the HERA).
Using an attribute sample, we randomly selected 120 unique loan records\textsuperscript{12} from each of these two quarters (240 loans in total) from NLMA’s and ECFC’s LaRS data files. The March 31, 2005, universe contained a population of 278,139 unique loan records.\textsuperscript{13} The June 30, 2006, universe contained a population of 12,605 unique loan records.

We tested for compliance to the TTPA by using the following criteria for the loans sampled in the quarter ended March 31, 2005:\textsuperscript{14}

- The loan must have been classified in an eligible LID-Branch combination (i.e., eligible tax-exempt bond) prior to or during the billing quarter.
- The loan could not be refinanced after September 30, 2004.

We tested for compliance to the HERA and the TTPA by using the following criteria for the loans sampled in the quarter ended June 30, 2006:\textsuperscript{15}

- The loan must have been classified in an eligible LID-Branch combination (i.e., eligible tax-exempt bond) prior to or during the billing quarter.
- The loan must be originated prior to February 8, 2006.
- The loan could not be refinanced after September 30, 2004.

### Identification of Loans Billed After Bond 93F Maturity

When we were performing the audit’s survey phase, SLMA officials notified us that SLMA had continued to bill loans associated with Bond 93F under the 9.5 percent floor past the bond’s maturity date. We identified these ineligible loans using the documentation provided to us by SLMA in its summary of the NLMA bond maturity transactions. In the summary, SLMA outlined the amount of loans funded by Bond 93F that were sold to ECFC when the bond matured on July 1, 2004, and then billed under the usual special allowance rates. Subsequent to the sale of loans to ECFC, SLMA’s documentation detailed its process of recapturing the 9.5 percent SAP rate through current billings and billing adjustments during the quarters ended March 31, 2005, and June 30, 2005 (the adjustments were applicable to the quarters ended September 30, 2004, and December 31, 2004).

### Estimate of Ineligible 9.5 Percent SAP and Usual SAP on Loans Funded by Bond 93F

To estimate the SAP overpayment on the loans funded by Bond 93F, we—

- Reviewed the Datamart database and ECFC’s quarterly LaRS data files of loans billed under the 9.5 percent floor calculation for the quarters ending September 30, 2004, through

\textsuperscript{12} For each universe, a unique loan record was created by combining the borrowers’ SSN together with the loan Suffix and Loan Sequence Number fields.

\textsuperscript{13} The quarter ending March 31, 2005, also included the LaRS adjustments made in subsequent quarters that applied to the March 31, 2005 quarter.

\textsuperscript{14} SLMA was unable to provide documentation to show that 2 of the 120 loans in the March 31, 2005, sample were eligible for the 9.5% floor calculation. Based upon the two errors in the sample, we are 90 percent confident that the overall error rate for this sampled quarter is no more than 4.4%. (We considered these two errors to be materially insignificant.)

\textsuperscript{15} We noted no errors in the June 30, 2006, sample of 120 loans. Based upon the results of the sample, we are 90 percent confident that the overall error rate for this sampled quarter is no more than 1.9%.
June 30, 2005, to determine the amount of loans billed under the 9.5 percent floor calculation that were funded with ineligible funding sources after Bond 93F matured on July 1, 2004, and the amount of SAP paid on those loans.

- Queried the Datamart database for ECFC, LID 834071, for the quarterly LaRS data files of special allowance current billings, and the quarterly LaRS data files of the special allowance summary of tax-exempt current billings, billing adjustments for the quarters ended September 30, 2004, through June 30, 2005.


- Used data analysis software to reconcile the LaRS/799 Lender Reports with the Datamart data to identify the amount of loans billed under the 9.5 percent floor calculation funded by Bond 93F.

- Estimated the SAP that should have been paid on the ineligible loans for each quarter by—
  - Based on the LaRS reports, identifying the ADB for loans that were billed under the usual SAP rates and the amount of SAP paid on those loans;
  - Dividing the SAP paid on the loans by their ADB; and
  - Multiplying the resulting percentages by the ADB for the ineligible loans.

- Subtracted the estimated usual SAP that should have been paid on the ineligible loans associated with Bond 93F from the 9.5 percent SAP that was actually paid.

**Estimate of Loans Billed After Bonds 93B, 93G, and 93H Matured**

SLMA was unable to provide documentation that quantified the loans associated with the matured Bonds 93B, 93G, and 93H that were maintained in a holding tank and billed under the 9.5 percent floor until the maturity of Bond 93A in July 2005. We could not easily identify the ineligible loans and the quarterly ineligible ADBs associated with these loans. Therefore, we performed calculations to estimate the ineligible loan amounts associated with Bonds 93B, 93G, and 93H by amortizing the final amount of bonds outstanding at the time each bond matured, starting with the month of the bond’s maturity (Table 11).

<table>
<thead>
<tr>
<th>Bond Name</th>
<th>Bond Maturity</th>
<th>Outstanding Bond Amount at Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>93B</td>
<td>6/1/2002</td>
<td>$10,700,000</td>
</tr>
<tr>
<td>93G</td>
<td>8/1/2002</td>
<td>$47,400,000</td>
</tr>
<tr>
<td>93H</td>
<td>12/1/2002</td>
<td>$14,370,000</td>
</tr>
</tbody>
</table>

The estimate was based on the assumptions that (1) the amount of loans transferred to the holding tank equaled the bond’s outstanding amount for each bond at the time at which the bond
matured; (2) each loan was paid off over an 8.5 year period;\(^{16}\) and (3) zero percent interest accrued on the loans. Our estimate excluded any loans associated with Bonds 93B, 93G, and 93H that were transferred to the holding tank prior to the respective bonds’ maturity date because we could not reliably estimate amounts associated with these ineligible loans. The ADBs were prorated, between amounts eligible and ineligible for the 9.5 percent floor calculation, based upon periods in each quarter in which the bonds were outstanding. The prorated ADBs were for Bond 93B for the quarter ended June 30, 2002; Bond 93G for the quarter ended September 30, 2002; and Bond 93H for the quarter ended December 31, 2002. The result of the amortization for each bond was an estimated quarterly ADB for the loans associated with the matured Bonds 93B, 93G, and 93H for which we could estimate the 9.5 percent SAP paid (see Table 8).

**Estimate of Ineligible 9.5 Percent SAP and Usual SAP on Loans Funded by Bonds 93B, 93G, and 93H**

We estimated the 9.5 percent SAP paid on the estimated quarterly ADB for loans associated with the matured Bonds 93B, 93G, and 93H by calculating the percentage of 9.5 percent SAP paid as compared to the ADB billed by NLMA (LID 833691). We divided the net 9.5 percent SAP paid by the total ADB billed by NLMA for each quarter ended June 30, 2002, through June 30, 2005. We multiplied the resulting percentage by the estimated quarterly ADB (based on the amortization results) to estimate the amount of 9.5 percent SAP paid to NLMA on the loans associated with the matured Bonds 93B, 93G, and 93H.

We calculated the percentage of usual SAP paid by quantifying the ADB and SAP paid on loans billed by NLMA under usual SAP rates. We divided the SAP paid for these loans by their ADB to identify the percentage of estimated usual SAP rates for each quarter described above. We multiplied the resulting percentage of estimated usual SAP rates by the ADB of the loans associated with the matured Bonds 93B, 93G, and 93H in the quarters ended June 30, 2002, through June 30, 2005, to achieve the amount of usual SAP that should have been paid to SLMA. Finally, we subtracted this amount of usual SAP from the 9.5 percent SAP to estimate the overpayment made to SLMA for the ineligible loans associated with the matured Bonds 93B, 93G, and 93H.

**Computer-Processed Data**

To accomplish the audit’s objective, we relied, in part, on computer-processed data provided by SLMA. We obtained SLMA’s LaRS data files for the quarters ended December 31, 2003, through September 30, 2006. To determine the reliability of the data, we performed limited data testing. These tests included comparing the files’ average and ending principal balances against the Department’s FSA Datamart files, comparing information for the 240 randomly selected loans (described under “Initial Selection and Review of Loans for TTPA and HERA Compliance”) to SLMA’s CLASS loan servicing system, and applying logical tests to the data.\(^{16}\) The Department has determined the average life span of non-consolidated FFELP loans to be 8.5 years. The Department made this determination as part of its obligation under the Federal Credit Reform Act of 1990, 2 U.S.C. § 661 et seq., to calculate the subsidy cost for FFELP loans. NLMA’s 9.5 percent floor billings for the quarters ended June 30, 2002, through June 30, 2005, contained only non-consolidated loans. In comments submitted to a draft of this finding, SLMA stated that the weighted average life of a loan on its FFELP Stafford portfolio ranges from 3.7 to 4.6 years, and asked us to revise our assumption from 8.5 years to 4.0 years. We have not made this revision; our estimate relies on the average life span calculated by the Department.
files for the two quarters we selected. Based upon our preliminary assessment of the data, we concluded that the data were sufficiently reliable for use in achieving the audit’s objective.

**Internal Controls**

As part of our audit, we assessed SLMA’s system of internal control significant to the audit objective and applicable to its billing for SAP under the 9.5 percent floor calculation, the process used to identify loans eligible for special allowance billing under the 9.5 percent floor calculation. Our assessment disclosed a significant management control weakness that adversely affected SLMA’s ability to accurately identify loans eligible for special allowance billing under the 9.5 percent floor calculation. Specifically, SLMA continued to bill loans under the 9.5 percent floor calculation after the maturity of the eligible tax-exempt bonds and after the loans were refinanced with funds derived from ineligible sources. As a result of its management control weakness, SLMA’s billing activities did not comply with laws, regulations, and guidance for the 9.5 percent floor calculation. The weakness and its effects are fully discussed in the Audit Results section of this report.

We conducted on-site fieldwork at SLMA’s office in Reston, Virginia, during the period October 16, 2007, through May 14, 2008. On January 22, 2009, we held an exit conference with SLMA. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our finding and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objectives.
Enclosure: SLMA Comments

SLMA provided three exhibits with its cover letter. The enclosed Exhibit B excludes 36 pages of the amortization tables supporting the two Eligible Loan Balance tables on page 56. The full Exhibit B will be made available upon request.
May 6, 2009

Mr. Bernard Tadley
Regional Inspector General for Audit
Audit Services, Region III
Office of Inspector General
U.S. Department of Education
The Wanamaker Building
100 Penn Square East, Suite 502
Philadelphia, PA 19107
bernard.tadley@ed.gov

Re: Sallie Mae - ED-OIG/A03I0006

Dear Mr. Tadley:

I am pleased to enclose Sallie Mae, Inc.'s ("Sallie Mae") response to the above-referenced draft report received under your cover letter dated March 10, 2009. Pursuant to Mr. Howard Sorensen's April 13, 2009 e-mail message and April 28, 2009 e-mail message to Mr. Stan Freeman of Powers Pyles Sutter & Verville P.C., this response is timely.

Please do not hesitate to contact me with any questions you may have regarding the enclosed response, including the accompanying attachments and exhibits. I may be reached at (703) 984-5677.

Sincerely,

[Redacted]

cc: Stan Freeman, Esq., Powers Pyles Sutter & Verville P.C.
Anne Gish, Esq., Kutak Rock
Patricia Smisone, Esq., Thompson Hine LLC
Howard Sorensen, Esq., U.S. Department of Education

Enclosures
RESPONSE TO OFFICE OF INSPECTOR GENERAL
UNITED STATES DEPARTMENT OF EDUCATION
DRAFT AUDIT REPORT

FOR
SALLIE MAE, INC.
ED-OIG/A03I0006

Special Allowance Payments to Sallie Mae’s Subsidiary, Nellie Mae, for Loans Funded by Tax-Exempt Obligations.

May 6, 2009
I. **Introduction and Summary of Arguments**

The U.S. Department of Education’s Office of Inspector General (“OIG”) conducted a review of Sallie Mae’s subsidiary Nellie Mae (defined below). According to the OIG, the purpose of the audit was to determine if Nellie Mae: (1) billed loans under the 9.5% floor (defined below) in compliance with the Taxpayer Teacher Protection Act of 2004 (“TTPA”) and the Higher Education Reconciliation Act of 2005 (“HERA”); and (2) billed loans under the 9.5% floor after the eligible tax exempt bonds from which the loans derived their eligibility matured or were retired. The audit covered the period from October 1, 2003 through September 30, 2006. For purposes of this response, “Sallie Mae” refers to Sallie Mae, Inc., and its affiliates other than the Student Loan Marketing Association and “Nellie Mae” refers to the New England Education Loan Marketing Corporation and its successors including SLM Education Credit Finance Corporation.17

With respect to the first audit purpose, the OIG found that Sallie Mae’s billing for its Nellie Mae subsidiary for special allowance payments (“SAP”) under the 9.5% floor complied with TTPA and HERA. Sallie Mae agrees with this finding.

With respect to the second audit purpose, the OIG adopted a new narrow legal interpretation of the term “obligation.” An interpretation that, to the best of our knowledge, does not appear in the Higher Education Act of 1965, as amended (“HEA” or “Act”) or in any legislative history and has never been published or communicated to the student lending community in any manner. In connection with the second audit purpose, the OIG concluded that Sallie Mae erred when it took the position that it was entitled to bill the 9.5% floor on loans funded with the proceeds of bonds issued under such a single master indenture until the last bond issued under such indenture matured.

Sallie Mae strongly disagrees with the OIG’s conclusions. We disagree for the following reasons:

**Sallie Mae’s Interpretation is Correct and Consistent with Congressional Intent**

In a case of first impression, the issue is whether loans financed by the issuance of bonds in the same calendar year that share common characteristics, and are governed by a single master indenture or trust agreement, may be treated as an “obligation” for purposes of Section 438(b) of the Act and 34 C.F.R 682.302(e). Although there have been several OIG Audit Reports and other Department guidance on the 9.5% floor rate, such guidance has never addressed this particular issue. Indeed, this particular construction is inconsistent with the original federal legislative intent that the 9.5% rate act as a floor and thus a limitation on the yield lenders could obtain. Therefore, the federal government encouraged maximizing loans within the 9.5% floor. In the past, the Department insisted that lenders not be permitted to turn loans originally financed through tax-exempt obligations, for which special allowance was one half the normal special allowance, into loans that yielded full special allowance by refinancing the loans through taxable financings. Sallie Mae’s interpretation is the only interpretation consistent with that Congressional intent.

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17 The Student Loan Marketing Association, a government sponsored enterprise that was a subsidiary of SLM Corporation, was dissolved as of December 31, 2004 pursuant to the terms of its privatization process.
Sallie Mae’s Interpretation was Reasonable

Even if the Department were to now adopt OIG’s new narrow legal interpretation of the term “obligation”, Sallie Mae’s practice was based on a reasonable application of the Act, the Department’s regulations, and clear legislative intent. This is particularly true here, where neither the statute nor regulations currently specifically define “obligation” and the precise issue raised in the OIG’s audit is one of first impression.

Sallie Mae reasonably interpreted the term “obligation,” a term that is not specifically defined in Section 438 (b) of the HEA or Section 682.302 in the regulations, to include multiple bonds issued in the same calendar year under a single trust agreement where the bonds shared important characteristics. If the Department takes the new position that “obligation” for purposes of Section 438(b) and 34 CFR 683.302 should be interpreted more narrowly as an individual tax-exempt bond, it should publish public guidance for industry participants. Moreover, the OIG should not use an audit to advance a particular construction of an undefined term in a statutory provision that has long perplexed lenders, Congress, the Department and the press.

The OIG’s Estimate is Incorrect and Overstated

Apart from question of how the Act and federal regulations should be interpreted, the OIG’s estimate of the amount of special allowance that it believes Sallie Mae should return is incorrect, speculative, and based on a flawed assumption of the average life of non-consolidated FFELP loans and should be removed from any final audit report.

The Issues Addressed have no Application to Other Sallie Mae Subsidiaries

The OIG also suggests in its Draft Report that other Sallie Mae subsidiaries should be reviewed for the same issue. The issue addressed in the Draft Report is limited to Nellie Mae’s special allowance billings and there is no reason for any final audit report to include the recommendation to the FSA as to information on Sallie Mae’s other subsidiaries. The issue addressed in this audit is not relevant to Sallie Mae’s other subsidiaries, since none of Sallie Mae’s other subsidiaries with 9.5% floor loans: (1) issued tax-exempt bonds under similar indentures or trust agreements with similar structures; (2) issued general obligation or unsecured bonds; or (3) had similar trust structures that lacked a defined pool of loans. As such, Sallie Mae properly treated the Nellie Mae-bonds differently than the bonds of its other subsidiaries and therefore there is no need to recommend any further review on this issue.
Sallie Mae’s Legal Interpretation is not a Management Control Weakness

Finally, the OIG claims that there was a management control weakness at Sallie Mae. Even assuming for the sake of argument, that Sallie Mae incorrectly interpreted the 9.5% floor special allowance provision by continuing to bill 9.5% special allowance until the last bond issued under a single trust agreement matured, Sallie Mae’s legal reasoning and interpretation on an issue of first impression is not a management control weakness, and the reference to management control weaknesses in the Draft Report should be removed from any final audit report.

We address each of the Draft Report’s findings in detail below. It is important to note that the findings in the Draft Report relate to activities that ceased in June 2005, prior to the date of the Draft Report and prior to September 30, 2006, the end date of the last quarterly period for which Sallie Mae billed at the 9.5% floor rate.

II. Factual Background.

Nellie Mae issued tax-exempt bonds in series from time-to-time during a nine month period in 1993 (collectively, the “1993 Bonds”) under the terms of the 1993 Trust Agreement (defined below). The purpose of these 1993 Bonds was to generate proceeds totaling approximately $458 million that could be used to refund tax-exempt bonds that were previously issued to purchase eligible student loans. In accordance with the HEA and as acknowledged by the OIG in its Draft Report, the loans that were refinanced with the proceeds of the 1993 Bonds qualified to be billed under the 9.5% special allowance floor rate.

III. 9.5% Floor Rate Statutory and Regulatory Provisions.

The Act provides for the Secretary of Education to make special allowance payments to eligible lenders. The rates are based on formulas that differ according to the type of the loan; the date the loan was originally made or insured; and the type of funds used to finance the loan (taxable or tax-exempt). In 1980, concerned that lender yields for loans financed with tax-exempt obligations did not adequately reflect the lower costs associated with tax-exempt financing, Congress reduced the special allowance to be paid on loans financed with tax-exempt obligations to one-half of that otherwise payable (“Half-SAP”). At the same time, however, Congress guaranteed that the lender yield for loans financed with tax-exempt obligations would be no less than 9.5% (the “9.5% floor”). In the Student Loan Reform Act of 1993, included in the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, secs. 4105 and 411 (1993), Congress eliminated the Half-SAP and 9.5% floor for loans financed with tax-exempt obligations issued on or after October 1, 1993.

Section 438(b)(2)(B) of the Act, which specifies the criteria for eligible loans to initially qualify for the 9.5% floor, states in pertinent part:

(i) The quarterly rate of the special allowance for holders of loans 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 shall be one-half the quarterly rate of
the special allowance established under subparagraph (A)[the full special allowance rate], except that . . . .

(ii) The quarterly rate of the special allowance set under division (i) of this subparagraph shall not be less than 9.5 percent minus the applicable interest rate on such loans, divided by 4.\textsuperscript{18}

The Department’s regulations at Section 682.302(c)(4)\textsuperscript{19} further specify that “[l]oans made or purchased with funds obtained by the holder from the issuance of tax-exempt obligations originally issued on or after October 1, 1993, . . . do not qualify for the minimum special allowance rate [of 9.5%].” As noted above, the OIG acknowledges that the student loans purchased or refinanced with the proceeds of the 1993 Bonds did properly qualify for the 9.5% floor rate.

The regulations also address when such loans lose their eligibility for the 9.5% floor. Section 682.302(e)(2)(ii) states that such loans lose their entitlement to the 9.5% floor rate when they are “pledged or otherwise transferred in consideration of funds” that would not have previously qualified for the 9.5% floor and “the prior tax-exempt obligation [the proceeds of which were used to purchase the loans] is retired [or defeased].”

IV. **Sallie Mae Correctly Applied the Act and the Regulations in Billing Special Allowance on Loans Financed under Nellie Mae’s 1993 Trust Agreement.**

Sallie Mae correctly applied the Act and the regulations in billing Special Allowance on loans financed under Nellie Mae’s 1993 Trust Agreement. Sallie Mae’s practice was based on a reasonable application of the Act and the Department’s Regulations.\textsuperscript{20} As the OIG stated, Sallie Mae’s practice was to continue to bill loans that it purchased from Nellie Mae that were floor loans at the time of acquisition by Sallie Mae at the 9.5% SAP rate until the last serial issue associated with the 1993 Bond series associated with the 1993 Trust Agreement matured. Specifically, Sallie Mae treated loans it purchased from Nellie Mae that were made with the proceeds of the 1993 Bonds issued under the 1993 Trust Agreement as eligible for the 9.5% floor calculation until the last bond issued matured on July 1, 2005. Sallie Mae never purchased loans

\textsuperscript{18} Congress first enacted legislation which established different special allowance for holders of loans “made or purchased with funds obtained by the holder from the issuance of obligations, the income of which is exempt from taxation” in 1980, through the Education Amendments of 1980, Pub. L. 96-374, Title IV, § 420(b), Oct. 3, 1980. In the Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, Congress repealed the 9.5% floor for all loans “financed with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993, the income of which is excluded from gross income under the Internal Revenue Code of 1986.”

\textsuperscript{19} The OIG’s Draft Report cites an outdated copy of the Code of Federal Regulations. While the relevant regulations have been substantially restructured and rewritten, there are no material differences in their application to this issue.

\textsuperscript{20} In its Draft Report, the OIG claims that Sallie Mae’s position is that obligation means indenture. The OIG goes on to explain why an indenture is not an obligation. The OIG completely misstates Sallie Mae’s position. Sallie Mae’s position is that obligation refers to all bonds issued under the single master indenture, not the indenture itself.
that were made with the proceeds of Bonds 93C-E, thus at issue here is Sallie Mae’s billing of 9.5% floor on loans that were included in Bonds 93B, F, G and H.21

Again, Sallie Mae’s practice is based on a reasonable application of the Act and the Department’s regulations. All of the 1993 Bonds shared common characteristics that support treating them as a single obligation for purposes of applying the 9.5% floor provisions. The common characteristics of the 1993 Bonds are based on the specific terms of the 1993 Trust Agreement with The First National Bank of Boston (the “Trustee”) dated March 1, 1993 (the “1993 Trust Agreement”) and the relationship between the 1993 Bonds and the collective pool of loans purchased with the proceeds from the 1993 Bonds. Enclosed as Exhibit A to this submission is a legal memorandum from experienced bond counsel at Thompson Hine which agrees with Sallie Mae’s position.

(a) 1993 Trust Agreement

Nellie Mae issued the 1993 Bonds in series A through H from time-to-time during a nine-month period in 1993 under the terms of the 1993 Trust Agreement. The purpose of these 1993 Bonds were to generate proceeds totaling approximately $458 million that could be used to refund tax-exempt bonds that were previously issued by Nellie Mae to purchase eligible student loans. In accordance with the Act and as acknowledged by the OIG’s report, the loans that were refinanced with the proceeds of the 1993 Bonds qualified to be billed under the 9.5% special allowance floor rate.

Notably, all of the 1993 Bonds were governed by the terms of the same 1993 Trust Agreement, were issued in the same calendar year, were payable from the same sources of funds and because they were unsecured, had no claim or security interest on a specific pool of loans. Additionally, the rights of each bondholder under each series of 1993 Bonds were identical to the rights of the bondholders under the other series of 1993 Bonds issued pursuant to the 1993 Trust Agreement. Per the terms of the 1993 Trust Agreement, each 1993 Bond was treated collectively and on a parity basis with the other 1993 Bonds in terms of the bondholders’ right to payments, default provisions, and remedies. The terms of these provisions are discussed below.

Right to Payment: Article IV of the 1993 Trust Agreement stipulates that on each date on which payment on any of the 1993 Bonds is due, the Corporation [Nellie Mae] pays to the Trustee and the Trustee pays to the bondholders the requisite amount of interest on or principal of the 1993 Bond. Collections on the purchased loans were not dedicated as the sole source of repayment of the 1993 Bonds.22 The provisions make no distinction and give no preference to any bondholder of any separate series of the 1993 Bonds.

Events of Default: Article VIII of the 1993 Trust Agreement states that the failure to make a timely payment of the principal of or the interest on any of the 1993 Bonds constitutes an Event of Default for all of the 1993 Bonds. Following an Event of Default, the 1993 Trust Agreement provides for the acceleration of the principal of all of the outstanding 1993 Bonds regardless of the series of 1993 Bonds. In other words, the

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22 This feature was unique to these Nellie Mae 1993 Bonds. These 1993 Bonds were general obligations of Nellie Mae and were therefore payable from the general revenues of Nellie Mae as opposed to collections from the loans.
interests of all of the bondholders under the 1993 Trust Agreement are evenly linked — if one bondholder is not paid, the Corporation [Nellie Mae] is in default with regard to all bondholders.

**Remedies:** Article VIII of the 1993 Trust Agreement also provides for the distribution of funds received from the Corporation [Nellie Mae] to remedy an Event of Default or following a judgment from a suit filed by the Trustee. The distribution provision causes those funds to be shared on a parity basis across all of the 1993 Bonds based on the amount of interest, principal, and redemption premium owed. There is no right of the holder of an individual 1993 Bond or even the holders of all of the 1993 Bonds of a separate series to file suit to enforce the 1993 Trust Agreement without the consent of a total of two-thirds (2/3) of the aggregate principal amount of the 1993 Bonds outstanding (and not separated by series of 1993 Bonds).

**Amendments:** Similar to the remedial rights, the 1993 Bonds also require collective action of all bondholders without regard to any separate series of 1993 Bonds to amend certain provisions of the 1993 Trust Agreement. Under Section 7.2 of the 1993 Trust Agreement, the written consent of the holders of two-thirds (2/3) of the principal amount of all of the 1993 Bonds outstanding is required to modify or adopt an amendment to the rights and obligations of the Corporation [Nellie Mae] or the holders of the 1993 Bonds. In other words, series of 1993 Bonds that matured earlier than other series of 1993 Bonds did not control or have greater rights over the administration of all of the 1993 Bonds. This provision has the potential effect of an amendment being adopted that modified the rights of the bondholders of a particular series of 1993 Bonds even if all of the bondholders of that series voted against the amendment.

**Proceeds:** In addition to equal treatment of all the bondholders under the 1993 Trust Agreement, the terms of the 1993 Trust Agreement do not create a connection between an individual 1993 Bond or series and the student loans purchased with the proceeds from the 1993 Bonds. Unlike most student loan bond financings, the loans purchased with proceeds from the 1993 Bonds are not pledged as collateral in support of a particular series of 1993 Bonds. Rather, all unencumbered loans of the Corporation [Nellie Mae], along with its general assets and credit, are the source of credit for the entire financing under the 1993 Trust Agreement. A more specifically identifiable relationship between one series of bonds and one loan portfolio (e.g., where the loans are secured collateral for the specific series) did not exist because of the nature and terms of the 1993 Trust Agreement.

**Loan Servicing:** Section 5.3(b) of the 1993 Trust Agreement requires the Corporation [Nellie Mae] to properly service all student loans owned by it regardless of the source of the proceeds used to purchase the loan. The 1993 Trust Agreement details the criteria for executing a servicing agreement to service the loans and similarly treats each of the Corporation’s [Nellie Mae’s] loans equally regardless of which 1993 Bond series’ proceeds were used to finance the loan.
(b) Application of the Act to the 1993 Bonds

When Congress first enacted the statutory provision in 1980 that established Half-SAP treatment for certain loans, it did not specifically define the term “obligation.” Indeed, despite the fact that Congress has amended the special allowance provisions on numerous occasions since 1980, Section 438(b)(2) has never included a specific definition of “obligation” for purposes of applying the 9.5% floor rule. The current regulations that address the 9.5% floor provision similarly lack any specific definition of the term “obligation.” Indeed, in interim regulations promulgated in 2006, the Department specifically acknowledged that “current regulations refer to obligations originally “issued” before or after specified dates, but do not define that term, derived from Section 438(b)(2)(B) of the Act.” Interim Regulations, 71 Fed. Reg. 45680, August 9, 2006.

Because of an ambiguity inherent in the text of the Act and the regulations, Sallie Mae acted reasonably in relying on a good faith interpretation of the regulations to determine the appropriate practice for billing 9.5% floor rate loans. The regulations specifically state that an otherwise eligible student loan loses its 9.5% floor rate status when “the prior tax-exempt obligation,” the proceeds of which were used to purchase the loan, is retired or defeased. The ambiguity arises from the use of the word “obligation” in its singular form.

(c) The Department has Never Addressed the Issue Raised in the Draft Report.

The Department’s regulations and guidance have not clearly answered the question of which group of bonds should be used for purposes of applying the 9.5% floor rules. Such bonds could be grouped based on a multitude of different characteristics to determine which bonds should be associated with which particular loans. For example, with secured bond issuances, the relationship between a group of bonds that are secured by a specific group of loans may be easy to discern. Absent that arrangement, it is reasonable to associate bonds based on their issue date, maturity date, or some other common term(s), such as the terms of the applicable indenture or trust agreement.

Sallie Mae treated the 1993 Bonds as a single obligation because they were all issued during the same year with identical terms and provisions as discussed above. That application is arguably consistent with the Department’s interpretation of the regulations. Sallie Mae’s interpretation recognizes the 1993 Bonds as the group of issuances that has the most common and significant shared characteristics including issue year, payment rights, collateral and remedies.

It is a reasonable approach to treat the 1993 Bonds as a single obligation because of their common terms and characteristics, rather than arbitrarily identifying each bond series as a separate obligation. The OIG’s separate consideration of each series relies on arguing that each series is unique only because of its issue date. However, the 1993 Bonds were not organized in such a way. For example, within certain of the series there were multiple interim maturity dates.

23 Regulations implementing the Half-SAP provision, promulgated in 1985 broadly defined “obligation” to mean “any interest-bearing debt or original issue discount debt incurred by an Authority pursuant to its borrowing powers. [A]s used in this subpart, this term means only an obligation issued to acquire funds for financing or refinancing the making or purchasing of student loans.” 50 Fed. Reg. 5515, February 8, 1985. The Department removed the definition of “obligation” from the regulations in December 1992.
reflecting the maturity of some, but not all of the 1993 Bonds of an individual series. Additionally, of the eight series of the 1993 Bonds, half of them shared a common issue date. Instead of being substantively different financings, the use of multiple series for the 1993 Bonds was based on logistical convenience or investor demands.

In sum, Sallie Mae had a reasonable basis to treat the collective group of the 1993 Bonds as the obligation. Sallie Mae’s position that all of the 1993 Bonds issued under the 1993 Trust Agreement — not the Agreement itself — constitute one obligation with a maturity date of July 1, 2005 is consistent with the intent of Congress in enacting the 9.5% floor provision, namely to offer less than full special allowance to non-profit lenders with access to tax-exempt financing and lower cost of funds than for-profit lenders. To address the 1993 Bonds by their separate series designation is to impart to each series distinct characteristics that do not exist under the 1993 Trust Agreement.

The OIG’s Draft Report would rely on the final maturity date of a bond series to determine eligibility for the 9.5% floor rate and ignore any interim maturity dates within the series. Sallie Mae’s practice just as reasonably relies on the final maturity date of the 1993 Bonds of July 1, 2005 as the appropriate end date for the 9.5% floor rate. The original intent of Congress in enacting the 9.5% floor provision was to maximize the amount of loans billed at 9.5% to penalize non-profit lenders and minimize any potential windfall they would otherwise obtain due to their low cost of funds. Sallie Mae’s interpretation is the only interpretation consistent with that Congressional intent.

(d) The OIG’s Reliance on Alleged Inconsistencies in Sallie Mae’s Practices is Misplaced.

In its Draft Audit Report, the OIG also attempts to highlight alleged inconsistencies between Sallie Mae’s treatment of 9.5% floor loans after its acquisition of Nellie Mae and Nellie Mae’s practice prior to the acquisition, as well as alleged inconsistencies in Sallie Mae’s treatment of loans funded by Bond 93F. The OIG’s attempt to rely on these alleged inconsistent interpretations is irrelevant and further misstates the facts.

Since its acquisition of Nellie Mae in July of 1999, Sallie Mae’s billing procedure for loans eligible for the 9.5% special allowance floor has been consistent. As noted in the Overview of Policies Sallie Mae submitted to the OIG, Sallie Mae’s policy for the management of Nellie Mae’s student loans financed by tax-exempt obligations required that:

- Nellie Mae issues tax-exempt obligations under the terms of a trust indenture or trust agreement, which established the trust and governed the administration of the trust and the assets owned by the trust.
- Loans remained 9.5% floor loans if they were transferred to an affiliate of the entity issuing the tax-exempt obligations but not refinanced with an ineligible source of funds. These affiliates were referred to as “holding tanks” and were funded with general corporate funds including equity, cash and taxable, not tax-exempt debt.
• As the related bond trust was extinguished with the last tax-exempt bond series maturity, the eligibility of the related loans in the holding tank for 9.5% special allowance was extinguished and the loans had to start receiving full special allowance. 24

Sallie Mae acknowledges that this interpretation was inconsistent with Nellie Mae’s 9.5% billing practices in place prior to the acquisition of the company in 1999. 25 However, the Nellie Mae loans cited in the OIG Draft Report that Sallie Mae purchased under the 1993 Trust Agreement (loans associated with the 93A, 93B, 93F, 93G, and 93H bond series) were billed at the 9.5% floor rate under the policy outlined above. 26 The loans associated with the 1993 Bonds under the 1993 Trust Agreement that matured prior to Sallie Mae’s purchase (bond series 93C, 93D, and 93E) were not loans Sallie Mae purchased and therefore were not billed under this policy. 27

The OIG has included statements in the Draft Report and in its workpapers indicating that the purpose of the July 2004 sale of loans associated with bond series 93F was “to cease billing the loans under the 9.5% floor calculation, and to classify the loans as eligible for the usual special allowance rates, as Bond 93F was scheduled to mature on July 1, 2004.” 28 This sentence mischaracterizes the events associated with the July 2004 sale of loans associated with the 93F bond series.

As Sallie Mae has previously explained to the OIG, the July 2004 sale was an erroneous early liquidation of bond series 93F. 29 As noted in Sallie Mae’s February 1, 2005 memorandum, the process that had been used by Sallie Mae to “tag” loans qualified to receive 9.5% SAP was not entirely effective. 30 As part of the monitoring process Sallie Mae initiated in 2004 to correctly identify and tag all 9.5% loans, Sallie Mae determined that the loans associated with the 93F bond series had been switched from 9.5% to the full special allowance rate in error. 31 Sallie Mae corrected its 799 billings with respect to this error between January, 2005 and June, 2005.

24 OIG Workpaper H.1.16, D.3.1
25 See OIG Workpaper D.3.5., p. 2.
26 OIG Workpaper A.1.1 – July 28, 2008 e-mail communication from J. Wheeler to Robert Janney; OIG Workpaper G.1.1.
27 See OIG Workpaper G.4.1, p. 2.
28 See Draft Report, p. 13; OIG Audit Workpaper D.3.4, D.3.5
29 See OIG Workpaper H.1.39.
30 See OIG Workpaper H.1.22, p. 2.
31 Note, the February 1, 2005 memorandum refers to the loans associated with bond series 93F as bond series 93B, in error.
32 See OIG Workpaper H.1.22 at p. 3.
(e) **The History of the 9.5% Provision Supports Sallie Mae’s Interpretation of “Obligation.”**

The historical context of the 9.5% floor loan provisions also provides support for Sallie Mae’s interpretation of “obligation.” As the Comptroller General recognized in a report issued by the General Accountability Office (“GAO”) in 2004, in the early 1990s, the Department expected that interest rates would rise, and that such predicted rise would result in a higher lender yield for loans not subject to the Half-SAP limitation. The Department was concerned that holders would transfer loans out of floor loan eligible issuances in order to obtain a higher yield, “thus resulting in higher special allowance payments for the Government.” GAO Report at p. 5. The Department amended 34 C.F.R. § 682.302(e)(2) in 1992 to prevent holders from avoiding the Half-SAP cap through refinancing into non-floor eligible loans, by adding a provision that if the authority retained a legal interest in those loans and the original tax-exempt obligation remained outstanding, floor loan treatment must continue. Given this historical context, if interest rates had been high in 2005, by following the OIG’s interpretation of the word, “obligation,” Sallie Mae would have subjected itself to accusations of improperly boosting its yield on loans by treating bonds issued under a single trust agreement as separate obligations for purposes of the 9.5% floor.

(f) **In the Absence of Clear Regulatory or Dear Colleague Letter Guidance, it was Reasonable for Sallie Mae to look to other Statutory Guidance or Definitions.**

In the absence of clear statutory, regulatory, or Dear Colleague Letter Guidance, it was reasonable for Sallie Mae to look to other statutory guidance or definition.

Treasury’s regulations that permit a series of bonds to be treated as one obligation support Sallie Mae’s practice of treating the 1993 Bonds as a single financial obligation. Under the Treasury’s regulations governing student loan bonds during the lifespan of the 1993 Bonds, Sallie Mae was permitted to calculate a single yield for all of the 1993 Bonds because of their significant relationship to each other under the 1993 Trust Agreement. Treas. Reg. 1.148-4(a). This exception to the yield-calculation rules exists because the failure to treat bonds such as the 1993 Bonds as a single obligation can result in discriminatory treatment of the students whose loans were purchased.

While the Treasury regulations are tax-based and not derived from the Act, the OIG has indicated that it may consider economic-related rules and regulations from outside the Department when addressing billing issues. In the OIG’s Final Audit Report entitled “Special Allowance Payments to Nelnet for Loans Funded by Tax-Exempt Obligations,” the OIG relied in part on Financial Accounting Standards Board (“FASB”) Accounting Standards, Statements of Standards FAS 125 and FAS 140 to determine whether certain loan transactions constituted sales or transfers. Such consideration of other federal regulations supports Sallie Mae’s reliance on the Treasury’s regulations in its practices with respect to the 1993 Bonds, and in the absence of a specific definition of “obligation” in the HEA, Sallie Mae’s analogy to the Treasury regulations was reasonable.

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34 For a copy of the Nelnet Report see, [www.ed.gov/about/offices/list/oig/auditreports/a07f0017.pdf](http://www.ed.gov/about/offices/list/oig/auditreports/a07f0017.pdf).
The Treasury regulation cited above is relevant to the consideration of the meaning of the term “obligation” under the HEA. One of the fundamental canons of statutory construction is that the words of a statute must be read in context with a view to how those provisions fit in the overall statutory scheme. The courts have consistently held that undefined terms in a statute be placed beside other statutes relevant to the subject and given a meaning and effect derived from the combined whole. Generally, where legislation dealing with particular subject consists of system of related general provisions indicative of settled policy, new enactments of a fragmentary nature on such subject are to be taken as intended to fit into the existing system and to be carried into effect conformably thereto, except where a different purpose is clearly shown.

The original provision of the HEA that established the Half-SAP program explicitly incorporated the Internal Revenue Code provisions to determine which obligations are tax-exempt. To this day, the Internal Revenue Code provisions establish and govern those obligations entitled to receive tax-exempt treatment. In view of these facts, IRS interpretations establishing the meaning of a tax-exempt obligation; which bonds are entitled to be considered an ‘obligation’; and the tax-treatment of those obligations, are relevant and appropriate guides to determine the meaning and treatment of those tax-exempt obligations under the HEA for purposes of the Half-SAP provision.

In summary, for all the reasons stated above, Sallie Mae’s billing practices with respect to the 1993 Bonds issued under the 1993 Trust Agreement were a good faith effort to comply with the Act and as a reasonable and supported conclusion under the Act and the Department's regulations.

V. The OIG’s Estimate of the Alleged Overpayment of SAP is Incorrect.

35 Food and Drug Admin. v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 120 S.Ct. 1291 (2000) (Tobacco manufacturers, retailers and advertisers challenged the Food and Drug Administration regulation of tobacco products. In construing the relevant provisions of Food, Drug and Cosmetic Act, the court considered various statutes enacted to regulate the use of tobacco products in reaching the conclusion that the FDA did not have jurisdiction to regulate tobacco products as customarily marketed.)

36 See e.g., United States v. American Trucking Association, 310 U.S. 534, 543-44 (1940) (Supreme Court interpreted Motor Carrier Act of 1935 in light of the Hours of Service Act, the Motor Vehicle Act, and other statutes where it was hesitant to interpret clause in question in a way that would deviate from the meaning of other related statutes); United States v. Abreu, 962 F.2d 1447 (10th Cir. 1992)(noting that in construing ambiguous or undefined statutory term, Supreme Court has indicated that references to other statutes may may be appropriate as well); Stribling v. United States, 419 F.2d 1350 (8th Cir. 1969)(where interpretation of particular statute is in doubt, express language of another statute not strictly in pari material but employing similar language and applying to similar persons and things may control by force of analogy).

37 United States v. Arizona, 295 U.S. 174, 55 S.Ct. 666 (1935) (Court considered the statutory history of acts governing rivers and streams in reaching conclusion that one isolated provision did not evidence intention of Congress to change its long-standing interpretations).


In its Draft Report, the OIG recommends that the Department require Sallie Mae to return approximately $12.3 million in SAP billings for loans associated with Bond 93F and approximately $10 million in SAP billings for loans associated with Bonds 93B, 93G and 93H. Putting aside the issue of whether the OIG’s interpretation of the term “obligation” for purposes of the 9.5% floor loans is correct, the OIG’s estimates of alleged SAP overpayments are based on a flawed assumption about the average life span of loans in the bonds at issue here for purposes of amortizing the loan balances, and therefore are overstated.

The OIG based its estimates of the alleged ineligible loan amounts associated with Bonds 93B, 93G and 93H on the assumption that each loan was paid off over an 8.5 year period. Draft Report, p. 17-18. This 8.5 year average life may in fact be valid for loans originated in 2008. We submit, however, that it is not valid for loans originated before or during the audit period of 2002-2005. We also submit that OIG incorrectly assumed that the loans were newly originated at the time of the bond maturity rather than having been in repayment for several years. The OIG’s faulty assumptions about the average life of the loans, therefore, skewed its estimate of the alleged SAP overpayment.

Sallie Mae provided information to the OIG that the average life span on the actual FFELP Stafford portfolios in question ranges from 3.7 to 4.6 years. These lower average lives result from two facts.

First, most of the loans in question were originated before the audit period 2002-2005 and therefore were well into repayment. Second, frequent loan consolidation during the relevant period makes the use of a non-consolidation average life span flawed. While these loans were “non-consolidation” FFELP loans, a significant percentage of these loans would have consolidated which would significantly speed up the overall pay down of the portfolio.

As the OIG is familiar, the FFEL Program witnessed a massive amount of loan consolidation during the 2002-2007 timeframe. In fact, over $40 billion of Sallie Mae’s non-consolidation FFELP loans (Stafford and PLUS) consolidated between 2002-2005. On an annual basis, this constituted between 20-40% of Sallie Mae’s entire non-consolidation portfolio. Because of this high level of prepayment experience, Sallie Mae calculates the average life of non-consolidation loans to use in determining a number of accounting related results. These results are included in our publicly disclosed filings with the SEC and are audited by our independent external auditors. These reports are available on our website (www.salliemae.com) and on the SEC’s EDGAR system. The affect of these prepayments have the impact of shortening the overall average life of the portfolio. Our audited weighted average life information on our FFELP Stafford portfolio disclosed in our 10K report ranged from a high of 4.6 years to a low of 3.7 years. Sallie Mae previously provided amortization tables (attached as Exhibit B as a courtesy) which recalculate the impact to the average billed balance using a 4.0 year average life of loan instead of the 8.5 year average used by the OIG. See Exhibit C for excerpts from relevant Sallie Mae disclosure documents.

The OIG ignored the more specific Sallie Mae data and arbitrarily determined that the average life span of nonconsolidated FFELP loans is 8.5 years. See Draft Report n.14. If the OIG had used the data specific to Sallie Mae’s Stafford portfolio, the alleged SAP overpayment would be reduced.

For the reasons set forth above, Sallie Mae reaffirms its request that the OIG take this Sallie Mae specific information on the average life span of Stafford loans into consideration in calculating its estimate of the alleged SAP overpayments.

VI. OIG’s Allegation that a Weakness in Sallie Mae’s Internal Controls led to the Alleged Improper Billing lacks any Merit.

The OIG’s finding that a weakness in Sallie Mae’s internal controls led to the alleged improper billing lacks any merit and should be removed from any final report. A difference in legal interpretation of an undefined statutory provision is not a management weakness in internal controls.

In its Draft Report, the OIG takes issue with Sallie Mae’s interpretation of the 9.5% special allowance floor provisions in the Act and the regulations. As described in detail above, the issue raised in the audit report is whether an “obligation” can be all bonds issued under a single trust agreement with common characteristics, or whether, as the OIG contends, each bond issued under that trust agreement is a separate “obligation” for purposes of applying the 9.5% floor calculation. The OIG disputes Sallie Mae’s legal interpretation that all of the 1993 Bonds issued under the 1993 Trust Agreement with common provisions are a single obligation and concludes that “[t]his management control weakness resulted in noncompliance with regulations and special allowance overpayments.” Draft Report at p.1. At the end of its Draft Report, the OIG again made reference to Sallie Mae’s internal controls as it relates to the 9.5% floor billing. The Draft Report states:

As part of our audit, we assessed SLMA’s system of internal control significant to the audit objective and applicable to its billing for SAP under the 9.5 percent floor calculation, the process used to identify loans eligible for special allowance billing under the 9.5 percent floor calculation. Our assessment disclosed a significant management control weakness that adversely affected SLMA’s ability to accurately identify loans eligible for special allowance billing under the 9.5 percent floor calculation. Specifically, SLMA continued to bill loans under the 9.5 percent floor calculation after the maturity of the eligible tax-exempt bonds and after the loans were refinanced with funds derived from ineligible sources. As a result of its management control

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41 The Draft Report states: “The Department has determined the average life span of non-consolidated FFELP loans to be 8.5 years. The Department made this determination as part of its obligation under the Federal Credit Reform Act of 1990,…to calculate the subsidy cost for FFELP loans. NLMA’s 9.5% floor billings for the quarters ended June 30, 2003, through June 30, 2005, contained only non-consolidated loans. In comments submitted to a draft of this finding, SLMA stated that the average weighted life of a loan on its FFELP Stafford portfolio ranges from 3.6 to 4.7 years. We have not made this revision; our estimate relies on the average life span calculated by the Department.” Draft Report n.14.
weakness, SLMA’s billing activities did not comply with laws, regulations, and guidance for the 9.5 percent floor calculation.


Whether Sallie Mae’s legal interpretation of the regulatory language relating to what is an “obligation” ultimately is determined to be the correct interpretation, the OIG’s statement that a weakness in Sallie Mae’s internal controls led to the alleged improper billing lacks any merit. A company’s legal interpretation of a statutory provision on an issue of first impression is not an internal control. None of the Public Company Accounting Oversight Boards, the Securities and Exchange Commission or the Office of Management and Budget is in line with the OIG’s position.

The Public Company Accounting Oversight Board (“PCAOB”) has issued an Auditing Standard that requires auditors to issue an opinion on the effectiveness of their public company clients’ internal controls. Auditing Standard 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements”, states that an internal control deficiency exists when the design or operation of a control does not allow for timely prevention or detection of misstatements. It defines a “material weakness” in internal controls as “a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.” Standard 2 defines “significant deficiency” as “one that affects the company’s ability to reliably process and report financial data such that there is more than a remote likelihood that the financial statements will be impacted in a manner that is consequential but not material.” There is absolutely nothing in Standard 2 to suggest that a company’s process of formulating a legal interpretation of a statute constitutes an internal control. Indeed, in a publication of frequently asked questions concerning its Rules on Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (Release No. 34-47986, June 5, 2003), the Securities and Exchange Commission concluded that “[t]he definition of the term ‘internal control over financial reporting’ does not encompass a registrant’s compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission’s financial reporting requirements.” FAQ, revised October 6, 2004, Question and Answer 10.

In addition, the Office of Management and Budget (“OMB”) has recognized that, in determining standards for internal control in government, statutory interpretation is not an internal control activity. The Federal Managers’ Financial Integrity Act of 1982 (“FMIA”), 31 U.S.C. §3512, requires the General Accounting Office (“GAO”) to issue standards for internal control in government. These standards are supposed to provide the framework for establishing and maintaining internal control and for identifying and addressing major performance and management challenges and areas at greatest risk of fraud, waste, abuse and mismanagement. OMB Circular A-123, Management Accountability and Control, provides the specific requirements for assessing and reporting on controls in government. In Circular A-123, Internal Control Systems, the OMB discussed internal control activities designed to provide reasonable assurance that government resources are protected against fraud, waste and mismanagement, but specifically carved out statutory interpretation from the definition of internal controls. Circular A-123 states “[i]nternal control does not encompass such matters as statutory development or interpretation.” While OMB Circular A-123 was revised on December 21, 2004, nothing in the
revision suggests that statutory interpretation is an internal control. Indeed, in the revised Circular, OMB gave examples of control activities as proper segregation of duties, physical controls over assets, proper authorization, and appropriate documentation and access to that documentation. Nothing in the revised circular remotely suggests that the method by which a company comes to a legal interpretation or the resulting legal interpretation itself is a management control.

Sallie Mae’s legal reasoning and interpretation of arguably ambiguous statutory and regulatory provisions is not a management control, and the report’s reference to management control weaknesses should be deleted.

VII. The Issues Addressed in the Draft Report have no Application to Other Sallie Mae Subsidiaries.

While the Draft Report focuses on special allowance payments to Nellie Mae for 9.5% floor loans, the OIG recommends that Federal Student Aid (“FSA”) ask Sallie Mae to disclose “any other instances, at any of its subsidiaries (i.e., NLMA, Southwest Student Services Corporation, Student Loan Funding Resources, Student Loan Finance Association) of loans billed under the 9.5% floor calculation after the eligible tax-exempt bond issue matured and after the loans were refinanced with funds derived from an ineligible funding source.” Without conceding that the OIG’s findings as to Nellie Mae’s billings are correct, Sallie Mae can state that none of its other subsidiaries with 9.5% floor loans issued tax-exempt bonds under similar indentures or trust agreements with similar structures. No other subsidiaries issued general obligation or unsecured bonds. No other subsidiaries had similar trust structures that lacked a defined pool of loans. As such, Sallie Mae treated the Nellie Mae-bonds differently than the bonds of its subsidiaries. The issue addressed in the Draft Report is limited to Nellie Mae’s special allowance billings. Thus, there is no reason for any final audit report to include the recommendation to the FSA as to information on Sallie Mae’s other subsidiaries.

VIII. Conclusion

Sallie Mae appreciates the opportunity to respond to the OIG’s Draft Report. We believe our response demonstrates that Sallie Mae did not violate the Act or the applicable regulations in billing special allowance at the 9.5% floor on certain Nellie Mae loans. As explained in detail above, there is no definition of the term “obligation” in the statutory or regulatory provisions addressing the 9.5% floor provisions and Sallie Mae properly treated the 1993 Bonds which have significant and numerous common terms and conditions as a single obligation for purposes of determining the date on which to cease billing at the 9.5% floor on loans that were financed with the proceeds of such 1993 Bonds. In the alternative, even if the Secretary were to adopt the OIG’s statutory interpretation, this case would be an appropriate one for the Secretary to exercise his discretion under the regulations to waive any repayment by Sallie Mae of the special allowance payments at issue.

Further, even assuming that the OIG has correctly interpreted the Act and the regulations, its estimate of the alleged overpayment of special allowance is speculative and excessive and must be reduced. Additionally, since Nellie Mae was the only subsidiary of Sallie Mae with this particular type of bond structure, there is no reason to recommend any further review of other Sallie Mae subsidiaries on this issue.
Finally, the OIG’s finding that the alleged overbilling of special allowance was due to a weakness of management controls has no merit and must not be included in any final audit report, as a company’s good faith interpretation of an ambiguous statutory provision is not a management weakness or a weakness in internal controls.
RESPONSE TO OFFICE OF INSPECTOR GENERAL
UNITED STATES DEPARTMENT OF EDUCATION
DRAFT AUDIT REPORT

FOR
SALLIE MAE, INC.
ED-OIG/A03I0006
Special Allowance Payments to Sallie Mae’s Subsidiary, Nellie Mae, for Loans Funded by Tax-Exempt Obligations.

May 6, 2009

EXHIBIT A
MEMORANDUM

January 16, 2009

TO:     Mark Heleen, General Counsel
CC:     Eric Watson, Associate General Counsel
FROM:  Patricia Mann Smitsion
        Michael D. Baroisky
RE:     OIG Exception Report — 9.5% Special Allowance Billing

This memorandum is in response to your request for our review and comments regarding a draft
Exception Report dated December 5, 2008 and prepared by the U.S. Department of Education’s (the
“Department’s”) Office of the Inspector General (“OIG”). Specifically, you have asked us to consider
Sallie Mae’s practice of billing qualified student loans under the 9.5% Special Allowance floor rate,
where the loans were financed by the proceeds of tax-exempt bonds issued in 1993 under a single trust
agreement (the “1993 Bonds”).

As part of our analysis, we have reviewed the draft Exception Report entitled “Audit of SLMA ---
A03-I0006: Exception Report dtld 12.5.08” as well as the existing statutes, regulations, and Department
guidance pertaining to the Higher Education Act of 1965 (the “Act”). We have also reviewed the trust
agreement under which the tax-exempt bonds were issued. Finally, we have reviewed related regulations
from the U.S. Department of the Treasury (the “Treasury”) as well as certain audit reports issued
previously by the Department.

It is our understanding that Sallie Mae’s practice was to treat all of the 1993 Bonds as a single financial
obligation. We also understand that in keeping with that practice, Sallie Mae billed the qualified student
loans purchased with the proceeds of the 1993 Bonds under the 9.5% floor rate until the last of the 1993
Bonds matured on July 1, 2005.

In our view, Sallie Mae’s practice is based on a reasonable application of the Act and the Department’s
regulations as well as Treasury regulations relating to qualified student loan bonds. All of the 1993
Bonds shared common characteristics that support treating them as a single obligation for purposes of
applying the 9.5% floor regulations; in addition, the applicable tax rules permitted treating them as part of
a single issue. The common characteristics and the tax treatment of the bonds are based on the specific
terms of the Trust Agreement with The First National Bank of Boston dated March 1, 1993 (the “1993
Trust Agreement” or the “Agreement”) and the relationship between the 1993 Bonds and the collective
pool of loans purchased with the proceeds from the bonds.
9.5% Floor Rate Statutory and Regulatory Provisions

Section 438(b)(2)(B) of the Act, which specifies the criteria for eligible loans to initially qualify for the 9.5% floor, states:

(i) The quarterly rate of the special allowance for holders of loans 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 the Internal Revenue Code of 1954 . . . .

(ii) . . . shall not be less than 9.5 percent minus the applicable interest rate on such loans, divided by 4.

The Department's regulations at Section 682.302(e)(4) further specify that "[l]oans made or purchased with funds obtained by the holder from the issuance of tax-exempt obligations originally issued on or after October 1, 1993, . . . do not qualify for the minimum special allowance rate [of 9.5%]." The OIG acknowledges that the student loans purchased or refinanced with the proceeds of the 1993 Bonds did properly qualify for the 9.5% floor rate.

The regulations also address when such loans lose their eligibility for the 9.5% floor. Section 682.302(e)(2)(ii) states that such loans lose their entitlement to the 9.5% floor rate when they are "pledged or otherwise transferred in consideration of funds" that would not have previously qualified for the 9.5% floor and "the prior tax-exempt obligation [the proceeds of which were used to purchase the loans] is retired [or defeased]."

The 1993 Trust Agreement

The New England Education Loan Marketing Corporation (the predecessor in interest to SLM Education Credit Finance Corporation) issued tax-exempt bonds from time-to-time during a nine month period in 1993 under the terms of the 1993 Trust Agreement. The purpose of these bonds was to generate proceeds totaling approximately $458 million that could be used to refund tax-exempt bonds that were previously issued to purchase eligible student loans. In accordance with the Act and as acknowledged by the OIG's report, the loans that were refinanced with the proceeds of the 1993 Bonds qualified to be billed under the 9.5% special allowance floor rate.

Notably, all of the 1993 Bonds were governed by the terms of the same 1993 Trust Agreement, were issued in the same calendar year, and were payable from the same sources of funds. Additionally, the

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1 The OIG's exception report cites an outdated copy of the Code of Federal Regulations. While the relevant regulations have been substantially restructured and rewritten, there are no material differences in their application to this issue.
rights of each bondholder under each series of bonds were identical to the rights of the bondholders under the other series of bonds issued pursuant to the 1993 Trust Agreement. Per the terms of the 1993 Trust Agreement, each bond was treated collectively and on a parity basis with the other bonds in terms of the bondholders' right to payments, default provisions, and remedies. The terms of these provisions are discussed below.

**Right to Payment:** Article IV of the 1993 Trust Agreement stipulates that on each date on which payment on any of the 1993 Bonds is due, the Corporation pays to the Trustee and the Trustee pays to the bondholders the requisite amount of interest on or principal of the bond. The provisions make no distinction and give no preference to any bondholder of any separate series of the 1993 Bonds.

**Events of Default:** Article VIII of the Agreement states that the failure to make a timely payment of the principal or the interest on any of the 1993 Bonds constitutes an Event of Default for all of the 1993 Bonds. Following an Event of Default, the Agreement provides for the acceleration of the principal of all of the outstanding 1993 Bonds regardless of the series of bonds. In other words, the interests of all of the bondholders under the Agreement are evenly linked — if one bondholder is not paid, the Corporation is in default with regard to all bondholders.

**Remedies:** Article VIII of the Agreement also provides for the distribution of funds received from the Corporation to remedy an Event of Default or following a judgment from a suit filed by the Trustee. The distribution provision causes those funds to be shared on a parity basis across all of the 1993 Bonds based on the amount of interest, principal, and redemption premium owed. There is no right of the holder of an individual bond or even the holders of all of the bonds of a separate series to file suit to enforce the Agreement without the consent of a total of two-thirds (2/3) of the aggregate principal amount of the 1993 Bonds outstanding (and not separated by series of bonds).

**Amendments:** Similar to the remedial rights, the 1993 Bonds also require collective action of all bondholders without regard to any separate series of bonds to amend certain provisions of the 1993 Trust Agreement. Under Section 7.2 of the Agreement, the written consent of the holders of two-thirds (2/3) of the principal amount of the 1993 Bonds outstanding is required to modify or adopt an amendment to the rights and obligations of the Corporation or the holders of the bonds. This provision has the potential effect of an amendment being adopted that modified the rights of the bondholders of a particular series of bonds even if all of the bondholders of that series voted against the amendment.

**Proceeds:** In addition to equal treatment of all the bondholders under the 1993 Trust Agreement, the terms of the Agreement do not create a connection between an individual bond or series and the student loans purchased with the proceeds from the 1993 Bonds. Unlike most student loan bond financings, the loans purchased with proceeds from the 1993 Bonds are not pledged as
collateral in support of a particular series of bonds. Rather, all unencumbered loans of the company, along with its general assets and credit, are the source of credit for the entire financing under the 1993 Trust Agreement. A more specifically identifiable relationship between one series of bonds and one loan portfolio (e.g., where the loans are secured collateral for the specific series) did not exist because of the nature and terms of the Agreement.

**Loan Servicing:** Section 5.3(b) of the Agreement requires the Corporation to properly service all student loans owned by it regardless of the source of the proceeds used to purchase the loan. The Agreement details the criteria for executing a servicing agreement to service the loans and similarly treats each of the Corporation’s loans equally regardless of which series’ proceeds were used to finance the loan.

**Tax Treatment of the 1993 Trust Agreement**

Sallie Mae’s practice of treating the 1993 Bonds as a single financial obligation is supported by the Treasury’s regulations regarding the tax treatment of that group of bonds. Under the Treasury’s regulations governing student loan bonds during the lifespan of the 1993 Bonds, Sallie Mae was permitted to calculate a single yield for all of the 1993 Bonds because of their significant relationship to each other under the 1993 Trust Agreement. Treas. Reg. 1.148-4(a). This exception to the yield-calculation rules exists because the failure to treat bonds such as the 1993 Bonds as a single obligation can result in discriminatory treatment of the students whose loans were purchased.

In a private letter ruling specifically addressing this regulation, the Internal Revenue Service noted that, where a “Corporation has a program for returning earnings on student loans in excess of the permitted yield to borrowers by forgiving a portion of the student loan[,]” “[t]he calculation of separate yields may . . . result in the disparate treatment of the student borrowers.” IRS PLR 200403095.

To avoid such possible discriminatory and unfair treatment of student borrowers, the IRS ruling recognized that treating a financing like the 1993 Bonds as a single obligation with a single portfolio of loans would eliminate such negative effects without resulting in additional costs to the Treasury and enable issuers to more efficiently and fairly manage their loans.

While the Treasury regulations are tax-based and not derived from the Higher Education Act, the OIG has indicated that it may consider economic-related rules and regulations from outside the Department when addressing billing issues. In the OIG’s Final Audit Report entitled “Special Allowance Payments to Nelnet for Loans Funded by Tax-Exempt Obligations,” the OIG relied in part on Financial Accounting Standards Board (FASB) Accounting Standards, Statements of Standards FAS 125 and FAS 140 to determine whether certain loan transactions constituted sales or transfers. Such consideration of other federal regulations supports Sallie Mae’s reliance on the Treasury’s regulations in its practices with respect to the 1993 Bonds.
January 16, 2009
Page 5

Application of the Act to the 1993 Bonds

Because of an ambiguity inherent in the text of the Act’s regulations, both Sallie Mae and the OIG were required to rely on a good faith interpretation of the regulations to determine the appropriate practice for billing 9.5% floor rate loans. The regulations specifically state that an otherwise eligible student loan loses its 9.5% floor rate status when “the prior tax-exempt obligation,” the proceeds of which were used to purchase the loan, is retired or defeased. The ambiguity arises from the use of the word “obligation” in its singular form.

An “obligation” is an “agreement or acknowledgment of a liability to pay a certain sum or do a certain thing.” Black’s Law Dictionary, 6th ed., “Obligation” (1990). In apparent agreement with this definition, the OIG’s Exception Report indicates at footnote 1 that an obligation is a bond (e.g., as represented by a bond certificate issued to a single bondholder). However, the OIG then applies the term “obligation” to each of the multiple series of the 1993 Bonds even though the regulations do not state that a series of bonds constitutes an “obligation.” Rather, the plain language of the regulations uses “obligation” in its singular form, which suggests that only a single bond (i.e., represented by a single bond certificate) — not a group of bonds — qualifies as an obligation.

The ambiguity in applying the language of the regulations arises because identifying the specific bond (i.e., as represented by a certificate) that was used to purchase a specific loan is a generally impractical task because issuers such as Sallie Mae issue hundreds of millions of dollars of bonds at a single time, with denominations as small as $5,000, resulting in hundreds of potential bondholders from a single issuance. The Department does not interpret an “obligation” as a single bond because doing so would be unmanageable. Instead, the Department and the OIG have consistently interpreted “obligation” more broadly to refer to groups of bonds with common characteristics such as a common issue or maturity date or other common terms regarding characteristics such as pledged collateral. Under this approach, the Department does not distinguish between bonds of a single series. For example, the Department does not require issuers to recognize the redemption of a portion of the bonds of a series prior to the series’ stated maturity date for purposes of the 9.5% floor rule.

The Department does not track eligible loans at a level more granular than that of a group (e.g., an issue or series) of bonds, which would be impractical if not impossible to do. The Department does not connect an individual loan with an individual bond, and its regulations and guidance have not clearly answered the question of which group of bonds should be used for purposes of applying the 9.5% floor rules. Such bonds could be grouped based on a multitude of different characteristics to determine which bonds should be associated with which particular loans. For example, with secured bond issuances, the relationship between a group of bonds that are secured by a specific group of loans may be easy to discern. Absent that arrangement, it is reasonable to associate bonds based on their issue date, maturity date, or some other common term(s), such as the terms of the applicable indenture or trust agreement.
Sallie Mae treated the 1993 Bonds as a single obligation because they were all issued during the same year with identical terms and provisions as discussed above. That application is arguably consistent with the Department’s interpretation of the regulations. Sallie Mae’s interpretation recognizes the 1993 Bonds as the group of obligations that has the most common and significant shared characteristics including issue year, payment rights, collateral, and remedies, as well as the right to receive common tax treatment as a single issue under the Treasury regulations.

It is a reasonable approach to treat the 1993 Bonds as a single obligation because of their common terms and characteristics, rather than arbitrarily identifying each bond series as a separate obligation. The OIG’s separate consideration of each series relies on arguing that each series is unique because of its issue and maturity dates. However, the 1993 Bonds were not organized in such a way. For example, within certain of the series there were multiple interim maturity dates reflecting the maturity of some, but not all of the bonds of an individual series. Additionally, of the eight series of the 1993 Bonds, half of them shared a common issue date. Instead of being substantively different financings, the use of multiple series for the 1993 Bonds was based on logistical convenience or investor demands.

We understand the OIG’s position that the Agreement itself does not constitute the “obligation,” but Sallie Mae had a reasonable basis to treat the collective group of the 1993 Bonds as the obligation. Sallie Mae’s position that the bonds under the 1993 Trust Agreement — not the Agreement itself — constitute one obligation with a maturity date of July 1, 2005 is consistent with the OIG’s approach to interpreting the regulations. To address the 1993 Bonds by their separate series designation is to impart to each series distinct characteristics that do not exist under the 1993 Trust Agreement.

The OIG’s Exception Report would rely on the final maturity date of a bond series to determine eligibility for the 9.5% floor rate and ignore any interim maturity dates within the series. Sallie Mae’s practice just as reasonably relies on the final maturity date of the 1993 Bonds of July 1, 2005 as the appropriate end date for the 9.5% floor rate.

Based on the analysis above, Sallie Mae’s billing practices with respect to the 1993 Bonds issued under the 1993 Trust Agreement should be viewed as a good faith effort to comply with the Act and as a reasonable and supported conclusion under the Department’s regulations and related Treasury regulations.

Please do not hesitate to contact us with any questions or comments about this memorandum.
RESPONSE TO OFFICE OF INSPECTOR GENERAL
UNITED STATES DEPARTMENT OF EDUCATION
DRAFT AUDIT REPORT

FOR
SALLIE MAE, INC.
ED-OIG/A03I0006
Special Allowance Payments to Sallie Mae’s Subsidiary, Nellie Mae, for Loans Funded
by Tax-Exempt Obligations.

May 6, 2009

EXHIBIT B
### Eligible Loan Balances

**ORIGINAL assuming 8.5 yr average life**

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<th>Quarter Ended</th>
<th>Bond 93B</th>
<th>Bond 93G</th>
<th>Bond 93H</th>
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<td></td>
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<tr>
<td>September 30, 2002</td>
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**Revised assuming 4.0 year average life**

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</tr>
<tr>
<td>June 30, 2003</td>
<td>8,523,284</td>
<td>40,256,147</td>
<td>13,207,720</td>
</tr>
<tr>
<td>September 30, 2003</td>
<td>7,867,647</td>
<td>37,379,779</td>
<td>12,327,206</td>
</tr>
<tr>
<td>December 31, 2003</td>
<td>7,212,010</td>
<td>34,504,412</td>
<td>11,448,694</td>
</tr>
<tr>
<td>March 31, 2004</td>
<td>6,556,373</td>
<td>31,626,044</td>
<td>10,566,176</td>
</tr>
<tr>
<td>June 30, 2004</td>
<td>5,900,735</td>
<td>28,753,676</td>
<td>9,985,662</td>
</tr>
<tr>
<td>September 30, 2004</td>
<td>5,248,098</td>
<td>25,878,309</td>
<td>9,305,147</td>
</tr>
<tr>
<td>December 31, 2004</td>
<td>4,589,461</td>
<td>23,002,941</td>
<td>7,924,832</td>
</tr>
<tr>
<td>March 31, 2005</td>
<td>3,933,824</td>
<td>20,127,573</td>
<td>7,044,117</td>
</tr>
<tr>
<td>June 30, 2005</td>
<td>3,278,196</td>
<td>17,252,206</td>
<td>6,183,803</td>
</tr>
</tbody>
</table>
RESPONSE TO OFFICE OF INSPECTOR GENERAL
UNITED STATES DEPARTMENT OF EDUCATION
DRAFT AUDIT REPORT

FOR
SALLIE MAE, INC.
ED-OIG/A0310006

Special Allowance Payments to Sallie Mae's Subsidiary, Nellie Mae, for Loans Funded by Tax-Exempt Obligations.

May 6, 2009

EXHIBIT C
9. Student Loan Securitization (Continued)

non-amortizing, fixed rate and foreign currency denominated tranches. (As of December 31, 2004, the Company had $31.5 billion of securitized student loans on balance sheet securitization trusts.) These securitizations are included as financings in the table below.

The following table summarizes the Company's securitization activity for the years ended December 31, 2004, 2003 and 2002. Those securitizations issued as sales are off-balance sheet transactions and those listed as financings remain on balance sheet.

<table>
<thead>
<tr>
<th>Years ended</th>
<th>December 31, 2004</th>
<th>December 31, 2003</th>
<th>December 31, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of</td>
<td>Amount</td>
<td>Pre-Tax Gain</td>
</tr>
<tr>
<td>ITELP</td>
<td>Transactions</td>
<td>Securitized</td>
<td>Gain</td>
</tr>
<tr>
<td>Staffed loans</td>
<td>4</td>
<td>$10,000</td>
<td>$164</td>
</tr>
<tr>
<td>Consolidation Loans</td>
<td>1</td>
<td>3</td>
<td>241</td>
</tr>
<tr>
<td>Private Education Loans</td>
<td>7</td>
<td>5,555</td>
<td>248</td>
</tr>
<tr>
<td>Total securitizations—sales</td>
<td>12</td>
<td>12,552</td>
<td>275</td>
</tr>
<tr>
<td>Asset-backed commercial paper</td>
<td>1</td>
<td>4,086</td>
<td>—</td>
</tr>
<tr>
<td>Consolidation Loans</td>
<td>6</td>
<td>17,844</td>
<td>—</td>
</tr>
<tr>
<td>Total securitizations—financings</td>
<td>12</td>
<td>52,406</td>
<td>959</td>
</tr>
<tr>
<td>Total securitizations</td>
<td>52</td>
<td>12,494</td>
<td>275</td>
</tr>
</tbody>
</table>

(1) In the second quarter of 2004 the Company closed its first asset-backed commercial paper program. The program is a revolving, 364-day multi-seller conduit, that allows the Company to borrow up to $5 billion subject to annual extensions. The Company may purchase loans out of this trust at its discretion and as a result, the trust does not qualify as a QSPE and is accounted for on-balance sheet as a VIE.

Key economic assumptions used in estimating the fair value of the Residual Interests at the date of securitization resulting from the student loan securitization sale transactions completed during the year ended December 31, 2004 and 2002 were as follows.

<table>
<thead>
<tr>
<th>Years ended December 31</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ITELP</td>
<td>FELSP</td>
</tr>
<tr>
<td>Prepayment speed</td>
<td>**</td>
<td>6%</td>
</tr>
<tr>
<td>Weighted average life (in years)</td>
<td>4.2</td>
<td>7.3</td>
</tr>
<tr>
<td>Expected credit losses (as % of principal securitized)</td>
<td>0.12%</td>
<td>4.72%</td>
</tr>
<tr>
<td>Residual cash flows discounted at (weighted average)</td>
<td>12%</td>
<td>12%</td>
</tr>
</tbody>
</table>

(1) No securitizations in the period qualified for sale treatment.

SLM CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Dollars in thousands, except per share amounts, unless otherwise stated)

9. Student Loan Securitization (Continued)

Key economic assumptions used in estimating the fair value of the Residual Interests at the date of
securitization resulting from the student loan securitization sale transactions completed during the years
ended December 31, 2006, 2005 and 2004 were as follows:

<table>
<thead>
<tr>
<th>Assumption</th>
<th>2006</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepayment spread (annual rate)</td>
<td>**</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>Weighted average life</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Expected credit losses</td>
<td>**</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>Residual interest rate</td>
<td>12.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Residual interest rate (weighted)</td>
<td>12.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
</tbody>
</table>

** The key economic assumptions include the impact of prepayment. 

The following table summarizes cash flows received from or paid to the off-balance sheet securitization
trucks during the years ended December 31, 2006, 2005 and 2004:

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
</tr>
<tr>
<td>Net proceeds from new securitizations completed during the period</td>
</tr>
<tr>
<td>Purchases of delinquent Private Education Loans from securitization trusts</td>
</tr>
<tr>
<td>Servicing fees received</td>
</tr>
<tr>
<td>Cash distributions from trusts related to Residual Interests</td>
</tr>
</tbody>
</table>

** The Company measures actual servicing fees of 30 basis points. No base points and 30 basis points of the servicing fees paid to the off-balance sheet securitization trusts reduced the prepayment spread. 

F-40