

Issue Paper 3
Session 3: February 12-15, 2018

Issue: Financial Responsibility and Administrative Capability

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

Regulatory cite: 34 CFR 668.91, 668.94, 668.171, 668.172, and 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.~~

Updates the actions of the hearing official.

Identifies actions or events that the Secretary may consider in determining whether an institution is financially responsible.

Provides that the Secretary may accept other types of surety or financial protection in lieu of letters of credit.

Provides for a four-year transition period for operating leases entered into before January 1, 2019.

Updates the Appendices to Subpart L to account for changes in accounting standards and terminology.

Changes: See attached regulatory text.

§ 668.91 Initial and final decisions.

(a)...

(3) Notwithstanding the provisions of paragraph (a)(2) of this section—

(i) If, in a termination action against an institution, the hearing official finds that the institution has violated the provisions of §668.14(b)(18), the hearing official also finds that termination of the institution's participation is warranted;

(ii) If, in a termination action against a third-party servicer, the hearing official finds that the servicer has violated the provisions of §668.82(d)(1), the hearing official also finds that termination of the institution's participation or servicer's eligibility, as applicable, is warranted;

(iii) If an action brought against an institution or third-party servicer involves its failure to provide ~~surety in the amount specified by the Secretary~~ a letter of credit or other financial protection under §668.15 or §668.171, the hearing official finds that the amount of the ~~surety~~ letter of credit or other financial protection established by the Secretary under §668.15 or §668.175 was appropriate, unless the institution can demonstrate that the amount was ~~unreasonable~~ not warranted;

(iv) In a termination action taken against an institution or third-party servicer based on the grounds that the institution or servicer failed to submit a required audit by the deadlines established in §668.23 or otherwise failed to comply with the requirements of §668.23 ~~(c)(3)~~, if the hearing official finds that the institution or servicer failed to meet those deadlines or requirements, the hearing official finds that the termination is warranted;

(v) (A) In a termination action against an institution based on the grounds that the institution is not financially responsible under §668.15(c)(1), the hearing official finds that the termination is warranted unless the institution demonstrates that all applicable conditions described in §668.15(d)(4) have been met; ~~and~~ or

~~(v)~~ (B) In a limitation or termination action against an institution on the grounds that the institution is not financially responsible-

(1) Upon proof of the conditions in §668.174(a), the hearing official finds that the limitation or termination is warranted unless the institution demonstrates that all the conditions in §668.174(f) have been met; or

(2) Upon proof of the conditions in §668.174(b)(1), the hearing official finds that the limitation or termination is warranted unless the institution demonstrates that all applicable conditions described in §668.174(b)(2) or §668.175(g) have been met.

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§ 668.94 Limitation.

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(h) A change in the participation status of the institution from fully certified to participate to provisionally certified to participate under §668.13(c).

(hi) A requirement that a third-party servicer obtain surety, in a specified amount, to assure the servicer's ability to meet the servicer's financial obligations under a contract; or

(ij) Other conditions as may be determined by the Secretary to be reasonable and appropriate.

§ 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) ~~Administer properly the title IV, HEA programs in which it participates; and~~ 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 paragraphs (c) ~~and (d)~~ 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; ~~and~~

(4) The institution is ~~meetingable~~ meetingable to meet all of its financial obligations, ~~(including but not limited to making refunds--~~

(i) ~~Refunds that it is required to make under its refund policy, including the return of and returning title IV, HEA program funds for which it is responsible under §668.22~~ and 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 that has or is likely to have an adverse material effect on the institution's operations or ability to continue as a going concern; and

(ii) Repayments to the Secretary for debts and liabilities arising from the institution's participation in the title IV, HEA programs.

(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, unless 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—

(i) The U.S. Securities and Exchange Commission (SEC) notifies or warns the institution that it may suspend trading on the institution's stock or suspends trading on its 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 for any reason; 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. The Secretary recognizes the actual amount of the debt or liability incurred by an institution for borrower defense claims under paragraph (c)(1) of this section as an expense, and accounts for that expense by—

(1) For the Primary Reserve ratio, increasing expenses and decreasing adjusted equity by that amount;

(2) For the Equity ratio, decreasing modified by that amount; and

(3) For the Net Income ratio, decreasing income before taxes in the net income ratio by that amount.

(e) Reporting requirements. (1) In accordance with procedures established by the Secretary, an institution must notify the Secretary of the following actions or events--

(i) For a withdrawal of owner's equity described in paragraph (c)(2), no later than 10 days after the withdrawal is made;

(ii) For the SEC and stock exchange provisions for publicly traded institutions described in paragraph (c)(3), no later than 10 days after the SEC or exchange notifies, warns, 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), no later than 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 under this paragraph (e) .

(3) In its notice to the Secretary under this paragraph, or in its response to a determination by the Secretary that the institution is not financially responsible because of an action or event under paragraph (c) of this section, the institution may—

(i) Demonstrate that the reported withdrawal of owner's equity under paragraph (c)(2) was used exclusively to meet tax liabilities of the institution or its owners for income derived from the institution;

(ii) Show that the action or event has been resolved, or demonstrate that the institution has insurance that will cover all or part of the debts and liabilities that arise from borrower defense claims under paragraph (c)(1); or

(iii) Explain or provide information about the conditions or circumstances that precipitated that action or event that demonstrates that the action or event has not or will not have a material adverse effect on the institution.

(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 ~~in violation~~ subject to a condition of ~~any~~ past performance ~~requirement~~ 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 ~~in violation subject to a condition of any~~ past performance ~~requirement~~ under § 668.174.

~~(d)(g) Audit opinions and past performance provisions.~~ 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 ~~(1)~~, 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 have a significant bearing on the institution's financial condition; ~~or.~~

~~(2) As provided under the past performance provisions in §668.174 (a) and (b)(1), the institution violated a title IV, HEA program requirement, or the persons or entities affiliated with the institution owe a liability for a violation of a title IV, HEA program requirement.~~

~~(e)(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 ~~permitted~~ 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).

§ 668.172 Financial Ratios.

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~~(d) Transition period for certain operating leases. (1) As a result of changes to the accounting for leases required by Financial Accounting Standards Board Accounting Codification ASC 842 (Leases), for an institution's four consecutive fiscal years beginning on or after January 1, 2019 for which the Secretary calculates the institution's composite score, the Secretary also calculates a transition score by excluding from the calculation operating leases that the institution entered into before July 1, 2019, provided that those leases are properly disclosed in the Supplemental Schedule required under Appendix A or B of this subpart. For each year of the transition period, the Secretary uses the higher of the composite or transition score in determining, in part, whether the institution is financially responsible.~~

(2) For the transition period described in paragraph (d)(1), the Secretary suspends the conditions in § 668.175(d)(1)(i)(B) and (ii) under which an institution continues to qualify for the zone alternative. For any fiscal year following the transition period, the institution's transition period scores have no bearing on whether the institution qualifies under an alternative standard in §668.175(c), (d), or (f).

§ 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(dg), 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, except that this provision does not apply to a public institution.

(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 this ~~se~~ zone alternative, the Secretary ~~---~~

(i) Requires the institution to make disbursements to eligible students and parents 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 adverse action, including a probation or similar action, taken against the institution by its accrediting agency;

(B) Any event that causes the institution, or related entity as defined in the Statement of Financial Accounting Standards (SFAS) ~~57~~ 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;

(C) Any violation by the institution of any loan agreement;

(D) Any failure of the institution to make a payment in accordance with its debt obligations that results in a creditor filing suit to recover funds under those obligations; or

~~(E) Any withdrawal of owner's equity from the institution by any means, including by declaring a dividend; or~~

(F) Any extraordinary losses that are unusual in nature or infrequently occur, or both, as defined in accordance with Accounting Principles Board (APB) Opinion Standards Update (ASU) No. 30-2015-01 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 under paragraph (d)(2)(ii) of this section, in accordance with procedures established by the Secretary, ~~by certified mail or electronic or facsimile transmission,~~ notify the Secretary no later than 10 days after that event occurs. ~~An institution that provides this information electronically or by facsimile transmission is responsible for confirming that the Secretary received a complete,~~ and legible copy of that transmission; 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 paragraphs (d) ~~(1)~~(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—

(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, it is subject to an action or event under § 668.171(c) that has or is likely to have an adverse material effect on the institution, or because of an audit opinion described ~~under §~~ in § 668.171(e); 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

(2) Under this alternative, the institution must—

(i) ~~Submit~~Provide 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, except that this requirement does not apply to a public institution;

(ii) Demonstrate that it was current on its debt payments and has met all of its financial obligations, as required under § 668.171(b)(3) and (b)(4), for its two most recent fiscal years; and

(iii) Comply with the provisions under the zone alternative, as provided under paragraph (d) (2) and (3) of this section.

(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 ~~may again permit the institution to participate under a provisional certification, but the Secretary—~~

(i) 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 ~~submit~~ provide to the Secretary financial guarantees for an amount determined by the Secretary to be sufficient to satisfy any potential liabilities that may arise from the institution's participation in the title IV, HEA programs; and

~~(B)(ii)~~ 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.

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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. Requires the institution to comply with the provisions under the zone alternative, as provided under paragraph (d)(2) and (3) 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 six to twelve-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