Special Allowance Payments to the Kentucky Higher Education Student Loan Corporation for Loans Made or Acquired with the Proceeds of Tax-Exempt Obligations

FINAL AUDIT REPORT

ED-OIG/A05I0011
May 2009

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U.S. Department of Education
Office of Inspector General

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UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

AUDIT SERVICES
Chicago/Kansas City/Dallas Audit Region

May 28, 2009

Edward J. Cunningham
Executive Director
Kentucky Higher Education Student Loan Corporation
10180 Linn Station Road, Suite C200
Louisville, KY 40223

Dear Mr. Cunningham:

Enclosed is our final audit report, Control Number ED-OIG/A05I0011, entitled *Special Allowance Payments to the Kentucky Higher Education Student Loan Corporation for Loans Made or Acquired with the Proceeds of 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 Department of Education official, who will consider them before taking final Departmental action on this audit:

James Manning
Acting Chief Operating Officer, Federal Student Aid
U.S. Department of Education
830 First Street, NE, Room 112E1
Washington, D.C. 20202

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

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

Sincerely,

/s/

Gary D. Whitman
Regional Inspector General for Audit

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Acronyms and Abbreviations Used in this Report

ADB	Average Daily Balance
C.F.R.	Code of Federal Regulations
DCL	Dear Colleague Letter
Department	U.S. Department of Education
ED-OIG	U.S. Department of Education, Office of Inspector General
Fed. Reg.	Federal Register
FFEL	Federal Family Education Loan
FP	Financial Partners
FSA	Federal Student Aid
GBR	General Bond Resolution
HEA	Higher Education Act of 1965, as amended
HERA	Higher Education Reconciliation Act of 2005
KHESLC	Kentucky Higher Education Student Loan Corporation
LaRS	Lender's Interest and Special Allowance Request and Reports
No.	Number
OIG	Office of Inspector General
Pub. L.	Public Law
SAP	Special allowance payments
Sec.	Section
SLSS	Student Loan Servicing System
TTPA	Taxpayer-Teacher Protection Act of 2004
U.S.C.	United States Code

EXECUTIVE SUMMARY

The objective of the audit was to determine whether the Kentucky Higher Education Student Loan Corporation (KHESLC) billed for special allowance payments (SAP) under the 9.5 percent floor calculation for the period October 1, 2001, through September 30, 2006[1] in compliance with the requirements in the Higher Education Act of 1965, as amended (HEA), regulations, and other guidance issued by the U.S. Department of Education (Department).

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

The HEA includes a special allowance calculation for loans that are made or acquired with the proceeds of tax-exempt obligations issued before October 1, 1993. The quarterly special allowance payment for these loans may not be less than 9.5 percent, minus the interest the lender receives, divided by four. We refer to this special allowance 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 KHESLC's billings did not comply with requirements for the 9.5 percent floor. KHESLC's billings under the 9.5 percent floor—

- Included loans whose billings were supported by ineligible refunding obligations. We estimate that this resulted in improper special allowance payments of $9 million.
- Contained loans (1) assigned to a retired bond or (2) with incorrect bond histories because of errors in the loan servicing system. We estimate that this resulted in improper special allowance payments of $18,400.
- Included loans that were not first-generation or second-generation loans. We estimate KHESLC received improper special allowance payments of $79.5 million for third-generation or later loans; however, KHESLC is not required to reimburse the Department for this amount as long as it complies with the terms of Dear Colleague Letters (DCLs) FP-07-01 and FP-07-06.

We also found that KHESLC improperly billed during the 1997 and 1998 calendar years for loans made or acquired with the proceeds of a tax-exempt bond that was ineligible because it was not originally issued before October 1, 1993. We did not calculate estimated improper payments because the billing was outside the scope of our audit.

[1] KHESLC did not receive special allowance payments under the 9.5 percent floor calculation after the quarter ended September 30, 2006.

We recommend that the Acting Chief Operating Officer for Federal Student Aid (FSA)—

- Require KHESLC to calculate and return the actual amount of improper special allowance payments it received (which we estimate to be $9 million) for the quarters ended June 30, 2002, through September 30, 2006, and
- Monitor KHESLC's special allowance billings for the quarters ended on or after December 31, 2006, and, if KHESLC bills under the 9.5 percent floor for these quarters and does not comply with the terms of the DCLs, calculate and return the actual amount of improper special allowance payments it received (which we estimate to be $79.5 million).

In its comments to the draft of this report, KHESLC concurred that it had billed improperly for loans assigned to a retired bond and for loans with incorrect bond histories (Finding No. 2). However, KHESLC did not concur that it had billed improperly for loans supported by ineligible refunding obligations (Finding No. 1) or for loans that were not first-generation or second-generation (Finding No. 3). The full text of KHESLC's comments is included as Enclosure 4 to the report.

In response to KHESLC's comments, we revised Finding No. 1 to cite new criteria on determining the date the obligation is considered "originally issued" and to clarify the process KHESLC used to designate the loans as eligible for the 9.5 percent floor. We have revised the finding's criteria to rely on requirements in 34 C.F.R. § 682.302(f)(2)(ii)(2006). However, we did not change our conclusion or recommendation. In addition, we made some minor changes to Finding Nos. 2 and 3 to improve clarity, but we did not change the substance of the findings.

BACKGROUND

Special Allowance Payments

A lender participating in the FFEL Program is entitled to a quarterly special allowance payment 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,[2] the amount of the quarterly special allowance payment is calculated in four steps:

1. Determining the average of the bond equivalent rates of 91-day Treasury bills auctioned during the quarter,
2. Adding a specified percentage to this amount (the specified percentage varies based on the loan 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))[3]

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

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

9.5 Percent Floor

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

In general, the quarterly special allowance rate for these loans is one half of the percentage determined under the method described above, using 3.5 percent as the specified percentage in Step 2. However, the separate calculation also provides a minimum payment. The special allowance payments for these loans "shall not be less than 9.5 percent minus the applicable interest rate on such loans, divided by 4." (Section 438(b)(2)(B)(i) and (ii) of the HEA)

[2] The calculation used for other types of FFEL Program loans is slightly different.
[3] Unless otherwise noted, all regulatory citations are to the version dated July 1, 2003.

When interest rates are low, the 9.5 percent floor calculation results in significantly greater special allowance payments than the lender would otherwise receive. For example, a FFEL Program Stafford loan made on January 15, 2000, currently in repayment, with an average daily balance of $10,000 would be eligible for special allowance as shown in Table 1.

Table 1 – Special Allowance Payment Example

	If Loan Is Eligible for 9.5 Percent Floor		If Loan Is Not Eligible for 9.5 Percent Floor		Additional Payment (Difference)	
Quarter Ending	Payment Rate	Payment Amount	Payment Rate	Payment Amount	Amount	Percent Increase
December 31, 2003	1.52%	$152.00	.0025%	$0.25	$151.75	60,700%
June 30, 2006	1.05%	$105.00	.565%	$56.50	$48.50	86%

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, 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.

Dear Colleague Letter 96-L-186

In March 1996, the Department issued DCL 96-L-186, *Clarification and interpretative 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:

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

Taxpayer-Teacher Protection Act of 2004 (TTPA)

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 floor 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 (HERA)

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 their January 1, 2006, sunset date. Second, under the HERA, except for loans made by certain low-volume lenders, a loan is ineligible for the 9.5 percent floor 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.

Dear Colleague Letter FP-07-01

The Department's DCL FP-07-01, *FFELP Loans Eligible for 9.5 Percent Minimum Special Allowance Rate* (January 23, 2007), restated the requirements of the HEA and the Department's regulations. Section 438(b)(2)(B)(i) of the HEA and 34 C.F.R. § 682.302(c)(3)(i) identify the specific sources of funds that can be used to acquire loans that qualify for the 9.5 percent floor. These sources are—

1. Funds obtained from the issuance of an eligible tax-exempt obligation, or from investment earnings on the proceeds of such an obligation. Loans acquired with these funds are known as "first-generation loans."
2. Funds obtained as collections, interest benefits, special allowance payments, or income on first-generation loans. Loans acquired with these funds are known as "second-generation loans."

The DCL states that funds obtained as collections, interest, special allowance payments, or income on second-generation loans, or those same kinds of funds obtained from later-generation loans, are not eligible sources of funds under the HEA or regulations.

In an attachment to DCL FP-07-01, the Department provided an example of the letter it sent to lenders, which described the requirements for an audit or review at each lender of the loans billed for special allowance payments under the 9.5 percent floor for the quarter ended December 31, 2006—

> . . . in order to determine which loans are first-generation and second-generation loans. . . . The Department will pay all claims for SAP at the standard rate until the results of the audit or review have been received, evaluated, and accepted by the Department.

The example letter stated that the Department would not require lenders to repay prior improper payments if they complied with or accepted the requirements in the DCL:

> Therefore, the Department will not seek to recoup SAP already received in excess of that payable at the standard rate for quarters ending on or before September 30, 2006 at the 9.5 percent minimum return rate for loans that were neither first-generation loans nor second-generation loans for those lenders that promptly comply with or accept, as applicable, the following—

1. The statutory and regulatory requirements for eligibility for SAP at the 9.5 percent minimum rate . . . ;
2. The requirement that a request for payment of SAP at the 9.5 percent rate be supported by the management certification . . . ; and
3. The Department's payment of all SAP claims at the standard rate, rather than the 9.5 percent minimum return rate, until the Department receives, accepts, and evaluates the results of the audit or review . . . .

Dear Colleague Letter FP-07-06

In DCL FP-07-06, issued on April 27, 2007, *Audit Requirements for 9.5 Percent Minimum Special Allowance Payment Rate*, the Department provided procedures for the audit required in FP-07-01. The required audit was to be performed by an independent accounting firm using the audit methodology established by the Department. Attached to this DCL was the *Auditor's Guide*: *For audits to ensure the accuracy of certain Federal Family Education Loan Program special allowance payments*.

Kentucky Higher Education Student Loan Corporation

The Kentucky General Assembly created KHESLC in 1978 as an independent municipal corporation to make, finance, service, and collect educational loans. Its mission is to promote higher education opportunities by providing the lowest cost loan programs and related services. KHESLC is also known as "The Student Loan People," and its principal office is located in Louisville, Kentucky. As of June 30, 2007, KHESLC owned $1.782 billion in FFEL loans.

KHESLC issued bonds that were authorized by General Bond Resolutions (GBRs). Each GBR authorized several bond issues or series used to finance loans and created a single trust estate to secure repayment of all of the bonds issued under the GBR. A bond series could include bonds of varying maturities. The loans and other assets financed by a GBR's bond issues were not bond-specific; they cross-collateralized all of the bonds authorized by the GBR.

<u>Bond Pools</u>

Prior to May 1, 2003, KHESLC did not assign loans to individual bonds. Instead, it divided the GBRs into pools of bonds that had similar characteristics. For example, the 1983 GBR authorized bonds that were divided into three pools.

- Pool 1 consisted of tax-exempt bonds originally issued prior to October 1, 1993, that were subject to pre-1990 tax rules.
- Pool 2 consisted of tax-exempt bonds originally issued prior to October 1, 1993, that were subject to post-1989 tax rules.
- Pool 3 consisted of tax-exempt bonds originally issued on or after October 1, 1993, that were subject to post-1989 tax rules.

In its accounting system, KHESLC assigned loans to each of these pools. Each loan served as collateral for any bond of the GBR, including bonds assigned to other pools. It billed under the

9.5 percent floor for all loans assigned to Pools 1 and 2 and billed under the regular special allowance rate for loans assigned to Pool 3.

Beginning May 1, 2003, KHESLC created account numbers in its accounting system for each tax-exempt bond by dividing the pools into their individual bond components. KHESLC calculated the value of loans in each individual tax-exempt bond estate that was subject to the Internal Revenue Service's rules governing arbitrage and recovery of excess yield on tax-exempt bonds.[4] Next, KHESLC randomly assigned loans from the pools to the corresponding individual bond accounts up to the value that was subject to arbitrage rules. After this reassignment of loans, Pools 1 and 2 had loans remaining that were not subject to the arbitrage rules. KHESLC reassigned these loans from Pools 1 and 2 to a new account, Pool 100, and continued to bill for these loans under the 9.5 percent floor.

9.5 Percent Floor Project

KHESLC reported a substantial increase in its loan balance eligible under the 9.5 percent floor in 2004 (See Table 2). From January 16 through 20, 2004, KHESLC carried out a special project where it "refinanced" or transferred nearly all of its loan portfolio in and out of a partially eligible bond estate, so it could be billed under the 9.5 percent floor (in this report, we refer to this project as the "9.5 Percent Floor Project").[5] During this project, KHESLC used the proceeds of sales of loans assigned to the partially eligible 2003A-2 series tax-exempt senior bond (Bond 206) to purchase into the estate of that bond additional loans that were originally made or acquired by ineligible sources. Then, KHESLC sold the loans from Bond 206 back to the original ineligible sources. KHESLC began billing under the 9.5 percent floor for these loans when the loans were refinanced with Bond 206. It continued to bill for these loans under the 9.5 percent floor after it refinanced or sold the loans back to the original funding source. The proceeds of the sales of these loans were used to purchase additional loans through Bond 206. This process was repeated 59 times in $15.9 million batches.

[4] Arbitrage is the amount of return on a loan that exceeds the cost of the bond that finances the loan.
[5] See Finding No. 3 for a detailed description of the 9.5 Percent Floor Project.

Table 2 – 9.5 Percent Special Allowance Billings

Quarter Ending	Average Daily Balance (ADB) Billed - 9.5 Percent Loans	ADB Billed - Non-9.5 Percent Loans	9.5 Percent SAP Paid
December 31, 2001	$167,554,909	$509,180,672	$1,021,502
March 31, 2002	$166,510,182	$548,014,860	$1,035,820
June 30, 2002	$157,773,203	$556,499,143	$981,887
September 30, 2002	$148,344,705	$583,310,124	$1,334,584
December 31, 2002	$138,679,458	$621,677,118	$1,271,772
March 31, 2003	$130,394,797	$674,831,521	$1,190,335
June 30, 2003	$124,144,152	$684,598,367	$1,147,593
September 30, 2003	$129,168,671	$701,624,500	$1,495,204
December 31, 2003	$135,480,790	$743,837,664	$1,653,629
March 31, 2004	$821,394,362	$133,698,500	$11,388,663
June 30, 2004	$977,670,330	$118,729	$13,667,736
September 30, 2004	$1,017,520,008	$108,894	$14,432,318
December 31, 2004	$1,059,270,888	$28,469,432	$15,090,493
March 31, 2005	$1,104,168,467	$80,833,503	$15,820,184
June 30, 2005	$1,071,808,945	$139,581,969	$15,384,004
September 30, 2005	$839,307,842	$416,193,685	$9,059,814
December 31, 2005	$769,820,460	$564,870,602	$8,266,231
March 31, 2006	$716,292,928	$739,765,474	$7,681,811
June 30, 2006	$676,830,537	$817,493,818	$7,272,505
September 30, 2006	$738,618,971	$805,105,842	$5,830,379
Net Adjustments (a)			$7,734,580
Grand Total			**$142,761,044**

(a) Net Adjustments is the total of special allowance payment adjustments (made after the initial billing request) included on the *Lender's Interest and Special Allowance Request and Reports* (LaRS) billing statements for the above listed quarters.

From October 1, 2001, through September 30, 2006, KHESLC was paid about $142.8 million in special allowance payments under the 9.5 percent floor. KHESLC received its last 9.5 percent special allowance payment for the quarter ended September 30, 2006. It could not receive further payments, because KHESLC officials determined that they could not make the required management assertions to continue receiving the 9.5 percent special allowance pursuant to DCLs FP-07-01 and FP-07-06.

AUDIT RESULTS

The objective of our audit was to determine whether KHESLC billed for special allowance payments under the 9.5 percent floor calculation in compliance with the requirements in the HEA, regulations, and other guidance issued by the Department. Our audit covered special allowance billings for the quarters ended December 31, 2001, through September 30, 2006.

We found that KHESLC's billings for special allowance payments under the 9.5 percent floor did not comply with the requirements in the HEA, regulations, and Departmental guidance. KHESLC's billings under the 9.5 percent floor—

- Included loans whose billings under the 9.5 percent floor were supported by ineligible refunding obligations. We estimate that this resulted in improper special allowance payments of $9 million.
- Because of minor errors in the loan servicing system, contained loans (1) assigned to a retired bond or (2) with incorrect bond histories. We estimate that this resulted in improper special allowance payments of $18,400 ($12,500 for loans assigned to a retired bond plus $5,900 for loans with incorrect bond histories).
- Included loans that were not first-generation or second-generation loans. We estimate that KHESLC received improper special allowance payments of $79.5 million; however, KHESLC is not required to reimburse the Department for this amount as long as it complies with the terms of DCLs FP-07-01 and FP-07-06.

We recommend that FSA's Acting Chief Operating Officer (1) require KHESLC to calculate and return the actual amount of improper special allowance payments it received (which we estimate to be $9 million) for the quarters ended June 30, 2002, through September 30, 2006, for Finding Nos. 1 and 2, and (2) monitor KHESLC's special allowance billings for the quarters ended on or after December 31, 2006, and, if KHESLC bills under the 9.5 percent floor for these quarters and does not comply with the terms of the DCLs, calculate and return the actual amount of improper special allowance payments it received (which we estimate to be $79.5 million) for Finding No. 3.

In its comments to the draft report, KHESLC concurred with Finding No. 2, but did not concur with Finding Nos. 1 and 3 and our recommendations. The comments are summarized at the end of each finding. The full text of KHESLC's comments on the draft report is included as Enclosure 4 to the report.

FINDING NO. 1 – KHESLC Used Ineligible Refunding Obligations to Support Loans Billed Under the 9.5 Percent Floor

KHESLC billed under the 9.5 percent floor for loans that were ineligible because the refunding obligations on which KHESLC relied to support the eligibility of the loans were not tax-exempt obligations originally issued before October 1, 1993. We estimate KHESLC received $9 million in excess special allowance payments for loans pledged to the portions of three tax-exempt bonds that refunded a taxable line of credit instead of an eligible tax-exempt bond.

In an attempt to continue the availability of funds that could be used to make or acquire new loans eligible for the 9.5 percent floor, beyond the maturity dates of its original, eligible tax-exempt bonds, KHESLC refunded tax-exempt bonds issued prior to October 1, 1993. To designate additional loans as eligible for the 9.5 percent floor, KHESLC—

1. Transferred funds drawn from a taxable line of credit to the estate of the 1983 GBR and used those funds to retire three, eligible tax-exempt bonds (bonds from series 1991B, 1991D, and 1993B).

    a. No loans that had been made or acquired with the proceeds of the original tax exempt bond issues, or other funds associated with those issues, were transferred or pledged as security for the taxable refinancing.
    b. Although sufficient cash resided in the estate of the GBR to retire the three eligible tax-exempt bonds when they came due, KHESLC chose to incur additional indebtedness under a taxable line of credit to obtain funds to retire the bonds.
    c. KHESLC used the taxable line of credit to refund tax-exempt bonds because, at certain maturity dates of eligible tax-exempt bonds, it did not have new tax-exempt bond issues available to refund the maturing bonds. Therefore, KHESLC used its taxable line of credit to refund the maturing bonds until it could issue new tax-exempt refunding bonds.

2. Transferred an equivalent amount of cash from the GBR estate to the trust securing repayment of the taxable line of credit. While the cash was used to secure the repayment of the taxable line of credit, KHESLC did not use it to make or acquire new loans.

3. Refunded or paid down the taxable line of credit two to eight months after transferring the cash from the GBR estate to the taxable line of credit with—

    a. A portion of the proceeds of the issuance of two post-September 30, 1993, tax-exempt bonds (Bonds 107 and 206). The portion of these proceeds that did not refund the taxable line of credit was used to refund eligible tax-exempt bonds.
    b. All of the proceeds from the issuance of a third post-September 30, 1993, tax-exempt bond (Bond 211).

4. Transferred the cash securing repayment of the line of credit to the trust estate of the new tax-exempt bonds (Bonds 107, 206, and 211).

5. Used the cash transferred to the estate of the new tax-exempt bonds to make or acquire loans and began billing for these loans under the 9.5 percent floor for the first time under the new tax-exempt bonds (Bonds 107, 206, and 211).

6. Pledged these loans to the estate of the new tax-exempt bonds to secure repayment of those bonds.

Table 3 – Ineligible Bond Refundings

Eligible Bond Refunded by 2000 Line of Credit		Amount Refunded by Line of Credit	Date of Refunding by Line of Credit	Bond That Refunded Line of Credit	Date of Refunding the Line of Credit (a)
Bond Series from 1983 GBR	Maturity Date				
1991 B Series Tax-Exempt	December 1, 2002	$1,200,000	December 1, 2002	206	May 1, 2003
1991 D Series Tax-Exempt	December 1, 2002	$295,000	December 1, 2002	206	May 1, 2003
1993 B Series Tax-Exempt	December 1, 2002	$10,000,000	December 1, 2002	107	May 1, 2003
1993 B Series Tax-Exempt	December 1, 2003	$9,740,000	December 1, 2003	211	August 1, 2004
1993 B Series Tax-Exempt	June 1, 2004	$9,110,000	June 1, 2004	211	August 1, 2004

(a) As of June 1, 2003, all bonds in the 1991B and 1991D series had been retired. As of June 1, 2005, all bonds in the 1993B series had been retired.

The loans made or acquired with cash transferred from the estate of the taxable line of credit (Step 5 of the process) were not eligible under the 9.5 percent floor, because the tax-exempt bonds, or portions of tax-exempt bonds, on which KHESLC relied to support the eligibility of the loans, were not originally issued before October 1, 1993, and did not qualify as eligible refunding bonds. As a result, the cash transferred from the estate of the taxable line of credit could not qualify as one of the eligible sources of funding specified in 34 C.F.R. § 682.302 (c)(3)(i)(2002).

Pursuant to 34 C.F.R. § 682.302 (c)(3)(i)(A)(2002), to be eligible for the 9.5 percent floor, a loan must be made or purchased with funds obtained by the holder from ". . . [t]he proceeds of tax-exempt obligations originally issued prior to October 1, 1993, the income from which is exempt from taxation under the Internal Revenue Code of 1986 (26 U.S.C.) . . . ."

The date that a refunding obligation is "originally issued" is determined under 34 C.F.R. § 682.302(f)(2)(ii)(2006): [6]

> A tax-exempt obligation that refunds, or is one of a series of tax-exempt refundings with respect to [an eligible] tax-exempt obligation . . . is considered to be originally issued on the date on which the [eligible tax-exempt] obligation . . . was issued.

Under these requirements, the date a refunding bond is considered to have been "originally issued" is only the same as that of the refunded, eligible tax-exempt obligation if the refunding bond "is one of a series of tax-exempt refundings." Although Bond 211 and portions of Bonds

[6] We use "(2006)" to refer collectively to regulations published in the Federal Register (Fed. Reg.) on August 9, 2006, 71 Fed. Reg. 45666, and November 1, 2006, 71 Fed. Reg. 64378. This convention is used in Department guidance and KHESLC's comments to our draft report. A separate volume containing 34 C.F.R. Part 682 was not published in 2006.

107 and 206 were parts of a series of obligations used to refinance prior, eligible tax-exempt obligations from the 1991B, 1991D, and 1993B bond series, an intervening refunding was made with a taxable obligation. When this occurred, any eligibility associated with the original, eligible tax-exempt bonds ended.[7]

Pursuant to 34 C.F.R. § 682.302(f)(2)(ii)(2006), Bond 211 and portions of Bonds 107 and 206 were not originally issued before October 1, 1993: as shown in Table 3, above, Bond 211 was originally issued on August 1, 2004, and the ineligible portions of Bonds 107 and 206 were originally issued on May 1, 2003. Because Bond 211 and the ineligible portions of Bonds 107 and 206 were not originally issued prior to October 1, 1993, they do not meet the criteria provided in 34 C.F.R. § 682.302(c)(3)(i)(2002) and cannot be used to make or acquire loans eligible for the 9.5 percent floor rate.

Table 4 identifies the percentages of Bonds 107, 206, and 211 that refunded the taxable line of credit.

Table 4 – Percentages of Bonds That Refunded the Taxable Line of Credit

Bond	Total Bond Amount at Issuance	Amount of Bond That Refunded the Line of Credit	Percentage of Bond That Refunded the Line of Credit
107	$ 20,000,000	$ 10,000,000	50.00%
206	$ 16,950,000	$ 1,495,000	8.82%
211	$ 18,850,000	$ 18,850,000	100.00%

We estimate that KHESLC received improper special allowance payments of approximately $9 million, including (1) $1.7 million for billings for loans while those loans were pledged to Bonds 107, 206, or 211, and (2) $7.3 million for billings for loans that initially derived their purported eligibility from Bond 206 and then were pledged to other, ineligible bonds:

- Approximately $1.7 million of our estimate was received for loans whose billings were derived from Bond 211 and the ineligible percentages of Bonds 107 and 206 while the loans were pledged to those three bonds.

- Approximately $7.3 million of our estimate was received for loans that initially derived their purported eligibility from the ineligible portion of Bond 206, and then were pledged

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[7] For this reason, if any of the cash transferred from the 1983 GBR estate described in Step 2 was an eligible source of funds associated with the prior eligible tax-exempt bonds specified in 34 C.F.R. § 682.302 (c)(3)(i)(2002), that cash lost any eligibility due to the intervening taxable refunding. This conclusion is consistent with the guidance issued by the Department on October 6, 2006, in an attachment to DCL FP-06-15. The DCL states—

> If the lender uses funds from a taxable bond (regardless of its date of issue) to refund the tax-exempt bond used to acquire the loans, and then pledges the loans to that taxable bond, SAP is no longer payable at the special 9.5 percent rate. 34 C.F.R. § 682.302(e)(2)(ii)(A)(2006). The interim final rule here restates the provisions of the 1985 regulations. 34 C.F.R. § 682.302(e)(3)(1985).

If a loan loses eligibility for the 9.5 percent floor when transferred and pledged in consideration of an ineligible source of funds, then any remaining eligible sources of funds would also lose eligibility when similarly transferred and pledged.

to other, ineligible bonds. For its 9.5 Percent Floor Project, KHESLC used Bond 206 to designate loans as eligible for the 9.5 percent floor rate by (1) making or acquiring loans with funds associated with Bond 206 and then refinancing those loans to ineligible bonds and (2) using the proceeds of these loans (for example, the payments by borrowers, proceeds of sales, and special allowance payments), after those loans were refinanced to ineligible bonds, to make or acquire additional loans. As Table 4 indicates, 8.82 percent of Bond 206 was attributable to its refunding of the taxable line of credit. As a result, 8.82 percent of the loans deriving their purported eligibility from the 9.5 Percent Floor Project were never eligible under the 9.5 percent floor.[8]

A more detailed description of the calculation of the estimated improper special allowance payments for this finding is shown in Enclosure 2.

Recommendation

We recommend that the Acting Chief Operating Officer for FSA require KHESLC to—

1.1 Calculate the improper special allowance payments received for loans that relied on the ineligible refunding obligations for their eligibility for billing under the 9.5 percent floor (which we estimate to be approximately $9 million) for the quarters ended June 30, 2003, through September 30, 2006, and return that amount to the Department.

KHESLC Comments

KHESLC did not concur with the finding and recommendation. In its response to the draft audit report, KHESLC provided four justifications for the questioned billings:

1. The requirement cited by the OIG in the draft audit report, at 34 C.F.R. § 682.302(e)(2)(i)(2006), does not apply to KHESLC's billings; requirements for KHESLC's billings are at 34 C.F.R. § 682.302(e)(2)(ii)(2006). Requirements in paragraph (i) only apply to loans that have been financed continuously by an eligible tax-exempt obligation; requirements in paragraph (ii) apply to all other loans. Since KHESLC's loans have not been financed continuously by a tax-exempt obligation, the applicable requirements are in paragraph (ii).

   KHESLC's understanding of the requirement is supported by the Department's preamble to the final rule, published in the Federal Register on November 1, 2006 (71 Fed. Reg. 64386):

   > All loans that are initially eligible for a 9.5 percent SAP and have been refinanced can be divided into two mutually exclusive groups. The first group includes only those loans that have been refinanced exclusively and continuously from tax-exempt sources [paragraph (i)]. The second group

[8] In Finding No. 3, we separately address whether loans billed under the portion of Bond 206, not considered ineligible under the criteria of this finding were made or acquired with an eligible source of funds and qualified as eligible first-generation loans and second-generation loans, as those terms are described in DCLs FP-07-01 and FP-07-06.

> includes all loans not in the first group [paragraph (ii)]. The phrase "financed continuously" is used to describe the first group, not to exclude the second group from potential eligibility for SAP at the 9.5 percent minimum rate.

Under the applicable requirement, in 34 C.F.R. § 682.302(e)(2)(ii)(A)(2006), a loan only loses its eligibility for the 9.5 percent calculation if the prior tax-exempt obligation is retired or defeased. The prior eligible tax-exempt obligations have not been retired or defeased; thus the loans remain eligible for the 9.5 percent calculation under 34 C.F.R. § 682.302(e)(2)(ii)(B)(2006).

2. Even if the regulation at 34 C.F.R. § 682.302(e)(2)(i)(2006), as cited by the OIG, were the correct requirement, and this requirement pertained to KHESLC, applying this regulation after-the-fact would, improperly, retroactively apply the requirements in the TTPA and HERA. Requirements provided in the interim and final regulations as "longstanding" interpretations were not published or communicated to lenders until the interim regulations were issued. Lenders cannot be held accountable for rules that were not provided to them.

3. From December 2002 through May 2003, KHESLC used bridge financings to refund certain of its loan collateral from one long-term bond issue to another. In general, using bridge financings to refund prior tax-exempt obligations is a customary and accepted practice. Certain types of bridge financings have commonly been used as a "very temporary interim measure," to move loan collateral from one long-term bond issue to a refunding issue. This practice is used to avoid the unnecessary expense of issuing many small tax-exempt bond issues, by rolling them into a single issue.

4. The Department's Financial Partners conducted an in-depth review on the same issue, which is the basis for this finding, and found no overbilling related to the issue of the bridge financing.

OIG Response

We have revised the criteria for this finding and have made some additional changes, for clarity, but we have not changed our conclusion or recommendation.

1. We have revised the finding's criteria to rely on requirements in 34 C.F.R. § 682.302(f)(2)(ii)(2006). This revision does not change our conclusion that the loans we identified were never eligible for special allowance payments under the 9.5 percent floor.

   We do not agree with KHESLC's assertion that, under requirements in 34 C.F.R. § 682.302(e)(2)(ii)(B)(2006), the loans identified in our finding retain eligibility for the 9.5 percent floor.[9] Under 34 C.F.R. § 682.302(e)(2)(ii)(A)(2006), a loan receives special allowance payments under the usual special allowance calculation (not the 9.5 percent floor) if (a) it is "pledged or otherwise transferred in consideration of funds other than"

[9] In its comments, KHESLC focused its arguments on whether the regulations at 34 C.F.R. § 682.302(e)(2)(ii)(2006) permit a loan to retain eligibility for the 9.5 percent floor. KHESLC did not address how the loans that are the subject of Finding No. 1 acquired eligibility for the 9.5 percent floor.

eligible sources of funds, and (b) "[t]he prior tax-exempt obligation is retired." During the audit period, this requirement was located in the regulations at 34 C.F.R. § 682.302(e)(2)(i)(2002).

Even if the loans obtained eligibility for the 9.5 percent floor at some point in the process described in the finding, the loans would have lost their eligibility for the 9.5 percent floor special allowance payments in Step 6, because the loans then would have met the criteria for payment of special allowance at the regular rate under 34 C.F.R. § 682.302(e)(2)(ii)(2006):

a. The loans were pledged in consideration of an ineligible source of funds. As described in our finding, according to the requirements in 34 C.F.R. § 682.302(f)(2)(2006), the bonds to which the loans were pledged were "originally issued" on May 1, 2003, and August 1, 2004. Because these dates are not earlier than October 1, 1993, the loans were pledged in consideration of ineligible tax-exempt obligations. The bonds did not qualify as eligible refunding obligations.

b. The prior eligible tax-exempt obligations were retired. For purposes of the 9.5 percent floor calculation, the only requirements for "refunding" an obligation are provided in 34 C.F.R. § 682.302(f)(2)(ii)(2006), as cited in the finding. Bond 211 and the ineligible portions of Bonds 107 and 206 did not meet those requirements and cannot be considered "refunding" obligations for the purposes of billing loans under the 9.5 percent floor. KHESLC in its comments asserted that the prior tax exempt obligations had not been retired or defeased. However, KHESLC provided no factual support or further explanation for the statement. Our audit work indicated that the prior tax exempt obligations had been retired or paid off with funds drawn from the taxable line of credit.

2. Using the 2006 regulations as criteria for our finding is not an impermissible retroactive application of the TTPA or HERA. As the Department notes in its response to a similar comment in the preamble to its final rule (71 Fed. Reg. 64386), the requirements in these regulations were reflected in guidance issued by the Department long before the regulations were updated in 2006.

3. Using taxable obligations as temporary bridge financing is not consistent with any of the requirements we cite in our finding or in our prior responses. Those requirements allow an obligation to continue a prior obligation's eligibility for the 9.5 percent floor only if it is part of a series of tax-exempt refundings. These criteria are also consistent with 34 C.F.R. § 682.302(c)(3)(i)(A)(2002), which limits eligibility for the 9.5 percent floor to a loan "that was made or purchased with funds obtained by the holder from . . . [t]he proceeds of tax-exempt obligations . . . ."

   There are no provisions in the HEA, regulations, or other guidance governing billings under the 9.5 percent floor that allow an exception for the use of taxable refunding obligations as temporary bridge financing. Furthermore, it is unclear that bridge financing that lasted from two to eight months is properly classified as "very temporary."

4. We have reviewed the program review report that KHESLC cites in its comments. We do not find its conclusion on the issue discussed in our finding to be consistent with the HEA, regulations, and other policy guidance issued by the Department.

FINDING NO. 2 – KHESLC Made Billing Errors That Resulted in Improper Payments of Special Allowance

We identified minor billing errors on KHESLC's LaRS billing statements. KHESLC billed for loans that (1) were made or acquired with cash remaining in an account of the estate of a retired bond and (2) had incorrect bond histories.

Loans Made or Acquired with Cash Remaining in an Account of a Retired Bond

KHESLC billed under the 9.5 percent floor for loans made or acquired with cash remaining in an account of the estate securing Bond 107, which was retired on June 1, 2005. Cash remained in the account after Bond 107 was retired, but KHESLC's Student Loan Servicing System (SLSS) showed that KHESLC refinanced 1,220 loans from its line of credit to Bond 107 on October 6, 2005. Prior to this refinancing, these loans were not eligible for the 9.5 percent floor. KHESLC billed these 1,220 loans under the 9.5 percent floor for the first time on October 6, 2005, and continued to bill under the 9.5 percent floor until December 19, 2005, when the loans were transferred to another bond.

The regulation at 34 C.F.R § 682.302(c)(3)(i)(A) states that, to qualify for billing under the 9.5 percent floor, a loan must be made or acquired by "[t]he proceeds of tax-exempt obligations originally issued prior to October 1, 1993, the income from which is exempt from taxation under the Internal Revenue Code of 1986 (26 U.S.C.) . . . ."

The regulation at 34 CFR § 682.302(e)(3)(iii)(B)(2006) states, "The Secretary pays a special allowance to an Authority at the [regular rate] if, after September 30, 2004 . . . [t]hat obligation matures, is refunded, is defeased, or is retired, whichever occurs earliest." Therefore, the cash remaining in the estate of Bond 107 became ineligible to fund loans billed under the 9.5 percent floor when the bond was retired, because the bond's June 1, 2005, retirement date was later than September 30, 2004.

KHESLC's billing system identifies loans eligible under the 9.5 percent floor by bond number. However, it did not amend the SLSS table to mark Bond 107 ineligible after its retirement. KHESLC billed the loans under the 9.5 percent floor from October 6, 2005, until KHESLC refinanced the loans to another funding source on December 19, 2005. We estimate improper special allowance payments totaling $12,500 for loans made or acquired with cash associated with Bond 107 after its retirement date.

We calculated this estimate by—

- Multiplying the $2,673,905 loan balance assigned to Bond 107 on November 30, 2005, by the 80.43 percent of the quarter ended December 31, 2005, that the loans were

assigned to Bond 107 to obtain an estimated ineligible average daily balance of $2,150,622; and

- Multiplying the $2,150,622 estimated ineligible average daily balance by the difference between the 9.5 percent special allowance rate and the regular special allowance rate (0.58 percent) for the quarter ended December 31, 2005, to obtain an estimated $12,474 in improper special allowance payments. (See Enclosure 1 for the calculation of the special allowance rates.)

Loans with Incorrect Bond Histories

KHESLC billed under the 9.5 percent floor for 54 loans funded by ineligible bonds. The original bond histories for these loans were replaced in the SLSS by incorrect, alternate bond histories. These loans originally were funded by bonds that were ineligible for financing 9.5 percent floor loans. The original bond histories were replaced with histories that indicated the loans had been funded by an eligible bond, even though such a funding never actually occurred. This incorrect replacement of histories resulted in billings for these loans under the 9.5 percent floor for periods before the loans were assigned to an eligible funding source. The SLSS incorrectly adjusted the special allowance billings for these loans using the 9.5 percent special allowance rate for the lifetime of the loan when subsequent activities on the loans triggered prior period adjustments. The prior period adjustments occurred for these 54 loans when KHESLC attempted to adjust 7 loans where the prior period adjustment was executed incorrectly, and when KHESLC caused prior period adjustments to 44 loans that were reallocated, 2 loans that were being entered into the SLSS, and 1 loan that was receiving a principal balance add-on.

The regulation at 34 C.F.R § 682.302(c)(3)(i) states that, to qualify for billing under the 9.5 percent floor, a loan must be made or acquired by "[t]he proceeds of tax-exempt obligations originally issued prior to October 1, 1993, the income from which is exempt from taxation under the Internal Revenue Code of 1986 (26 U.S.C.) . . . ."

The loan history replacements occurred when KHESLC data entry staff incorrectly dated corrections and adjustments to the bond histories of these loans when entering the data into the SLSS.

We estimate improper special allowance payments for these loans totaling $5,900. We calculated this estimate by multiplying the quarterly average daily balance of each improper adjustment by the difference between the 9.5 percent special allowance rate and the regular special allowance rate to determine the improper amount of SAP paid for each bond and each quarter. (See Enclosure 1 for the calculation of the special allowance rates.)

Table 5 – Improper Special Allowance for Loans With Incorrect Bond Histories

Quarter Ending	ADB Billed	Difference Rate	Improper SAP Paid
June 30, 2002	$ 10,502	0.62%	$ 65
September 30, 2002	$ 10,502	0.87%	$ 91
December 31, 2002	$ 10,823	0.91%	$ 98
March 31, 2003	$ 17,729	0.91%	$ 161
June 30, 2003	$ 22,597	0.92%	$ 208
September 30, 2003	$ 26,866	1.15%	$ 309
December 31, 2003	$ 182,592	1.21%	$ 2,209
March 31, 2004	$ 86,834	1.37%	$ 1,190
June 30, 2004	$ 31,149	1.34%	$ 417
September 30, 2004	$ 27,387	1.33%	$ 364
December 31, 2004	$ 27,387	1.09%	$ 299
March 31, 2005	$ 27,387	0.99%	$ 271
June 30, 2005	$ 27,107	0.89%	$ 241
Total			**$ 5,923**

Recommendations

We recommend that the Acting Chief Operating Officer for FSA require KHESLC to—

2.1 Calculate the improper special allowance payments received for loans that were assigned to Bond 107 after its retirement date and billed under the 9.5 percent floor (which we estimate at approximately $12,500) and return that amount to the Department; and

2.2 Calculate the improper special allowance payments received for the 54 loans identified as requiring billing adjustments (which we estimate at approximately $5,900) and return that amount to the Department.

KHESLC Comments

KHESLC concurred with the finding but disagreed with our recommendations that KHESLC recalculate the amounts to return to the Department. Instead, KHESLC proposed that it accept our estimated amount of improper special allowance payments and repay that amount.

OIG Response

We have made minor changes to this finding, for clarity and to provide additional, relevant criteria, but we did not change the draft audit report in response to KHESLC's comments. Determinations of the corrective action to be taken will be made by the appropriate Department officials.

FINDING NO. 3 – KHESLC Billed Under the 9.5 Percent Floor for Loans That Were Not First-Generation or Second-Generation Loans

KHESLC billed under the 9.5 percent floor for loans that were not first-generation or second-generation loans. KHESLC does not document whether a loan is funded from the proceeds of a bond issue (first-generation loans) or the proceeds of loans (second-generation and later-generation loans). Therefore, we could not determine the generation of any loans in KHESLC's portfolio. However, KHESLC's 9.5 Percent Floor Project must have resulted in ineligible third-generation and later-generations loans being billed under the 9.5 percent floor, and there is substantial risk that all loans in KHESLC's portfolio from October 1, 2001, through September 30, 2006, are not eligible first-generation or second-generation loans, because KHESLC does not document the generation of its loans.

Below is a description of KHESLC's 9.5 Percent Floor Project:

- January 16, 2004, through January 20, 2004 (9.5 Percent Floor Project). KHESLC used the proceeds of sales of loans made or acquired by a partially eligible (see Finding No. 1) tax-exempt bond (Bond 206) to refinance loans that were originally made or acquired by ineligible sources and began billing for those loans under the 9.5 percent floor. KHESLC then "refinanced" or sold those loans from Bond 206 back to the original ineligible sources, continuing to bill for these loans under the 9.5 percent floor. The proceeds from the sale of these "refinanced" loans (from Bond 206 to the original, ineligible bond) were used to "refinance" additional loans through Bond 206. This process was repeated 59 times in $15.9 million batches. Each batch of loans was one generation later than the previous batch. If the loans made or acquired by Bond 206 before the first batch of the project was processed were considered first-generation loans, the first batch of refinanced loans would be second-generation loans. The second batch of refinanced loans would be third-generation loans, etc. Therefore, all loans that were refinanced from a taxable bond to Bond 206 and back to the taxable bond after the first batch were at least third-generation loans.

- January 21, 2004, through September 30, 2004. After the 9.5 Percent Floor Project refinanced nearly all of KHESLC's portfolio of loans, KHESLC made new loans with the proceeds of loans that had been financed by Bond 206. It then refinanced the new loans with ineligible funding sources. KHESLC billed under the 9.5 percent floor for these loans, even though the loans were not first-generation or second-generation loans. This refinancing process continued until October 1, 2004, the effective date of the TTPA.

- October 1, 2004, through September 30, 2006. After enactment of the TTPA, KHESLC stopped converting new loans from new bond issues. KHESLC used the proceeds of loans that had been refinanced through the 9.5 Percent Floor Project to fund a portion of its new loans and refinance existing loans. KHESLC called these loans "recycled loans." KHESLC does not have an accounting system that documents that it used the proceeds of loans rather than the proceeds of bonds to finance these recycled loans. KHESLC billed under the 9.5 percent floor for these recycled loans, even though they were not first-generation or second-generation loans. In response to an internal audit, KHESLC stopped recycling loans and reversed its 9.5 percent billing for these recycled loans beginning July 2005. Based on its

own review, FSA told KHESLC, in a program review report issued May 11, 2006, that KHESLC could bill under the 9.5 percent floor for the recycled loans. Therefore, in the September 2006 LaRS billing, KHESLC re-billed for these recycled loans under the 9.5 percent floor and recycled additional loans for which it billed under the 9.5 percent floor for the quarter ended September 30, 2006.

- After September 30, 2006. KHESLC billed for loans under the 9.5 percent floor for the last time during the quarter ended December 31, 2006. KHESLC did not receive any special allowance payments under the 9.5 percent floor for the quarter ended December 31, 2006. The last quarter that KHESLC was paid under the 9.5 percent floor was the quarter ended September 30, 2006. KHESLC did not qualify to continue receiving special allowance under the 9.5 percent floor after this quarter, because it did not conduct the audit required by DCL FP-07-01.

Pursuant to 34 C.F.R. § 682.302(c)(3)(i), there are five funding sources that qualify loans to be billed under the 9.5 percent floor. A loan can be billed under the 9.5 percent floor if it is—

> . . . a loan made or guaranteed on or after October 1, 1980 that was made or purchased with funds obtained by the holder from—
> (A) The proceeds of tax-exempt obligations originally issued prior to October 1, 1993, the income from which is exempt from taxation under the Internal Revenue Code of 1986 (26 U.S.C.);
> (B) Collections or payments by a guarantor on a loan that was made or purchased with funds obtained by the holder from obligations described in paragraph (c)(3)(i)(A) of this section;
> (C) Interest benefits or special allowance payments on a loan that was made or purchased with funds obtained by the holder from obligations described in paragraph (c)(3)(i)(A) of this section;
> (D) The sale of a loan that was made or purchased with funds obtained by the holders from obligations described in paragraph (c)(3)(i)(A) of this section; or
> (E) The investment of the proceeds of obligations described in paragraph (c)(3)(i)(A) of this section.

KHESLC converted nearly all of its loan portfolio to be billed under the 9.5 percent floor because management believed that eligibility was not limited to first-generation and second-generation loans. Before beginning the 9.5 Percent Floor Project, KHESLC obtained an external legal opinion that stated the law firm believed that refinancing ineligible loans with an eligible bond would make the loans eligible for the 9.5 percent special allowance payment, and the loans would retain the eligibility after being refinanced with an ineligible bond as long as the eligible bond was not retired or defeased.

We estimate KHESLC received improper special allowance payments of approximately $79.5 million for third-generation or later loans resulting from its 9.5 Percent Floor Project.[10] We calculated this amount by—

[10] Of this amount, an estimated $7 million is duplicated in the improper special allowance payments described in Finding No. 1.

- Multiplying the quarterly average daily balances of loans assigned to the bond accounts from the 9.5 Percent Floor Project by the difference between the 9.5 percent special allowance rate and the regular special allowance rate for that quarter. (See Enclosure 1 for the calculation of the special allowance rates.) We excluded from the calculation the quarterly average daily balance for the first batch of 9.5 Floor Project loans, because these loans might have been second-generation loans.
- Adding KHESLC's net adjustments for loan recycling by totaling the 9.5 percent special allowance payments increases less the regular special allowance decreases included on the LaRS billing statement for the quarter ended September 30, 2006, that adjusted billings for the quarters ended September 30, 2005, through June 30, 2006.

These calculations are shown in Enclosure 3.[11] We did not estimate the improper payments for third-generation or later loans that did not result from the 9.5 Percent Floor Project. As we discuss in the Background section, lenders are not required to reimburse the Department for special allowance billed under the 9.5 percent floor for loans that are third-generation or later-generation as long as the lender complies with all of the terms of DCLs FP-07-01 and FP-07-06.

Recommendation

We recommend that the Acting Chief Operating Officer for FSA—

3.1 Monitor KHESLC's special allowance billings to ensure that KHESLC does not bill for special allowance under the 9.5 percent floor on or after the quarter ended December 31, 2006. If KHESLC does bill for special allowance under the 9.5 percent floor on or after the quarter ended December 31, 2006, ensure that KHESLC has complied with the terms of DCLs FP-07-01 and FP-07-06 before any additional special allowance payment is made to KHESLC under the 9.5 percent floor. If KHESLC has not complied with the terms of DCLs FP-07-01 and FP-07-06—

- Require KHESLC to calculate the amount of improper special allowance payments received (which we estimate to be approximately $79.5 million) for ineligible loans resulting from the 9.5 Percent Floor Project, as described in our report, and return that amount to the Department;[12] and

- Return all prior special allowance payments made under the 9.5 percent floor for any other loan that KHESLC cannot identify, by direct evidence, as having been made or acquired from an eligible source, as defined in 34 C.F.R. § 682.302(c)(3)(i).

[11] To calculate a conservative estimate, we included in our calculation an allowance for possible eligible first- and second-generation loans. However, as noted in Finding No. 1, no existing 9.5 percent floor loans (which could conceivably be first-generation) were transferred from the estate of the prior eligible tax exempt bonds. We did not reduce the allowance for possible first- and second-generation loans by the portion of Bond 206 that did not qualify as an eligible refunding bond.

[12] Of the estimated $79.5 million, an estimated $7 million is duplicated in our estimated liability for Finding No. 1. As appropriate, liability calculations for Finding Nos. 1 and 3 should be consolidated to ensure that KHESLC is not required to return an overpayment attributable to the same loans under both findings.

KHESLC Comments

KHESLC stated, "Regarding Finding #3 and the recommendation, given that we do not anticipate billing for 9.5 percent special allowance payments (SAP) in the future, this should serve to make this finding immaterial. While we admit no wrongdoing and do not concur with Finding #3, in light of the recommendation, we do not plan to argue the issue at this time. We reserve the right to argue this issue in the future should the OIG's recommendation change."

OIG Response

We have made minor changes to this finding, for clarity, but we did not change the substance of the finding in response to KHESLC's comments.

OTHER MATTERS

Loans Funded by Tax-Exempt Obligations Not Issued Before October 1, 1993

KHESLC billed 37 ineligible loans at the 9.5 percent floor. These loans were funded by the 1997B Series Tax-Exempt Subordinate bond (Bond 4) which was originally issued on May 15, 1997, and did not refund a prior, eligible tax-exempt bond. The 9.5 percent floor billings occurred during the 1997 and 1998 calendar years.

When the coding for Bond 4 was loaded into the SLSS in 1997, it was incorrectly coded as an eligible funding source for 9.5 percent floor loans. In 1998, KHESLC corrected this coding in the SLSS and stopped billing under the 9.5 percent floor for these loans. KHESLC also adjusted its special allowance billings for loans funded by this bond during the 1997 and 1998 calendar years to correct for this error. However, KHESLC did not identify these 37 loans when it performed the adjustments, resulting in uncorrected billings for these loans.

None of the 9.5 percent floor billings related to these 37 loans occurred during our audit period. Therefore, we did not estimate the excess special allowance paid.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the audit was to determine if KHESLC billed for special allowance payments under the 9.5 percent floor calculation in compliance with the requirements in the HEA, regulations, and other guidance issued by the Department, for the period October 1, 2001, through September 30, 2006.

To achieve our objective, we performed the following procedures:

1. Reviewed applicable laws, regulations and guidance issued by the Department, including the HEA, 34 C.F.R. Part 682, and Dear Colleague Letters.
2. Reviewed KHESLC's annual financial and A-133 single audit reports, and the Department's FSA Financial Partners' reviews applicable to the audit period.
3. Held discussions with KHESLC officials, including the Vice President of Financial Management, the Operations Support Manager, and the Controller.
4. Reviewed documentation provided by KHESLC, including—
   - A written explanation, created and provided at our request, of KHESLC's policy on, and understanding and implementation of, special allowance billing under the 9.5 percent floor;
   - A listing of KHESLC's bonds funding 9.5 percent floor calculation loans, along with information related to each bond, each bond's taxable or tax-exempt status, and the outstanding amount of each bond; and
   - A written description of KHESLC's process for allocating loans to individual bonds and the results of that process.
5. Judgmentally selected and reviewed 12 of 26 bonds and 1 of 1 line of credit for supporting documentation from the official bond statements and other documentation.
6. Queried a database of 337,518 outstanding loans that were marked as eligible for 9.5 percent special allowance payments to identify the risk that KHESLC received 9.5 percent special allowance floor payments for loans that were not in compliance with the TTPA, HERA, and other guidance.[13] These included queries to identify loans that received special allowance under the 9.5 percent floor that were—
   - Made or insured prior to October 1, 1980;
   - Funded by ineligible bonds;
   - Assigned to bond numbers in the SLSS with effective dates prior to the existence of the bond numbers;
   - Refinanced from eligible to ineligible bonds after September 30, 2004; and
   - Not receiving special allowance under the 9.5 percent floor on February 8, 2006, but receiving special allowance under the 9.5 percent floor after February 8, 2006.
7. Reviewed the methodology that KHESLC used to assign loans to specific bond issues when changing from the bond pooling system of accounting to the specific bond identification system of accounting in May 2003.

[13] We did not review loans that were paid in full before the date we queried the database. We would not expect the results for the paid-in-full loans to be any different than the loans we reviewed.

8. Reviewed KHESLC's Quarterly LaRS billing reports for the quarters ended December 31, 2001, through September 30, 2006.
9. Reviewed quarterly average daily balances of each loan for the quarters ended June 30, 2002, through September 30, 2006.
10. Reviewed quarterly average daily loan balances by bond from the SLSS for the period October 1, 2001, through September 30, 2006.
11. Reviewed KHESLC's internal audit work papers that document KHESLC's review of loans that were billed in error.

We also relied, in part, on computer-processed loan history and average daily balance data obtained from KHESLC's SLSS. This data contained our universe of outstanding loans during the period October 1, 2001, through September 30, 2006, and average daily balances for loans during the period April 1, 2002, through September 30, 2006. We verified the completeness and accuracy of the loan history data by reviewing the data for missing data or fields, improper data relationships, and data outside of valid frames. We verified the completeness and accuracy of the loan average daily balance data by tracing LaRS billing report lines to the loan average daily balance data. The loan history and average daily balance data were generally supported. Therefore, we concluded that the computer-processed data were sufficiently reliable for the purposes of our audit.

We conducted our audit from January through August 2008 at KHESLC's office in Louisville, Kentucky, and at our offices. We discussed the results of our audit with KHESLC on November 12, 2008.

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 findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Enclosure 1: Quarterly Special Allowance Table

Calculation of 9.5 Percent Rate and Other Special Allowances by Difference Rate

	9.5 Percent Special Allowance			Other Special Allowances			Difference
Quarter Ending	ADB Billed	SAP Paid	Rate	ADB Billed	SAP Paid	Rate	Rate[14]
June 30, 2002	$ 157,773,203	$ 981,887	0.62%	$ 556,499,143	$ 0	0.00%	0.62%
September 30, 2002	$ 148,344,705	$ 1,334,584	0.90%	$ 583,310,124	$ 158,788	0.03%	0.87%
December 31, 2002	$ 138,679,458	$ 1,271,772	0.92%	$ 621,677,118	$ 36,737	0.01%	0.91%
March 31, 2003	$ 130,394,797	$ 1,190,335	0.91%	$ 674,831,521	$ 10,369	0.00%	0.91%
June 30, 2003	$ 124,144,152	$ 1,147,593	0.92%	$ 684,598,367	$ 8,512	0.00%	0.92%
September 30, 2003	$ 129,168,671	$ 1,495,204	1.16%	$ 701,624,500	$ 84,553	0.01%	1.15%
December 31, 2003	$ 135,480,790	$ 1,653,629	1.22%	$ 743,837,664	$ 104,432	0.01%	1.21%
March 31, 2004	$ 821,394,362	$11,388,663	1.39%	$ 133,698,500	$ 18,473	0.01%	1.37%
June 30, 2004	$ 977,670,330	$13,667,736	1.40%	$ 118,729	$ 70	0.06%	1.34%
September 30, 2004	$ 1,017,520,008	$14,432,318	1.42%	$ 108,894	$ 96	0.09%	1.33%
December 31, 2004	$ 1,059,270,888	$15,090,493	1.42%	$ 28,469,432	$ 95,109	0.33%	1.09%
March 31, 2005	$ 1,104,168,467	$15,820,184	1.43%	$ 80,833,503	$ 360,479	0.45%	0.99%
June 30, 2005	$ 1,071,808,945	$15,384,004	1.44%	$ 139,581,969	$ 757,979	0.54%	0.89%
September 30, 2005	$ 839,307,842	$ 9,059,814	1.08%	$ 416,193,685	$ 1,378,372	0.33%	0.75%
December 31, 2005	$ 769,820,460	$ 8,266,231	1.07%	$ 564,870,602	$ 2,801,280	0.50%	0.58%
March 31, 2006	$ 716,292,928	$ 7,681,811	1.07%	$ 739,765,474	$ 4,407,295	0.60%	0.48%
June 30, 2006	$ 676,830,537	$ 7,272,505	1.07%	$ 817,493,818	$ 5,867,652	0.72%	0.36%
September 30, 2006	$ 738,618,971	$ 5,830,379	0.79%	$ 805,105,842	$ 3,669,074	0.46%	0.33%

The figures in this table are the current quarter billings from KHESLC's quarterly LaRS billing statements. Using the ADB billed and SAP paid data from these LaRS billing statements, we calculated an estimate of the quarterly special allowance rates for 9.5 percent special allowance and other special allowances. We also calculated the difference between these rates to account for the other special allowances that would have been paid to KHESLC if it had not billed under the 9.5 percent floor. We applied the quarterly difference rate to all ineligible amounts of quarterly ADBs to estimate the cost of improper billings.

[14] The rates in this column do not always equal the 9.5 percent special allowance rate minus the other special allowances rate due to rounding.

Enclosure 2: Estimation of Improper Payments for Finding No. 1

Improper 9.5 Percent Special Allowance for Ineligible Bond Refundings

	Quarter Ending	ADB Billed	Refunding Percentage	Improper ADB Billed	Difference Rate	Improper SAP Paid
Bond 107	June 30, 2003	$ 4,574,000	50.00%	$ 2,287,000	0.92%	$ 21,040
	September 30, 2003	$ 19,696,755	50.00%	$ 9,848,378	1.15%	$ 113,256
	December 31, 2003	$ 19,213,116	50.00%	$ 9,606,558	1.21%	$ 116,239
	March 31, 2004	$ 18,551,422	50.00%	$ 9,275,711	1.37%	$ 127,077
	June 30, 2004	$ 18,724,762	50.00%	$ 9,362,381	1.34%	$ 125,456
	September 30, 2004	$ 19,718,625	50.00%	$ 9,859,313	1.33%	$ 131,129
	December 31, 2004	$ 19,169,201	50.00%	$ 9,584,601	1.09%	$ 104,472
	March 31, 2005	$ 20,096,282	50.00%	$ 10,048,141	0.99%	$ 99,477
	June 30, 2005	$ 11,924,802	50.00%	$ 5,962,401	0.89%	$ 53,065
Bond 206	September 30, 2003	$ 2,608,587	8.82%	$ 230,077	1.15%	$ 2,646
	December 31, 2003	$ 15,686,618	8.82%	$ 1,383,560	1.21%	$ 16,741
	March 31, 2004	$ 12,313,386	8.82%	$ 1,086,041	1.37%	$ 14,879
	June 30, 2004	$ 82,521	8.82%	$ 7,278	1.34%	$ 98
	September 30, 2004	$ 26,297	8.82%	$ 2,319	1.33%	$ 31
	December 31, 2004	$ 25,090	8.82%	$ 2,213	1.09%	$ 24
	March 31, 2005	$ 38,009	8.82%	$ 3,352	0.99%	$ 33
	June 30, 2005	$ 66,020	8.82%	$ 5,823	0.89%	$ 52
	September 30, 2005	$ 9,329,235	8.82%	$ 822,839	0.75%	$ 6,171
	December 31, 2005	$ 13,793,720	8.82%	$ 1,216,606	0.58%	$ 7,056
	March 31, 2006	$ 16,546,154	8.82%	$ 1,459,371	0.48%	$ 7,005
	June 30, 2006	$ 16,128,149	8.82%	$ 1,422,503	0.36%	$ 5,121
	September 30, 2006	$ 13,970,590	8.82%	$ 1,232,206	0.33%	$ 4,066
Bond 211	December 31, 2004	$ 3,540,337	100.00%	$ 3,540,337	1.09%	$ 38,590
	March 31, 2005	$ 18,096,501	100.00%	$ 18,096,501	0.99%	$ 179,155
	June 30, 2005	$ 17,674,924	100.00%	$ 17,674,924	0.89%	$ 157,307
	September 30, 2005	$ 17,188,894	100.00%	$ 17,188,894	0.75%	$ 128,917
	December 31, 2005	$ 16,512,654	100.00%	$ 16,512,654	0.58%	$ 95,773
	March 31, 2006	$ 16,122,008	100.00%	$ 16,122,008	0.48%	$ 77,386
	June 30, 2006	$ 15,752,476	100.00%	$ 15,752,476	0.36%	$ 56,709
	September 30, 2006	$ 15,307,489	100.00%	$ 15,307,489	0.33%	$ 50,515
Floor Project Loans	March 31, 2004	$ 658,911,152	8.82%	$ 58,115,964	1.37%	$ 796,189
	June 30, 2004	$ 852,169,756	8.82%	$ 75,161,372	1.34%	$1,007,162
	September 30, 2004	$ 894,313,018	8.82%	$ 78,878,408	1.33%	$1,049,083
	December 31, 2004	$ 937,806,331	8.82%	$ 82,714,518	1.09%	$ 901,588
	March 31, 2005	$ 963,829,682	8.82%	$ 85,009,778	0.99%	$ 841,597
	June 30, 2005	$ 954,700,568	8.82%	$ 84,204,590	0.89%	$ 749,421
	September 30, 2005	$ 752,715,150	8.82%	$ 66,389,476	0.75%	$ 497,921
	December 31, 2005	$ 683,484,908	8.82%	$ 60,283,369	0.58%	$ 349,644
	March 31, 2006	$ 623,974,676	8.82%	$ 55,034,566	0.48%	$ 264,166
	June 30, 2006	$ 584,815,653	8.82%	$ 51,580,741	0.36%	$ 185,691
	September 30, 2006	$ 654,012,468	8.82%	$ 57,683,900	0.33%	$ 190,357
	Net Loan Recycling Adjustments ($4,752,766 SAP) * 8.82%					$ 419,194
	Grand Total					**$8,991,499**

We calculated the estimate for Bonds 107, 206, and 211 by—

- Totaling for each quarter the average daily balances of loans assigned to the bond (ADB Billed);
- Dividing the portion of each bond that refunded the line of credit by the total value of the bond to obtain the percentage of the bond that is not eligible to fund 9.5 percent floor loans (Refunding Percentage – See Table 4);
- Multiplying the Refunding Percentage by the ADB Billed, to determine the average daily balance that was not eligible to be billed under the 9.5 percent floor (Improper ADB Billed); and
- Multiplying the quarterly Improper ADB Billed by the Difference Rate (as calculated in Enclosure 1) to determine the amount for each bond that was overpaid for each quarter (Improper SAP Paid).

We calculated the estimate for floor project loans by—

- Totaling for each quarter the average daily balances of loans assigned to the bond accounts from the project (ADB Billed);
- Multiplying the ADB Billed amount by the Refunding Percentage for Bond 206 (Improper ADB Billed);
- Multiplying the quarterly Improper ADB Billed by the Difference Rate (as calculated in Enclosure 1) to determine the amount for each bond that was overpaid for each quarter (Improper SAP Paid); and
- Including an amount for the recycling adjustments (the adjustments KHESLC made in the quarter ended September 30, 2006, to its previous billing for the quarters ended September 30, 2005, through June 30, 2006). To determine this amount, we totaled the 9.5 percent special allowance payments increases less the regular special allowance decreases included on KHESLC's LaRS billing statement for the quarter ended September 30, 2006. Then, we multiplied this amount by the Refunding Percentage for Bond 206.

Our estimate methodology applies the 8.82 percent bond refunding percentage to all floor project loans to calculate our estimate of improper billings. We considered, but rejected, an alternate methodology that may have resulted in a lower estimate of improper payments for the floor project loans. Floor project loans derived their eligibility from Bond 206. Because Bond 206 had $15,455,000 in eligible refundings and $1,495,000 in ineligible refundings, it is possible that $15,455,000 was available for refinancing floor project loans in each batch of the 9.5 Percent Floor Project. Floor project loans were refinanced in batches of $15,900,000. This amount exceeds the eligible refunding amount of $15,455,000 by $445,000. As a result, the ineligible portion of floor project loans may be as low as 2.80 percent ($445,000 divided by $15,900,000). However, we have no evidence that KHESLC used a refinancing method that applied all eligible refunding dollars before applying any ineligible refunding dollars. Therefore, we believe that an estimate using the 8.82 percent ineligible refunding percentage is the most appropriate method.

Enclosure 3: Estimation of Improper Payments for Finding No. 3

Improper Special Allowance for Loans That are Not First-Generation or Second-Generation

Quarter Ending	ADB of Floor Project and Bond 206 Loans	Maximum Amount That Could Be First or Second Generation Loans	ADB That Must Be Third or Later Generation Loans	Difference Rate	Improper SAP Paid
March 31, 2004	$671,224,538	$33,900,000	$637,324,538	1.37%	$ 8,731,346
June 30, 2004	$852,252,277	$33,900,000	$818,352,277	1.34%	$ 10,965,921
September 30, 2004	$894,339,315	$33,900,000	$860,439,315	1.33%	$ 11,443,843
December 31, 2004	$937,831,421	$33,900,000	$903,931,421	1.09%	$ 9,852,852
March 31, 2005	$963,867,691	$33,900,000	$929,967,691	0.99%	$ 9,206,680
June 30, 2005	$954,766,588	$33,900,000	$920,866,588	0.89%	$ 8,195,713
September 30, 2005	$762,044,385	$33,900,000	$728,144,385	0.75%	$ 5,461,083
December 31, 2005	$697,278,628	$33,900,000	$663,378,628	0.58%	$ 3,847,596
March 31, 2006	$640,520,830	$33,900,000	$606,620,830	0.48%	$ 2,911,780
June 30, 2006	$600,943,802	$33,900,000	$567,043,802	0.36%	$ 2,041,358
September 30, 2006	$667,983,058	$33,900,000	$634,083,058	0.33%	$ 2,092,474
Total					**$74,750,646**
Recycling Adjustments – Net Increases under the 9.5 Percent SAP Rate					
September 30, 2005					$ 2,169,387
December 31, 2005					$ 2,034,038
March 31, 2006					$ 1,977,867
June 30, 2006					$ 1,908,133
Total					**$ 8,089,425**
Recycling Adjustments – Net Decreases under the Regular SAP Rate					
September 30, 2005					($ 574,454)
December 31, 2005					($ 781,811)
March 31, 2006					($ 941,263)
June 30, 2006					($ 1,039,131)
Total					**($ 3,336,659)**
Total Net Recycling Adjustments					**$ 4,752,766**
Grand Total					**$79,503,412** (a)

(a) The amount that is duplicated with Finding No. 1 is $7,012,201 ($79,503,412 times the 8.82 percent ineligible portion of Bond 206).

We calculated this amount by—

- Totaling the quarterly average daily balances of loans assigned to the bonds involved in the 9.5 Percent Floor Project (ADB of Floor Project and Bond 206 Loans);
- Totaling the maximum amount from the 9.5 Percent Floor Project that could be first or second generation. The maximum amount of loans that may have been first-generation or second-generation was $33,900,000, because Bond 206 was issued for $16,950,000. Therefore, the first $16,950,000 in loans may have been first-generation and the second

$16,950,000 in loans may have been second-generation (Maximum Amount That Could Be First or Second Generation Loans);

- Subtracting the Maximum Amount That Could be First or Second Generation Loans from the ADB of Floor Project and Bond 206 Loans (ADB That Must be Third or Later Generation Loans);
- Multiplying the quarterly ADB That Must be Third or Later Generation Loans by the Difference Rate (as calculated in Enclosure 1) to determine the amount for each bond that was overpaid for each quarter (Improper SAP Paid); and
- Adding KHESLC's net adjustments for loan recycling by adding the 9.5 percent special allowance payments received minus the regular special allowance deducted for adjustments to the LaRS billing statement for the quarter ended September 30, 2006, that adjusted billings for the quarters ended September 30, 2005, through June 30, 2006.

Enclosure 4: KHESLC's Comments to the Draft Audit Report

On December 29, 2008, KHESLC provided comments to the draft audit report. We documented these comments in this enclosure.

December 29, 2009

Gary D. Whitman
Regional Inspector General for Audit
U.S. Department of Education
Office of Inspector General
500 West Madison Street, Suite 1414
Chicago, IL 60661

Dear Mr. Whitman:

This letter is Kentucky Higher Education Student Loan Corporation's ("KHESLC's") response to your correspondence dated December 3, 2008 and the Draft Audit Report ED-OIG/A05I0011 dated December 2008 ("Draft Report"). The Draft Report made the preliminary finding that KHESLC billed under the 9.5 percent floor for certain loans that were ineligible and recommended that we repay any amounts received for the purported inappropriate billing. KHESLC strongly objects to Finding #1 and your concomitant Recommendation for that finding. I am optimistic that you will objectively review the arguments set forth below, and reverse this initial preliminary finding, based on legal, equitable, as well as public policy grounds.

Regarding Finding #2, KHESLC concurs. However, we disagree with your recommendation that we recalculate the amount that you say that we owe. Instead, we propose that we accept your estimated amount of improper special allowance payments, and repay that amount.

Regarding Finding #3 and the recommendation, given that we do not anticipate billing for 9.5 percent special allowance payments (SAP) in the future, this should serve to make this finding immaterial. While we admit no wrongdoing and do not concur with Finding #3, in light of the recommendation, we do not plan to argue the issue at this time. We reserve the right to argue this issue in the future should the OIG's recommendation change.

Finding #1

I. Overview and Context of KHESLC's Loans at Issue *vis a vis* 9.5 Percent Floor

The background of the 9.5 percent floor issue is well-known. Nonetheless, in order to understand why the U.S. Department of Education (Department) proposed certain regulatory changes and issued certain Dear Colleague Letters (DCLs) at the times that they did, it is

necessary to place the evolution of the Department's handling of this issue into historical context.

During the period starting around 2001, low interest rates caused legislators to re-look at and reevaluate section 438(b)(2)(13)(i) and (h) of the Higher Education Act (20 U.S.C. 1087-1(b)(2)(B)(i) and (ii)). This reevaluation was necessary as a result of an interpretation made of that provision by the Department in March 1996. That 1996 interpretation, (March 1996 DCL, 96-L-186) was itself intended to address what at the time was viewed as an unintended policy outcome, and changed the rules applicable to loans financed with tax-exempt bond estates established prior to October 1, 1993.

Prior to the DCL 96-L-186, the regulations, found at 34 C.F.R. 682.302(e), provided that loans made or acquired with the proceeds of a tax-exempt obligation bond were subject to a change in the special allowance provisions applicable to the loans in certain circumstances. These circumstances were if the loan was refinanced with the proceeds of a taxable obligation <u>and</u> the prior tax-exempt obligation was retired or defeased. (However, the applicable regulations and guidance did not address the method of calculating a special allowance on loans that were made or acquired with a tax-exempt obligation and were subsequently refinanced with the proceeds of a taxable obligation, <u>but</u> the prior tax-exempt obligations remained outstanding.)

This interpretation created what some described as an opportunity for certain authorities to earn an unnecessarily large return in the then-prevailing interest rate environment. In that environment, the return under the special allowance provisions applicable to loans financed with taxable obligations was *higher* than that under loans financed with tax-exempt obligations. Some authorities transferred loans out of tax-exempt bond trust estates in order to secure a higher return on loans.
This situation prompted the Department to change its *then* long-standing interpretation and policy. The Department articulated its *new* interpretation and policy in DCL 96-L-186. That interpretation addressed the unintended policy outcome of 1996, in which certain holders were getting a higher return on loans originally subject to special allowance treatment relating to loans made or acquired with tax-exempt bonds corresponding to that special allowance treatment by transferring them out of the tax-exempt bond estate.

In the 1996 guidance, the Department stated that if a loan were financed with the proceeds of a tax-exempt obligation <u>and</u> refinanced with the proceeds of a taxable obligation, *then the loan remained subject to special allowance provisions applicable to loans financed with tax-exempt obligations if the prior tax-exempt bond obligation was not retired or defeased and if the authority retained legal interest in the loans*.

This clarification of the treatment of loans appeared to address the problem of unintentionally creating a means for loan authorities increasing the return on certain student loans by transferring them out of tax-exempt bond estates. The new treatment, however, created a new unintended policy outcome when interest rates reached new lows starting during the period 2001- 2003.

II. <u>KHESLC'S Actions within the Statutory and Regulatory Framework</u>

It is important to understand the context of KHESLC's actions upon which Finding #1 is based. As such, a brief overview and background discussion will ensue. During the period

between December, 2002 to May, 2003 KHESLC utilized bridge financings to refund certain of its loan collateral from one long-term bond issue to another.

In general, the practice of bridge financings relative to refunding prior tax exempt obligations is a customary and accepted practice in municipal financings. Certain types of bridge financings have commonly been used as a very temporary interim measure in moving loan collateral from one long-term bond issue to a refunding issue. This practice is utilized because it can avoid the unnecessary expense of issuing a multitude of small bond issues by rolling them into a single issue. There is no doubt that in applying the refunding provision of Internal Revenue Code Section 146(i) (2) (B), which limits certain tax-exempt refundings of student loan bonds to "the date 17 years after the date on which the refunded bond was issued (or in the case of a series of refundings, the date on which the original bond was issued"), the IRS would date this "series of refundings" back to the date of the original tax-exempt issue.

Such temporary interim financings were used by KHESLC. Advances from KHESLC's Line of Credit Agreement Note had been used in the past as bridge financing to refund pre-October 1993 tax-exempt bonds that were collateralized by 9.5 percent floor eligible loans. Significantly, the bridge financings undertaken by KHESLC during the 2002-2003 period (which are the underlying basis for the present Finding #1) were specifically reviewed in October, 2005 by Federal Student Aid (FSA) representatives as a part of their tax-exempt review of KHESLC's billing practices related to special allowance, particularly related to the 9.5 percent floor. FSA's report dated May 11, 2006, issued *no finding* that KHESLC's bridge financing practice rendered the loans funded from such financing ineligible to receive 9.5 percent SAP.

At the same time that FSA made *no finding* that KHESLC had billed incorrectly for 9.5 percent floor when they audited KHESLC in 2005 on the exact same matter that is the basis for the current Finding #1, they also insisted that KHESLC had *underbilled* on recycled loans eligible for 9.5 percent floor. Accordingly, the Department subsequently made additional payments to KHESLC to allow a recovery of the special allowance.

III. <u>Timeline of Statutory and Regulatory Developments Impacting 9.5 Percent Floor Issue</u>

The following will clearly demonstrate that KHESLC operated in good faith and well within the guidelines permitted by the relevant law, regulations and subregulatory guidance extant at the time that KHESLC did the refunding which is the basis of Finding #1.

- 34 C.F.R. §682.302(e)was revised effective December 18, 1992, to reflect a shift in the Department's then-longstanding policy regarding loan made or acquired with the proceeds of tax-exempt obligations.
    - Prior to this change, a lender received SAP on a loan made or acquired with the proceeds of a tax-exempt obligation based on the rules applicable to loans financed with taxable obligations after the loan was refinanced with the proceeds of a taxable obligation and the prior tax-exempt obligation was retired or defeased. However, the regulations were *silent* as to the method of calculating SAP for a loan made or acquired with a tax-exempt obligation that

was refinanced with the proceeds of a taxable obligation, but while the prior tax-exempt obligation remained outstanding.
  - In the December 18, 1992 regulations, the Department changed this long-standing policy.

- Dear Colleague Letter (DCL) 96-L-186 was issued in March, 1996, to clarify and interpret the December, 1992 regulations. Under the new regulations, if a loan made or acquired with the proceeds of a tax-exempt obligation is refinanced with the proceeds of a taxable obligation, the loan remains subject to the tax-exempt SAP if the authority retains legal interest in the loan. However, if the original tax-exempt obligation is retired or defeased, SAP is paid based on the rules applicable to the new funding source, whether it is taxable or tax-exempt.
- Prior to the effective date of the Taxpayer Teacher Protection Act (TTPA), the statute, Sec. 438 (20 U.S.C. 1087-1(b)(2)(B)) was silent respecting refunding of pre-October 1993 obligations, imposing no particular conditions on refunding.
- The TTPA was enacted on October 30, 2004. The TTPA amendments to the statute, Sec. 438 (20 U.S.C. 1087-1(b)(2)(B)(iv)), recognized the practice of refunding pre-October 1993 obligations, yet imposed only the condition that *refunding after September 30, 2004* would disqualify the loans financed by the refunding from the 9.5 percent floor. Additionally, the TTPA amendments contained no clear expression of legislative intent to justify retroactive application of the changes.
- The Higher Education Reconciliation Act of 2005 (HERA) was enacted on February 8, 2006. Under both HERA as well as TTPA, no refundings after September 2004 are eligible for the 9.5 percent floor. Additionally, the HERA amendments contained no clear expression of legislative intent to justify retroactive application of the changes.
- Interim final regulation amending 34 C.F.R §682.302(3) were published August 9, 2006 and the final regulations were published November 11, 2006.

IV. Main Basis for Finding #1 – OIG Interpretation and Application of 34 C.F.R. §682.302(e)(2)

Given that the foundation for Finding #1 rests on an erroneous interpretation and/or an impermissibly retroactive application of 34 C.F.R. §682.302, the following will discuss the genesis of this regulation and the Department's differing interpretations over the years of how this regulation was intended to address the relevant issues as they evolved.

34 C.F.R. §682.302 Interim Final Regulations Published August 9, 2006

Interim final regulations amending 34 C.F.R. § 682.302(e) were first published on August 9, 2006, (even though the final regulations were not effective until November 11, 2006). This was the first time since the enactment of TTPA that an additional condition had been added to the statutory change. Section 682.302(e) (2) attempted to paraphrase provisions of statutory language in Sec. 438(b) (2) (B) (v). However the regulatory language was problematic in several ways.

First, the paraphrase was an inaccurate rendition of the statutory requirement and the regulatory language in (e) (2) (i) added a condition not specified in the statute. Prior to TTPA,

the statute, Sec. 438(b) (2) (B), was silent respecting refunding of pre-October 1993 obligations, imposing no particular conditions on refunding. The TTPA amendments to the statute, Sec. 438(b)(2)(B)(iv), recognized the practice of refunding pre-October 1993 obligations, yet only imposed the one condition that refunding after September 30, 2004 would disqualify the loans financed by the refunding from the 9.5 percent floor. However, the proposed regulations now set forth a condition that *was not mentioned in the statute*; specifically, that the refunded pre-October 1993 debt must have been *continuously* financed by tax-exempt obligations.

Second, Section 682.302(e) was amended to redefine the circumstances under which a tax-exempt refunding bond is 9.5 percent floor eligible (meaning all the loans it holds are billable at the 9.5 percent rate). Under both TTPA and HERA however, no refundings after September 2004 are eligible refundings. Therefore, it appeared that addition of the new language in (e) (2) (i), that the refunded pre-October 1993 debt must have been *continuously* financed by tax-exempt obligations, was directed at refundings occurring prior to September 2004 and thus could have only be viewed as being imposed retroactively, since no refunding issues can be done after September 30, 2004 that would qualify loans pledged to the refunding for the 9.5 percent special allowance floor. However, nothing in the statutory language or legislative history of HERA or TTPA suggests any intent by Congress to impose retroactive changes to the payment of special allowance. To the contrary, the statutory language carefully imposed new requirements only on actions occurring *prospectively*. Limitations on refundings, refinancing, sales, transfers, originations, recycling and purchases were imposed on a prospective basis. Congress recognized that retroactive changes in the rules applicable to the payment of special allowance would threaten to destabilize the student loan marketplace through the introduction of significant new risks and uncertainty. The FFEL program relied, then as now, on a major and continuing investment of financial resources from national and international financial markets. These markets depend on the stability of the program's regulatory structure.

Third, the new condition added in (e) (2) (i) may have been attributed to the preamble to the Interim Final Regulations as reflecting "longstanding interpretation of the statute and regulations as applicable to the treatment of loans acquired from the tax-exempt funding sources…" However, no such "longstanding" interpretation had been published or communicated to the student loan industry until the issuance of the Interim Final Rules in August, 2006. The requirement in 682(e)(2)(i) that a loan must have been *continuously* financed by tax-exempt obligations is not found in the HEA, HERA or TTPA, nor in the regulations or subregulatory guidance as it existed when KHESLC undertook its refundings. The Department had not provided such clarifying guidance up to that point. Indeed, a major factor driving Congressional action on the issue was the steadfast assertion by the then-Administration that legislative action was necessary because such changes could not be made through regulation or administrative interpretation. To hold participants accountable for rules and interpretations never before provided them would have been an unattainable standard.

- **Department's Response and Elucidation to Comments on Proposed §682.302(e)(2)**

In response to the criticism that the proposed amendment to §682.302(e) (2) improperly required that a loan acquired with pre-October 1, 1993 tax-exempt funding be "financed continuously" by tax-exempt financing to retain eligibility for SAP at the 9.5 percent minimum, the Department, in the preamble to the final regulation, gave a detailed explanation of the intent

behind adding the qualifier "continuously". The Department's salient points are as follow. (The following is from Federal Register Vol. 71, No. 211, Wednesday, Nov. 1, 2006, pp 64386-64386.)

- "All loans that are initially eligible for a 9.5 percent SAP and SAP and have been refinanced can be divided into two mutually exclusive groups. The first group includes only those loans that have been refinanced exclusively and continuously from tax-exempt sources. The second group includes all loans not in the first group." (*ibid.* at 64386)
  - Taking this interpretation and applying it to the situation at hand, it is clear that KHESLC's refinancings fall into the second group, given that they were not refinanced continuously from tax-exempt sources.

The preamble goes on to explain:

- "The phrase 'financed continuously' is used to describe the first group, *not to exclude the second group from potential eligibility for SAP at the 9.5 percent minimum rate.* The interim final regulations contained no provisions that limit continued eligibility for SAP at the 9.5 percent minimum rate only to loans in the first group – those loans continuously refinanced from tax-exempt sources. *Some loans in the second group also retain that eligibility after refinancing."* (emphasis added) (*ibid.* at 64386-64387)
  - Again, in applying this interpretation to KHESLC's situation, it is clear that merely because KHESLC's loans were not financed continuously does *not* preclude them from 9.5 percent floor eligibility.

The preamble addresses the concern of some commenters that the proposed amendment to the regulation added a new condition not specified in the statute, i.e., that the loans had to be "financed continuously". The Department, in its explication of the interim regulations, stated emphatically:

- "The regulations add no condition on 9.5 percent SAP eligibility that was not already contained in the statute or regulations". (*ibid.* at 64387)
  - The Department is clearly reiterating that the only new condition on refunding, imposed by the TTPA amendments to the statute, is that refunding after September 30, 2004 would disqualify loans from the 9.5 percent floor. KHESLC's loans at issue in Finding #1 were refunded before September 30, 2004 and thus should not be disqualified.

The Department, in an effort to put to rest the apparent confusion and misunderstand of the phrase "financed continuously", thoroughly expounds upon the true interpretation, application and relevance.

- "The regulations in §682.302(e)(2)(i)(A) and (B) describe the first group of refinanced loans- those continuously refinanced using tax-exempt sources-and state that such loans qualify for a SAP at the 9.5 percent minimum return rate. *… The phrase 'financed continuously by tax-exempt obligations,' in §682.302(e) (2) (i) (B) (2) simply describes loans associated exclusively with tax-exempt refinancing."* (emphasis added) (*ibid.* at 64387)
  - This interpretation is of utmost relevance to our situation at hand. This is the exact regulation upon which the OIG has based its Finding #1.

The distinction made by this interpretation is critical. The Department is saying that "financed continuously" is merely used as a qualifier to describe the loans that fall into the already 9.5 percent-eligible group of loans (group #1) by virtue of the fact that they have been refinanced by tax-exempt obligations. The Department is *not* saying that this phrase is the only means by which loans may be 9.5 percent-eligible. This idea is further reinforced by the following.

- "The regulations do not exclude from eligibility for the 9.5 percent SAP loans affected by *other refinancings*. The Department's regulations in §682. (e)(2)(ii) describe loans refinanced from sources other than qualified tax-exempt sources." (emphasis added) (*ibid.* at 64387)
  - KHESLC's refunding/refinancings (the terms are used interchangeably by the Department) fall into the category of "other refinancings" and hence should not be excluded from 9.5 percent eligibility.

➢ **Foundation for Finding #1 Is Premised on an Incorrect Interpretation of the Pertinent Regulation**

To sum up the Department's interpretation at this point, it is clear that all loans that were initially eligible for the 9.5 percent floor and have been refinanced/refunded fall into one of two broad categories:

1) The first category is comprised of loans that are refinanced exclusively and continuously from tax-exempt sources; OR
2) The second category includes all loans not in the first group. The second group is comprised of two subgroups.
   a. The prior tax-exempt obligation has been retired or defeased; OR
   b. The prior tax-exempt obligation has *not* been retired or defeased.

If the loans fall into sub-category 2) b., then they retain 9.5 percent floor eligibility. KHESLC's loans, which are the subject of Finding #1, clearly and irrefutably fall into this sub-category. Hence, Finding #1 has absolutely no regulatory foundation to support it.

The logic and framework of the 2006 version of the regulation at issue reveals itself clearly when seen as a whole. The following contains the relevant excerpts of the regulation in question, after the final regulation was promulgated in November, 2006. It stated, in pertinent part:

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 CHAPTER VI--OFFICE OF POSTSECONDARY EDUCATION, DEPARTMENT OF EDUCATION

Sec. 682.302  Payment of special allowance on FFEL loans.
(e) (2) Effect of Refinancing on Special Allowance Payments. Except as
provided in paragraphs (e) (3) through (e) (5) of this section--
    (i) The Secretary pays a special allowance at the rate prescribed in
paragraph (c) (3) of this section to an Authority that holds a legal or
equitable interest in the loan that is pledged or otherwise transferred
in consideration of--
    (A) Funds listed in paragraph (c) (3) (i) of this section;
    (B) Proceeds of a tax-exempt refunding obligation that refinances a
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debt that--
    (1) Was first incurred pursuant to a tax-exempt obligation
originally issued prior to October 1, 1993;
    (2) Has been financed continuously by tax-exempt obligation.
    (ii) The Secretary pays a special allowance to an Authority that
holds a legal or equitable interest in the loan that is pledged or
otherwise transferred in consideration of funds other than those
specified in paragraph (e) (2) (i) of this section either--
    (A) At the rate prescribed in paragraph (c) (1) of this section, if--
    (1) The prior tax-exempt obligation is retired; or
    (2) The prior tax-exempt obligation is defeased by means of
obligations that the Authority certifies in writing to the Secretary
bears a yield that does not exceed the yield restrictions of section 148
of the Internal Revenue Code and the regulations thereunder, or
    (B) At the rate prescribed in paragraph (c) (3) of this section.
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As can be seen by reading the above, there are two categories of loans, the first described under §682.302(e) (2) (i), and the second under §682.302(e) (2) (ii). Those loans under (e) (2) (ii) are further sub-grouped under either (A) or (B). Loans under sub-category (A) are not eligible for the floor, because the prior tax-exempt obligation has been retired or defeased. Whereas, loans under (B) are eligible for the 9.5 percent floor, because the prior tax-exempt obligations are not retired or defeased. Significantly, in KHESLC's case, the prior tax-exempt obligations had *not* been retired or defeased. As such, KHESLC's loans retained the 9.5 percent floor eligibility.

KHESLC's loans which are at the heart of Finding #1 properly fall under 34 C.F.R. §682.302(e) (2) (ii) (B). They should *not* be considered to fall under 34 C.F.R. §682(e) (2) (i) (B) (2), as the OIG states in their Draft Report at page 10. As such, KHESLC's loans retained eligibility for the floor pursuant to the relevant regulations at the relevant time that they were effective in November, 2006. The OIG, inexplicably, has improperly misapplied and misinterpreted the regulations. The OIG has referred to the incorrect regulatory citation as the basis for their Finding #1. Accordingly, Finding #1 should be withdrawn and the Final Report should conclude that it was based on an erroneous interpretation and misapplication of the regulation at issue.

V. Assuming *Arguendo* that OIG Applied Correct Regulatory Cite, Would Be Impermissibly Retroactive

The above analysis conclusively shows that the OIG based Finding #1 on the incorrect portion of the regulation. However, even if the regulation cited were the correct one, and 34 C.F.R. §682.302(e)(2)(i) did pertain to KHESLC, applying this regulation after-the-fact would constitute the impermissible retroactive application of a regulation.

The Supreme Court, in *Smiley v. Citibank,* 517 US 735, 742-3 (1996), determined that the regulatory power of federal agencies such as the Department is subject to certain limitations. According to the Court,

> "Sudden and unexplained change, or change that does not take account of legitimate reliance on prior interpretation, may be 'arbitrary, capricious [or] an abuse of discretion'.

If indeed it were the case that 34 C.F.R. §682.302(e)(2)(i) governed KHESLC's loans at issue, then by adding the word "continuously" in 2006 to apply to actions taken in 2003 could be deemed arbitrary and capricious.

VI. Department's Financial Partners Previously Issued a Clean Audit on Same Issue

Even disregarding the above analysis which clearly demonstrates that the OIG erroneously misapplied the incorrect regulation to the KHESLC loans which are at issue, Finding #1 should be moot on the grounds that KHESLC has already been audited on this issue. The Department conducted an in-depth review on the same issue which is the basis for Finding #1, and found no overbilling related to the issue of the bridge financing.

During the week of October 24, 2005, a team from the Department's Partner Services conducted a program review of KHESLC's tax-exempt FFEL portfolio and compliance with the HEA, the TTPA and the pertinent regulations. Based on that review, the Department issued a report on May 11, 2006. In that report, the Department issued no negative findings regarding the issue of KHESLC's billing of the 9.5 percent SAP related to the bridge financing issue, and made no recommendation that KHESLC repay any amounts already received. On the contrary, in Finding #2, the Department concluded that KHESLC had in fact underbilled, and allowed KHESLC the opportunity to recover such funds.

This further demonstrates that KHESLC has applied the regulations properly and has complied with the spirit and letter of the applicable statutes, regulations and sub-regulatory guidance with regard to the issue of the 9.5 percent floor.

<u>Conclusion</u>

The OIG uses as the foundation for Finding #1 the flawed premise that:

> "When KHESLC refunded bonds using a taxable line of credit, the debt was no longer continuously funded by a tax-exempt obligation. Therefore, loans made or acquired with the portion of the three bonds refunding the taxable line of credit were not eligible for special allowance payments under the 9.5 percent floor". (Draft Report at page 10).

As discussed above, this Finding's premise was erroneously based on a misinterpretation of the regulation found at 34 C.F.R. §682.302(e) (2). The OIG misapplied a portion of the regulation which had no bearing on KHESLC's situation, when they cited to 682.302(e) (2) (i). Instead, the correct portion of the regulation which does properly apply to KHESLC is 682.302(e) (2) (ii). If the OIG's analysis had been based on the correct regulatory cite, then it is abundantly clear that KHESLC did not violate any statutory or regulatory provisions with respect to billing for the 9.5 percent SAP.

Accordingly, Finding #1 is fatally flawed. We thus propose that Finding #1 be withdrawn.

We appreciate your review of the response materials and look forward to working with you to complete the audit.

Sincerely,

/s/

Edward J. Cunningham
Executive Director