**Issue Paper 3**

**Session 2: January 8-11, 2018**

**Issue:** Financial Responsibility and Administrative Capability

**Statutory cite:** §498 of the Higher Education Act of 1965, as amended

**Regulatory cite:** 34 CFR668.171, 668.175

**Summary of changes:** For institutions that are not financially responsible, we propose to expand the types of financial protection those institutions may provide. In addition, we propose to recalculate the composite score for institutions that incur debts and liabilities from borrower defense claims.

**Changes:** See regulatory text below.

§ 668.171 General.

(a) Purpose. To begin and to continue to participate in any title IV, HEA program, an institution must demonstrate to the Secretary that it is financially responsible under the standards established in this subpart. As provided under section 498(c)(1) of the HEA, the Secretary determines whether an institution is financially responsible based on the institution’s ability to--

(1) Provide the services described in its official publications and statements;

(2) Meet all of its financial obligations; and

(3) Provide the administrative resources necessary to comply with title IV, HEA program requirements.

(b) General standards of financial responsibility. Except as provided under paragraph (c) of this section, the Secretary considers an institution to be financially responsible if the Secretary determines that--

(1) The institution's Equity, Primary Reserve, and Net Income ratios yield a composite score of at least 1.5, as provided under § 668.172 and appendices A and B to this subpart;

(2) The institution has sufficient cash reserves to make required returns of unearned title IV, HEA program funds, as provided under § 668.173;

(3) The institution is current in its debt payments. An institution is not current in its debt payments if—

(i) It is in violation of any existing loan agreement at its fiscal year end, as disclosed in a note to its audited financial statements or audit opinion; or

(ii) It fails to make a payment in accordance with existing debt obligations for more than 120 days, and at least one creditor has filed suit to recover funds under those obligations;

(4) The institution is otherwise able to meet all of its financial obligations and otherwise provide the administrative resources necessary to comply with title IV, HEA program requirements. An institution may not be able to meet its financial or administrative obligations if it is subject to an action or event described in paragraph (c) of this section. The Secretary may consider those actions or events in determining whether the institution is financially responsible; and

(5) The institution or persons affiliated with the institution are not subject to a condition of past performance under § 668.174(a) or (b).

(c) Other factors or events. The Secretary may determine that an institution is not able to meet its financial or administrative obligations under paragraph (b)(4) of this section if—

(1) After the end of the fiscal year for which the Secretary has most recently calculated an institution’s composite score, the institution incurs a debt or liability from borrower defense claims adjudicated by the Secretary, and as a result of that debt or liability the institution’s recalculated composite score is less than 1.0, as determined by the Secretary under paragraph (d) of this section;

(2) For a proprietary institution whose composite score is less than 1.5, there is a withdrawal of owner’s equity from the institution by any means, including by declaring a dividend. This provision does not apply if the withdrawal is a transfer to an entity included in the affiliated entity group on whose basis the institution’s composite score was calculated;

(3) For a publicly traded institution, the institution is currently subject to one or more of the following actions or events—

(i) The SEC warns the institution that it may suspend trading on the institution’s stock;

(ii) The institution failed to file a required annual or quarterly report with the SEC within the time period prescribed for that report or by any extended due date under 17 CFR 240.12b-25; or

(iii) The exchange on which the institution’s stock is traded notifies the institution that it is not in compliance with exchange requirements, or its stock is delisted; or

(4) For its most recently completed fiscal year, a proprietary institution did not derive at least 10 percent of its revenue from sources other than title IV, HEA program funds, as provided under § 668.28(c).

(d) Recalculating the composite score. As specified in Appendix C of this subpart, the Secretary recognizes and accounts for the actual debt or liability incurred by an institution for borrower defense claims under paragraph (c)(1) of this section and based on that accounting, may recalculate the institution’s most recent composite score using the financial statements on which the institution’s composite score has been calculated under § 668.172.

(e) Reporting requirements. (1) In accordance with procedures established by the Secretary, an institution must notify the Secretary of the actions or events identified in paragraph (c) of this section no later than--

(i) For a withdrawal of owner’s equity described in paragraph (c)(2), 10 days after the withdrawal is made. In its notice to the Secretary, the institution must identify whether the reported withdrawal of owner’s equity was used exclusively to meet tax liabilities of the institution or its owners for income derived from the institution;

(ii) For the SEC and stock exchange provisions for publicly traded institutions described in paragraph (c)(3), 10 days after the SEC or exchange warns, notifies, or takes an action against the institution, or 10 days after any extension granted by the SEC; or

(iii) For the non-title IV revenue provision in paragraph (c)(4), 45 days after the end of the institution’s fiscal year, as provided in § 668.28(c)(3).

(2) The Secretary may take an administrative action under paragraph (h) of this section against the institution if it fails to provide timely notice of the actions or events under this paragraph.

(f) Public institutions. (1) The Secretary considers a domestic public institution to be financially responsible if the institution--

(i)(A) Notifies the Secretary that it is designated as a public institution by the State, local, or municipal government entity, tribal authority, or other government entity that has the legal authority to make that designation; and

(B) Provides a letter from an official of that State or other government entity confirming that the institution is a public institution; and

(ii) Is not subject to a condition of past performance under § 668.174.

(2) The Secretary considers a foreign public institution to be financially responsible if the institution--

(i)(A) Notifies the Secretary that it is designated as a public institution by the country or other government entity that has the legal authority to make that designation; and

(B) Provides documentation from an official of that country or other government entity confirming that the institution is a public institution and is backed by the full faith and credit of the country or other government entity; and

(ii) Is not subject to a condition of past performance under § 668.174.

(g) Audit opinions. Even if an institution satisfies all of the general standards of financial responsibility under paragraph (b) of this section, the Secretary does not consider the institution to be financially responsible if, in the institution's audited financial statements, the opinion expressed by the auditor was an adverse, qualified, or disclaimed opinion, or the auditor expressed doubt about the continued existence of the institution as a going concern, unless the Secretary determines that a qualified or disclaimed opinion does not significantly bear on the institution's financial condition.

(h) Administrative actions. If the Secretary determines that an institution is not financially responsible under the standards and provisions of this section or under an alternative standard in § 668.175, or the institution does not submit its financial and compliance audits by the date and in the manner required under § 668.23, the Secretary may--

(1) Initiate an action under subpart G of this part to fine the institution, or limit, suspend, or terminate the institution's participation in the title IV, HEA programs; or

(2) For an institution that is provisionally certified, take an action against the institution under the procedures established in § 668.13(d).

§ 668.175 Alternative standards and requirements.

(a) *General.* An institution that is not financially responsible under the general standards and provisions in §668.171, may begin or continue to participate in the title IV, HEA programs by qualifying under an alternate standard set forth in this section.

(b) *Letter of credit alternative for new institutions.* A new institution that is not financially responsible solely because the Secretary determines that its composite score is less than 1.5, qualifies as a financially responsible institution by submitting an irrevocable letter of credit or other surety described under paragraph (h)(1)(i) of this section, that is acceptable and payable to the Secretary, for an amount equal to at least one-half of the amount of title IV, HEA program funds that the Secretary determines the institution will receive during its initial year of participation. A new institution is an institution that seeks to participate for the first time in the title IV, HEA programs.

 (c) Letter of credit alternative for participating institutions. A participating institution that is not financially responsible either because it does not satisfy one or more of the standards of financial responsibility under § 668.171(b) or (c), or because of an audit opinion described under § 668.171(g), qualifies as a financially responsible institution by submitting an irrevocable letter of credit or other financial protection described under paragraph (h) of this section, that is acceptable and payable to the Secretary, for an amount determined by the Secretary that is not less than one-half of the title IV, HEA program funds received by the institution during its most recently completed fiscal year.

(d) Zone alternative. (1) A participating institution that is not financially responsible solely because the Secretary determines that its composite score under § 668.172 is less than 1.5 may participate in the title IV, HEA programs as a financially responsible institution for no more than three consecutive years, beginning with the year in which the Secretary determines that the institution qualifies under this alternative.

(i)(A) An institution qualifies initially under this alternative if, based on the institution's audited financial statement for its most recently completed fiscal year, the Secretary determines that its composite score is in the range from 1.0 to 1.4; and

(B) An institution continues to qualify under this alternative if, based on the institution's audited financial statement for each of its subsequent two fiscal years, the Secretary determines that the institution's composite score is in the range from 1.0 to 1.4.

(ii) An institution that qualified under this alternative for three consecutive years, or for one of those years, may not seek to qualify again under this alternative until the year after the institution achieves a composite score of at least 1.5, as determined by the Secretary.

(2) Under the zone alternative, the Secretary--

(i) Requires the institution to make disbursements to eligible students and parents, and to otherwise comply with the provisions, under either the heightened cash monitoring or reimbursement payment method described in § 668.162;

(ii) Requires the institution to provide timely information regarding any of the following oversight and financial events--

(A) Any event that causes the institution, or related entity as defined in Accounting Standards Codification (ASC) 850, to realize any liability that was noted as a contingent liability in the institution's or related entity's most recent audited financial statement; or

(B) Any losses that are unusual in nature or infrequently occur, or both, as defined in accordance with Accounting Standards Update (ASU) No. 2015-01 and ASC 225;

(iii) May require the institution to submit its financial statement and compliance audits earlier than the time specified under § 668.23(a)(4); and

(iv) May require the institution to provide information about its current operations and future plans.

(3) Under the zone alternative, the institution must--

(i) For any oversight or financial event described in paragraph (d)(2)(ii) of this section for which the institution is required to provide information, in accordance with procedures established by the Secretary, notify the Secretary no later than 10 days after that event occurs; and

(ii) As part of its compliance audit, require its auditor to express an opinion on the institution's compliance with the requirements under the zone alternative, including the institution's administration of the payment method under which the institution received and disbursed title IV, HEA program funds.

(4) If an institution fails to comply with the requirements under paragraph (d)(2) or (3) of this section, the Secretary may determine that the institution no longer qualifies under this alternative.

(e) [Reserved]

(f) Provisional certification alternative. (1) The Secretary may permit an institution that is not financially responsible to participate in the title IV, HEA programs under a provisional certification for no more than three consecutive years if, as determined annually by the Secretary--

(i) The institution is not financially responsible because it does not satisfy the general standards under § 668.171(b), its recalculated composite score under § 668.171(d) is less than 1.0, is subject to an action or event under § 668.171(c), or because of an audit opinion described in § 668.171(g); or

(ii) The institution is not financially responsible because of a condition of past performance, as provided under § 668.174(a), and the institution demonstrates to the Secretary that it has satisfied or resolved that condition; and

(iii) The institution provides to the Secretary an irrevocable letter of credit that is acceptable and payable to the Secretary, or other financial protection described under paragraph (h) of this section, for an amount determined by the Secretary that is not less than 10 percent of the title IV, HEA program funds received by the institution during its most recently completed fiscal year.

(2) Under this alternative, the institution must comply with the provisions of the zone alternative, as provided under paragraph (d)(2) and (3).

(3) If at the end of the period for which the Secretary provisionally certified the institution, the institution is still not financially responsible, the Secretary--

(i) May permit the institution to participate under a provisional certification, but--

(A) May require the institution, or one or more persons or entities that exercise substantial control over the institution, as determined under § 668.174(b)(1) and (c), or both, to provide to the Secretary financial protection for an amount determined by the Secretary; and

(B) May require one or more of the persons or entities that exercise substantial control over the institution, as determined under § 668.174(b)(1) and (c), to be jointly or severally liable for any liabilities that may arise from the institution's participation in the title IV, HEA programs; and

(ii) May permit the institution to continue to participate under a provisional certification but requires the institution to provide, or continue to provide, the financial protection resulting from an event described in § 668.171(c) until the institution meets the requirements of paragraph (f)(5) of this section.

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(h) Financial protection. (1) In lieu of providing a letter of credit for the amount determined by the Secretary under this section, the Secretary may permit an institution to—

(i) Provide the amount required under this section in the form of other surety or form of financial protection as specified by the Secretary in a notice published in the Federal Register;

(ii) Provide cash for the amount required under this section; or

(iii) Enter into an arrangement under which the Secretary offsets the amount of title IV, HEA program funds that an institution has earned in a manner that ensures that, no later than the end of a nine-month period, the amount offset equals the amount of financial protection the institution is required to provide. The Secretary uses the funds to satisfy the debts and liabilities owed to the Secretary that are not otherwise paid directly by the institution, and provides to the institution any funds not used for this purpose during the period covered by the agreement, or provides the institution any remaining funds if the institution subsequently submits a letter of credit or other surety under this paragraph.