Special Allowance Payments to the Pennsylvania Higher Education Assistance Agency for Loans Funded by Tax-Exempt Obligations

FINAL AUDIT REPORT

ED-OIG/A03G0014
November 2007

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U.S Department of Education
Office of Inspector General
Philadelphia, Pennsylvania

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UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

Audit Services, Region III, Philadelphia

November 19, 2007

James L. Preston
Interim President and CEO
American Education Services
Pennsylvania Higher Education Assistance Agency
1200 North Seventh Street
Harrisburg, PA 17102-1444

Dear Mr. Preston:

Enclosed is our final audit report, Control Number ED-OIG/A03G0014, entitled *Special Allowance Payments to the Pennsylvania Higher Education Assistance Agency for Loans Funded by Tax-Exempt Obligations*. This report incorporates the comments that American Education Services, Pennsylvania Higher Education Assistance Agency, provided in response to the draft report. If you have any additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following Education Department official, who will consider them before taking final Departmental action on this audit:

Lawrence A. Warder
Acting Chief Operating Officer
Federal Student Aid
U.S. Department of Education
Union Center Plaza III, Room 112G1
830 First Street, N.E.
Washington, D.C. 20202-5132

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

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

Sincerely,

/s/
Bernard Tadley
Regional Inspector General for Audit

Enclosure

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EXECUTIVE SUMMARY

The objective of our audit was to determine if American Education Services/Pennsylvania Higher Education Assistance Agency (AES/PHEAA) billed for special allowance payments under the 9.5 percent floor in compliance with the requirements in the Higher Education Act of 1965, as amended (HEA), regulations, and other guidance issued by the Department, for the period July 1, 2003, through June 30, 2006.

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 funded by tax-exempt obligations issued before October 1, 1993. The quarterly special allowance payment for these loans may not be less than 9.5 percent, minus the interest the lender receives, divided by four. We refer to this calculation as the "9.5 percent floor." When interest rates are low, the 9.5 percent floor provides a significantly greater return than lenders receive for other loans.

We found that AES/PHEAA's billing did not comply with requirements for the 9.5 percent floor. AES/PHEAA's billing under the 9.5 percent floor—

- Included loans that were refinanced after September 30, 2004, by taxable obligations and ineligible tax-exempt obligations. Under amendments to the HEA in the Taxpayer-Teacher Protection Act of 2004 (TTPA), these loans are not eligible for the 9.5 percent floor. We estimate that this non-compliance resulted in special allowance overpayments of about $14 million.
- Included loans that were funded by tax-exempt obligations issued on or after October 1, 1993. Under the HEA, loans funded by these obligations are not eligible for the 9.5 percent floor. We estimate that this non-compliance resulted in special allowance overpayments of about $21 million. (About $1.5 million of this amount is also in the overpayment in item 1.)
- For the quarter ended March 31, 2006, contained two errors, which resulted in special allowance overpayments of about $134,000.

We also found that there was a significant risk that loans billed by AES/PHEAA under the 9.5 percent floor were ineligible for that calculation because they were not eligible first-generation or second-generation loans. AES/PHEAA had no controls in place to ensure that the loans billed under the 9.5 percent floor were funded by the eligible sources of funds identified in Section 438(b)(2)(B)(i) of the HEA and 34 C.F.R. § 682.302(c)(3)(i). However, since the Department has stated that it will not seek repayment of prior improper payments if a lender agrees to certain terms—which include a separate independent audit—and since a separate independent audit is in process to identify AES/PHEAA's eligible first-generation and second-generation loans, we did not determine the extent to which AES/PHEAA's 9.5 percent floor billings included only eligible first-generation and second-generation loans.

During our audit, we confirmed with management at AES/PHEAA that, other than in the change request forms it used to update its systems, it had no documented policies and procedures for the processes it used to manage its student loan portfolio. This lack of written policies and procedures may have caused its non-compliance and billing errors.

We recommend that the Acting Chief Operating Officer for Federal Student Aid (FSA) instruct AES/PHEAA to return the special allowance overpayments we describe in our report, stop billing under the 9.5 percent floor for ineligible loans, and document and implement policies and procedures for managing its student loan portfolio.

In its comments to the draft report, AES/PHEAA did not concur with our findings and recommendations. AES/PHEAA provided no evidence to cause us to revise our findings or recommendations. The full text of AES/PHEAA's comments on the draft report is included as an Enclosure to this report.

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, for Stafford loans,[1] 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))[2]

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

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

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

- For the quarter ending December 31, 2003, a lender would receive $76 under the 9.5 percent floor calculation (payment rate of 1.52 percent). Under the calculation that would be used if the same loan was not eligible for the 9.5 percent floor calculation (payment rate of 0.0025 percent), the lender would receive $0.125.
- For the quarter ending June 30, 2006, a lender would receive $52.50 under the 9.5 percent floor calculation (payment rate of 1.05 percent). Under the calculation that would be used if the same loan was not eligible for the 9.5 percent floor calculation (payment rate of 0.565 percent), the lender would receive $28.25.

The Student Loan Reform Act of 1993, which was included in the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66), repealed the 9.5 percent floor calculation, restricting it to loans made or purchased with the proceeds of tax-exempt obligations that were originally issued before October 1, 1993. In this report, we refer to these obligations as "eligible tax-exempt" obligations or bond issues. Tax-exempt obligations that were originally issued on or after October 1, 1993, are referred to as "ineligible tax-exempt" obligations or bond issues.

Dear Colleague Letter 96-L-186

In March 1996, the Department issued Dear Colleague Letter (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

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

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

Higher Education Reconciliation Act of 2005 (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 the January 1, 2006, sunset date provisions. Second, under the HERA, a loan is ineligible for the 9.5 percent floor calculation if it was—

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

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

American Education Services/Pennsylvania Higher Education Assistance Agency

PHEAA is a public corporation and government instrumentality created by the Commonwealth of Pennsylvania in 1963. Its mission is to improve higher education opportunities for Pennsylvanians. PHEAA conducts its business as American Education Services, providing financial aid services to students, families, schools, lenders, and other student financial aid providers. AES/PHEAA distributes grants; originates, purchases, and sells student loans; guarantees student loans; services student loans; and provides information technology services. AES/PHEAA operates both inside and outside of Pennsylvania. AES/PHEAA's principal offices are located in Harrisburg, Pennsylvania. In its *Annual Financial Report*,[3] for the year ended June 30, 2006, AES/PHEAA reported that it—

- Has approximately 2,600 employees and about $9 billion in student loans receivable, of which about $8.6 billion consists of FFEL Program loans; and
- Serviced $34.7 billion in loans for its clients and an additional $17.6 billion in student loans were serviced by customers using AES/PHEAA's computer services.

AES/PHEAA reported that it provided public service benefits totaling $161 million in 2006, $97 million in 2005, and $99 million in 2004.[4] As described to us by AES/PHEAA officials, AES/PHEAA's public service benefits are funded in part by the earnings on its eligible tax-exempt obligations. As described by AES/PHEAA, regulations issued by the Internal Revenue Service generally limit the earnings on a tax-exempt bond's proceeds to two percent over the interest rate on the bond issue. Earnings in excess of this limit are called "excess earnings." AES/PHEAA reduces the loan yields for its tax-exempt bonds, to limit excess earnings, by (1) paying the loan origination points for the borrower, (2) reducing the borrower's interest rate if the borrower makes consecutive on-time payments, and (3) paying a premium for the student

[3] For the years ended June 30, 2006 and 2005.
[4] According to the *Annual Financial Reports*, for the years ended June 30, 2006 and 2005, and June 30, 2005 and 2004, these public service benefits include origination fees paid on behalf of borrowers, guaranty fees waived on behalf of borrowers, Armed Forces Loan Forgiveness Program, Academic Excellence Scholarship, costs of operating state and federal governmental programs, funding and support of the Pennsylvania Higher Education Foundation, and other public service activities and outreach.

loans it purchases in the secondary market. AES/PHEAA cited these activities as contributing to its increase in 9.5 percent floor loans.

In a written confirmation of explanations provided by AES/PHEAA, dated January 5, 2007, AES/PHEAA stated—

> Because the upfront borrower benefits that AES/PHEAA funds under its Keystone Loan Program are considered a use of excess interest, AES/PHEAA attempts to originate loans in [bond] issues that have excess interest. This process sometimes necessitates selling loans from the issues that have excess interest so there is cash in the issues to originate fee-free loans (loans on which Federal Loan Originations and Federal Default Fees are paid on behalf of the borrower) to Pennsylvania students and students attending Pennsylvania schools. This practice, consistent with DCL 96-L-186, resulted in an increase in 9.5% floor loans.

From the period July 1, 2003, through June 30, 2006, AES/PHEAA had nine outstanding eligible tax-exempt obligations, totaling $858,925,000. On average, during the same period, AES/PHEAA billed about $1.8 billion in 9.5 percent floor loans for each quarter. During this period, the Department paid special allowance, totaling about $263 million to AES/PHEAA for its 9.5 percent floor loans. These amounts are provided below, in Table 1.

Table 1 - AES/PHEAA's Quarterly 9.5 Percent Floor Loan Balances and Special Allowance Paid

Quarter Ending	Ending Principal Balance	Average Daily Balance (ADB)	Special Allowance Payments (SAP) Paid by the Department
September 30, 2003	$ 1,474,903,695	$ 1,371,670,761	$ 17,546,093
December 30, 2003	$ 1,496,649,756	$ 1,482,366,640	$ 19,459,807
March 31, 2004	$ 1,689,648,782	$ 1,644,941,482	$ 22,173,398
June 30, 2004	$ 2,046,747,365	$ 1,757,006,404	$ 24,015,018
September 30, 2004	$ 2,311,383,351	$ 2,108,526,519	$ 28,610,513
December 31, 2004	$ 2,145,987,843	$ 2,245,015,455	$ 29,368,719
March 31, 2005	$ 2,155,238,246	$ 2,166,324,081	$ 28,216,680
June 30, 2005	$ 1,975,320,644	$ 2,046,395,876	$ 26,338,628
September 30, 2005	$ 1,729,507,729	$ 1,778,821,563	$ 17,295,890
December 31, 2005	$ 1,530,959,556	$ 1,667,420,448	$ 16,933,235
March 31, 2006	$ 1,674,254,780	$ 1,630,869,722	$ 16,929,735
June 30, 2006	$ 1,437,390,381	$ 1,520,487,449	$ 16,242,322
		Total:	**$ 263,130,038**

The amounts provided are current billings and exclude subsequent adjustments.
Source: U.S. Department of Education, Datamart

AUDIT RESULTS

The objective of our audit was to determine if AES/PHEAA 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 September 30, 2003, through June 30, 2006. We found that AES/PHEAA's billing for special allowance payments under the 9.5 percent floor did not comply with the requirements in the HEA, regulations, and Departmental guidance. Specifically, we found that AES/PHEAA billed 9.5 percent floor loans financed with ineligible obligations; its billing for the quarter ended March 31, 2006, contained two errors; it had no documented policies and procedures for the processes it used to manage its student loans portfolio; and there is a significant risk that loans billed under the 9.5 percent floor calculation were not eligible first-generation or second-generation loans.

In its comments to the draft report, AES/PHEAA did not concur with our findings and recommendations. AES/PHEAA provided no evidence to cause us to revise our findings or recommendations. Summaries of the comments and our responses are provided at the end of each finding. The full text of AES/PHEAA's comments on the draft report is included as an Enclosure to this report.

FINDING NO. 1 – AES/PHEAA Billed under the 9.5 Percent Floor for Loans Refinanced with Ineligible Funds after September 30, 2004.

AES/PHEAA's billing for special allowance payments under the 9.5 percent floor calculation was not in compliance with the TTPA. AES/PHEAA's billing under the 9.5 percent floor calculation included amounts for loans that were refinanced after September 30, 2004, with funds from taxable obligations and ineligible tax-exempt obligations. On average, for each of the quarters ended December 31, 2004, through June 30, 2006, AES/PHEAA billed for an average daily balance of about $178 million under the 9.5 percent floor calculation for these ineligible loans. We estimate that AES/PHEAA received about $14 million in improper special allowance payments under the 9.5 percent floor calculation for these ineligible loans.

AES/PHEAA asserted that, under the TTPA, a loan remains eligible for the 9.5 percent floor calculation if it is transferred (refinanced) from a taxable bond to another taxable bond, regardless of when that transfer occurs, unless the eligible tax-exempt bond is either retired or defeased. When determining eligibility for the 9.5 percent floor calculation, AES/PHEAA treats taxable bond issues and ineligible tax-exempt bond issues, in the same manner.

FSA issued a program review report on March 28, 2006, that contained a finding similar to ours regarding AES/PHEAA's compliance with the TTPA.[5] AES/PHEAA did not concur with FSA's interpretation of the TTPA and appealed the finding. In its appeal letter dated May 11, 2006, AES/PHEAA states that reading the TTPA to mean that loans are ineligible for the 9.5 percent floor if they are "transferred from taxable [bond] to taxable [bond]. . . is not supported by either

[5] FSA's program review did not attempt to quantify improper payments for its finding.

the plain language of the TTPA or [the Department's] prior guidance." The appeal has not been resolved by the Department. AES/PHEAA told us that it has suspended its refinancing of loans that are eligible for the 9.5 percent floor calculation, pending clarification on this issue by the Department.

The TTPA revised Section 438(b)(2)(B) of the HEA to make certain loans ineligible for the 9.5 percent floor calculation. Specifically, the TTPA added a new Section 438(b)(2)(B)(v) to the HEA:[6]

> Notwithstanding clauses (i) and (ii), the quarterly rate of the special allowance shall be the rate determined under subparagraph (A), (E), (F), (G), (H), or (I) of this paragraph, or paragraph (4), as the case may be, for a holder of loans that—
>
> (I) were made or purchased with funds—
>
> (aa) obtained from the issuance of obligations the income from which is excluded from gross income under the Internal Revenue Code of 1986 and which obligations were originally issued before October 1, 1993; or
>
> (bb) obtained from collections or default reimbursements on, or interest or other income pertaining to, eligible loans made or purchased with funds described in division (aa), or from income on the investment of such funds; and
>
> (II) are—
>
> (aa) financed by such an obligation that, after September 30, 2004, has matured or been retired or defeased;
>
> (bb) refinanced after September 30, 2004, with funds obtained from a source other than funds described in subclause (I) of this clause; or
>
> (cc) sold or transferred to any other holder after September 30, 2004.

In a DCL issued in January 2005 (FP-05-01), the Department summarized these requirements by saying that loans receiving special allowance payments under the 9.5 percent floor calculation revert to the usual rates if they are—

- Financed by a tax-exempt obligation that, after September 30, 2004, and before January 1, 2006, has matured or been retired or defeased;
- Refinanced after September 30, 2004, and before January 1, 2006, with funds obtained from a source other than [an eligible tax-exempt obligation or eligible proceeds of that obligation]; or
- Sold or transferred to any other holder after September 30, 2004, and before January 1, 2006.

During the period October 1, 2004, through June 30, 2006, AES/PHEAA's billing for special allowance payments under the 9.5 percent floor included 103,078 loans that were refinanced after September 30, 2004, with ineligible funds. We excluded 3,540 of these loans from our review because they were refinanced multiple times during the period October 1, 2004, through June 30, 2006, making it difficult to readily determine the loans' ineligible balances using data analysis software. For the remaining 99,538 loans, we estimate that AES/PHEAA received

[6] The quoted text includes amendments made by the HERA on February 8, 2006. These amendments removed the ending dates for the requirements included in the TTPA, but did not otherwise change the TTPA's requirements.

about $14.1 million in improper special allowance payments under the 9.5 percent floor calculation.

AES/PHEAA's billing under the 9.5 percent floor calculation and our estimate of the special allowance overpayment are provided below, in Table 2:

Table 2 – Questioned Special Allowance Paid on Ineligible Balances for Loans Refinanced After September 30, 2004

Quarter Ended	ADB for All Loans Billed at 9.5% Floor	Ineligible ADB for Loans Refinanced after September 30, 2004	Percent Ineligible ADB Billed	SAP Paid on Loans Billed	Questioned SAP Paid on Ineligible ADB
December 31, 2004	$ 2,245,015,455	$ 29,411,692	1.3%	$ 29,368,719	$ 384,756
March 31, 2005	$ 2,166,324,081	$ 210,347,708	9.7%	$ 28,216,680	$ 2,739,809
June 30, 2005	$ 2,046,395,876	$ 266,249,608	13.0%	$ 26,338,628	$ 3,426,829
September 30, 2005	$ 1,778,821,563	$ 213,115,340	12.0%	$ 17,295,890	$ 2,072,169
December 31, 2005	$ 1,667,420,448	$ 193,983,007	11.6%	$ 16,933,235	$ 1,969,965
March 31, 2006	$ 1,630,869,722	$ 174,174,868	10.7%	$ 16,929,735	$ 1,808,075
June 30, 2006	$ 1,520,487,449	$ 158,534,417	10.4%	$ 16,242,322	$ 1,693,514
			Totals	**$ 151,325,209**	**$ 14,095,118**

We calculated our estimate by—

- Identifying the ineligible amounts billed following the refinancing of the 99,538 loans ("Ineligible ADB for Loans Refinanced after September 30, 2004");
- Dividing this amount by the amount of all loans billed by AES/PHEAA under the 9.5 percent floor ("ADB for All Loans Billed at 9.5% Floor");
- Multiplying the resulting percentage ("Percent Ineligible ADB Billed") by the total amount of 9.5 percent floor special allowance paid to AES/PHEAA ("SAP Paid on Loans Billed"); and
- Adding the resulting amounts to estimate the total amount of improper payments made to AES/PHEAA under the 9.5 percent floor ("Questioned SAP Paid on Ineligible ADB").

The $14,095,118 that we are questioning includes $12,564,147 paid on loans funded by taxable obligations and $1,530,971 paid on loans funded by ineligible tax-exempt obligations. The $1,530,971 associated with the ineligible tax-exempt obligations is also included in the amount we question in Finding No. 2, which addresses payments under the 9.5 percent floor calculation for all loans funded by ineligible tax-exempt obligations.

Recommendations

We recommend that the Acting Chief Operating Officer for FSA—

1.1 Instruct AES/PHEAA to exclude all loans refinanced with ineligible funds after September 30, 2004, from its claims for payment under the 9.5 percent floor calculation.

1.2 Require AES/PHEAA to calculate special allowance payments received for loans that were refinanced with ineligible funds after September 30, 2004, and billed under the 9.5 percent floor calculation for the quarters ended December 31, 2004, through June 30, 2006 (for which we estimate about $14 million in improper payments), and return all overpayments.

1.3 Require AES/PHEAA to calculate special allowance payments received for loans that were refinanced with ineligible funds after September 30, 2004, and billed under the 9.5 percent floor calculation for the quarters after June 30, 2006, and return all overpayments.

AES/PHEAA Comments and OIG Responses

AES/PHEAA did not concur with Finding No. 1 and its recommendations. AES/PHEAA provided no evidence to cause us to revise our finding or recommendations. Summaries of AES/PHEAA's comments and our responses are provided below.

<u>Unresolved FSA Program Review</u>

- *AES/PHEAA Comment*. The finding is based on matters that were raised in an FSA Program Review Report and that are under appeal with the Department. OIG should withdraw its finding because "it is premised on matters that remain in dispute and under appeal and which are already under review by the Department under a separate report." FSA's Program Review acknowledged that its finding was the result of "confusion that exists within the lending community about the requirements of the TTPA." Confusion also existed within the Department as a prior FSA review of TTPA issues at PHEAA had no findings.

- *OIG Response*. Our audit was performed in accordance with *Government Auditing Standards* (2003 Revision). Under those standards, we are required to "design the audit methodology and procedures to provide reasonable assurance of detecting violations that could have a significant effect on the audit results." (Paragraph 7.17) Our findings are "complete to the extent that the objectives are satisfied and the report clearly relates those objectives to the elements of a finding," (Paragraph 7.62) and we are required to report our findings (Paragraph 8.13).

  The audit standards do not provide an exception to these requirements, or preclude the reporting of a finding, based on the report of the same or a similar violation elsewhere. Our report acknowledges that this finding has also been identified in a program review conducted by FSA, which alerts the Department of the need to avoid any duplicative recovery in resolution of this audit.

Alleged confusion cannot alter the requirements of the TTPA or authorize the payment or retention of 9.5 percent floor benefits for loans that do not qualify under the TTPA.

Statutory Language and Guidance

- *AES/PHEAA Comment*. Under Section 438(b)(2)(B)(v) of the HEA, a loan retains its eligibility for the 9.5 percent floor if it was (1) originated in an eligible tax-exempt obligation prior to October 1, 2004; then (2) transferred to a taxable obligation prior to October 1, 2004; and then (3) moved again from one taxable obligation to another taxable obligation after October 1, 2004.

  This interpretation is consistent with the FFEL community's understanding of the TTPA and with Departmental guidance available in the months immediately following the enactment of the TTPA. Section 438(b)(2)(B)(v) of the HEA and related special allowance provisions are ambiguous, and the Department did not issue regulations on the TTPA in a timely manner. The Department has historically changed its interpretation concerning these provisions. An example of this is provided in DCL 96-L-186, which reinterpreted eligibility requirements for the 9.5 percent floor. As such, AES/PHEAA has looked to the Department "to ascertain the precise interpretation of the statute."

  The TTPA states that a loan is ineligible for the 9.5 percent floor if it is "refinanced after September 30, 2004, and before January 1, 2006, with funds obtained from a source other than" an eligible tax-exempt bond or its eligible proceeds. However, the TTPA does not define the term "refinanced." In an audit report issued by the Government Accountability Office (GAO), *Federal Family Education Loan Program: Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments* (GAO-04-1070, issued September 2004), the term "refinancing" was only used to refer to the practice of transferring a loan from a tax-exempt bond to a taxable bond. As such, AES/PHEAA states that it "had no reason to believe that the term 'refinancing' referred to in the statute would include transfers of loans between taxable bonds."

- *OIG Response*. We do not agree that the TTPA and the Department's guidance are ambiguous. Nor do we agree that the Department's clarifying guidance was provided untimely. The TTPA was enacted on October 30, 2004, and though regulations were not published until August 9, 2006 (71 FR 45666), the Department issued clarifying guidance in DCL FP-05-01 on January 6, 2005.

  DCL FP-05-01 states, "Specifically, the loans for which the special allowance reverts to those usual rates are those that are . . . [r]efinanced after September 30, 2004, and before January 1, 2006, with funds obtained from a source other than funds described in section 438(b)(2)(B)(v)(I) of the HEA . . . ." Section 438(b)(2)(B)(v)(I) of the HEA describes eligible tax-exempt obligations.

  We do not agree that the omission of a definition in the TTPA for "refinanced" or a separate discussion of refinancing in a GAO report provides a reasonable basis for construing the term "refinanced" so narrowly that it includes the transfer of a loan from a tax-exempt obligation to a taxable obligation but does not include the transfer of a loan from a taxable obligation to a taxable obligation. On the contrary, the absence of such a restrictive definition in the TTPA indicates that the AES/PHEAA interpretation is unreasonable.

AES/PHEAA provided no evidence of an alleged "community understanding" or any change in interpretation of section 438(b)(2)(B)(v) by the Department. AES/PHEAA pointed only to DCL 96-L-186, which pre-dates the TTPA. Regardless of any "community understanding" or varying interpretation, the plain, unambiguous language of the TTPA controls eligibility for the 9.5 percent floor.

<u>Legislative History of the TTPA</u>

- *AES/PHEAA Comment*. The legislative history of the TTPA indicates that the statute was intended to prevent transfers of floor loans from eligible tax-exempt obligations to taxable obligations in order to impede creation of new floor loans. Congress intended Section 438(b)(2)(B)(v)(I) of the HEA to apply only to loans that are *currently* made or purchased with the proceeds of an eligible tax-exempt obligation, because only transfers involving such loans would result in creation of new floor loans. AES/PHEAA's transfers did not result in an increase in 9.5 percent floor billings and therefore its transfers were not implicated by the TTPA.

- *OIG Response*. We do not agree with AES/PHEAA's interpretation of the history of the TTPA. There is nothing in the sources that AES/PHEAA cites to indicate that Congress intended the TTPA to be so narrowly interpreted that it would only affect loans currently funded by eligible tax-exempt obligations, or that such an intention is reflected in the TTPA itself.

  The sources cited by AES/PHEAA support an understanding that *one* of the purposes of the TTPA was to prohibit continued special allowance payments under the 9.5 percent floor after a loan is transferred from an eligible tax-exempt obligation to a taxable obligation, but none of those sources contends that this was the only intended effect of the TTPA.

  As previously noted, the plain, unambiguous language of the TTPA controls eligibility for the 9.5 percent floor, regardless of any alleged contrary legislative history.

<u>Department's Statements on Repayment</u>

- *AES/PHEAA Comment*. In DCLs FP-07-01 and FP-07-06, the Department stated that it "will not seek repayment for SAP billings for quarters prior to September 2006 with respect to loans deemed not to have been first or second-generation." Since AES/PHEAA is undergoing the audit required by these letters, the "safe harbor" that the letters provide bars the report's repayment recommendations. If the report's finding was correct, the loans would not be first-generation or second-generation loans under the Department's guidance, and the Department has agreed not to seek repayment for prior quarters.

- *OIG Response*. We do not agree that the Department's offer in DCLs FP-07-01 and FP-07-06 extends to payments that are found to be in violation of the TTPA. The Department's offer in DCL FP-07-01 is provided below:

> 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.

The Department clarifies in its "Methodology to Identify Loans Eligible for the 9.5 Percent SAP," attached to DCL FP-07-06, that—

> A determination that a particular loan is an eligible first-generation or second-generation loan is not a determination that the loan retained eligibility for SAP at the 9.5 percent rate, or that the loan met other applicable legal requirements for receiving SAP.

The Department's offer not to recoup special allowance payments on certain ineligible loans extends only to those loans found to be ineligible under the criteria that are explained in DCLs FP-07-01 and FP-07-06, for determining whether a loan is a first-generation or second-generation loan. The criteria for determining whether a loan is eligible under the TTPA is not discussed in those DCLs, and as such, the amount of special allowance payments on the loans identified in our finding is not included in the Department's offer.

<u>Estimates of Special Allowance Overpayments</u>

- *AES/PHEAA Comment*. The questioned amount in the audit report is an estimate, and the OIG did not actually calculate the questioned special allowance payments. As such, the amount of questioned special allowance payments in the audit report is incorrect and speculative, and it should be removed from the report.

- *OIG Response*. We are not precluded by audit standards from estimating the effect of a finding in our report. Our audit report describes how the ineligible loans were identified and how the estimated special allowance overpayment for these loans was calculated. Other than its general objection, AES/PHEAA identified no specific error in our estimate. In Recommendations 1.2, 1.3, 2.2, and 2.3, we recommend that the Department require "AES/PHEAA to calculate special allowance payments received." If our recommendations are accepted, AES/PHEAA's liability will be based on the actual amounts that it calculates, not the amounts we have estimated.

<u>OIG Authority under the HEA and the IG Act</u>

- *AES/PHEAA Comment*. Under the HEA and the Inspector General Act of 1978 (IG Act), the OIG cannot impose new Department standards upon prior audit periods (20 U.S.C. § 1082(f)(4)) or conduct audits that assume program operating responsibilities that are integral or central to the Department's functions (5 U.S.C. App. 3 § 9(a)(2)). As such, the OIG cannot include Finding 1 in its report because—

  - It presumes "the outcome of the unresolved administrative appeal proceeding" and it applies "that presumed outcome to a prior audit period";

- The administrative process for resolving AES/PHEAA's appeal is underway and this finding "unlawfully assumes integral program operating responsibilities reserved to the Department . . . ."; and

- The finding is directly at odds with the "safe harbor" guidance published by the Department: the finding purports to rescind that guidance and, as such, constitutes the unlawful assumption by OIG of the Department's program operating responsibility.

The same provisions also preclude the issuance of Finding Nos. 2 and 4.

- *OIG Response*. The HEA does not prohibit us from issuing any of the findings in this report. The requirement that AES/PHEAA cites prohibits us from applying "subsequently determined standards, procedures, or regulations to the records of such agency, lender, or Authority." All of the criteria used in our report are from requirements in the HEA, regulations, and Department guidance that were published and in effect during the periods in which we found violations.

  The IG Act does not prohibit us from issuing this final audit report. PHEAA ignores § 4(a)(1) of the IG Act which expressly authorizes and directs the OIG to "conduct . . . audits . . . relating to the programs and operations" of the Department. Section 9(a)(2), as cited by AES/PHEAA, addresses the transfer of additional agency programmatic authority not included in the IG Act. In conducting this audit, we are conducting one of our core authorities under the IG Act. Our audit report provides recommendations to the Department, and the Department will make the management and programmatic decisions.

FINDING NO. 2 – AES/PHEAA Billed under the 9.5 Percent Floor for Loans Funded by Tax-Exempt Obligations Issued on or after October 1, 1993.

AES/PHEAA's billing for special allowance payments under the 9.5 percent floor calculation included amounts for loans funded by ineligible tax-exempt obligations. On average for each of the quarters ended September 30, 2003, through June 30, 2006, AES/PHEAA billed for an average daily balance of about $139 million under the 9.5 percent floor calculation for these ineligible loans. We estimate that AES/PHEAA received about $21 million in improper special allowance payments under the 9.5 percent floor calculation for these ineligible loans.

Pursuant to Section 438(b)(2)(B)(iv) of the HEA, loans funded by tax-exempt obligations originally issued on or after October 1, 1993, are not eligible for special allowance payments under the 9.5 percent floor calculation. Specifically, this section of the HEA states—

> Notwithstanding clauses (i) and (ii) [the clauses that allow a lender to receive payments under the 9.5 percent floor] the quarterly rate of the special allowance for holders of loans which are financed with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993, or refunded after September 30, 2004, the income from which is excluded from gross income under the Internal Revenue Code of

> 1986, shall be the quarterly rate of the special allowance established under subparagraph (A), (E), (F), (G), (H), or (I) as the case may be. Such rate shall also apply to holders of loans which were made or purchased with funds obtained by the holder from collections or default reimbursements on, or interest or other income pertaining to, eligible loans made or purchased with funds described in the preceding sentence of this subparagraph or from income on the investment of such funds.

By excluding subparagraph (B) from the list in the first sentence (subparagraph (B) provides requirements for the 9.5 percent floor calculation), this section of the HEA makes loans ineligible for the 9.5 percent floor calculation if they are funded by tax-exempt obligations originally issued on or after October 1, 1993. This requirement is similarly stated in 34 C.F.R. § 682.302(c)(4):

> Loans made or purchased with funds obtained by the holder from the issuance of tax-exempt obligations originally issued on or after October 1, 1993, and loans made with funds derived from default reimbursement collections, interest, or other income related to eligible loans made or purchased with those tax-exempt funds, do not qualify for the minimum special allowance rate specified in paragraph (c)(3)(iii) of this section, and are not subject to the 50 percent limitation on the maximum rate otherwise applicable to loans made with tax-exempt funds.

In these regulations, "the minimum special allowance rate specified in paragraph (c)(3)(iii)" is the special allowance rate calculated under the 9.5 percent floor.

During our interviews, AES/PHEAA managers stated that their billing for these loans under the 9.5 percent floor calculation was based on their understanding of DCL 96-L-186. Item 30 of this DCL states—

> 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).

AES/PHEAA managers stated that they understand this guidance to mean that, once a loan has been funded by an eligible tax-exempt obligation, it retains its eligibility for the 9.5 percent floor regardless of it subsequent funding source. They stated that, prior to the implementation of the TTPA, once a loan was made eligible for the 9.5 percent floor calculation, its subsequent funding by any taxable or tax-exempt obligation did not affect that eligibility.

The DCL to which the AES/PHEAA managers referred explicitly limits the retention of a loan's eligibility for the 9.5 percent floor calculation to subsequent transfers from the eligible tax-exempt obligation to a taxable obligation. It does not address subsequent transfers to tax-exempt obligations originally issued on or after October 1, 1993.

By billing under the 9.5 percent floor for loans funded by an ineligible source, the special allowance payments to AES/PHEAA for those loans were improper payments. We estimate that AES/PHEAA received about $21.3 million in special allowance payments under the 9.5 percent floor calculation for loans funded by ineligible tax-exempt obligations. AES/PHEAA's billing under the 9.5 percent floor calculation and our estimate of the special allowance overpayment are provided below, in Table 3:

Table 3 – Questioned Special Allowance Paid on Ineligible Balances for Loans Funded by Ineligible Tax-Exempt Obligations

Quarter Ended	ADB for All Loans With SAP Paid Under 9.5% Floor	ADB for Loans With SAP Paid in Ineligible Tax-Exempt Obligations	Percent Ineligible ADB With SAP Paid	SAP Paid on Loans Billed	Questioned SAP Paid on Ineligible ADB
September 30, 2003	$ 1,351,105,604	$ 112,263,238	8.3%	$ 17,546,093	$ 1,457,903
December 31, 2003	$ 1,462,471,877	$ 136,447,285	9.3%	$ 19,459,807	$ 1,815,582
March 31, 2004	$ 1,623,010,846	$ 147,557,021	9.1%	$ 22,173,398	$ 2,015,908
June 30, 2004	$ 1,730,142,051	$ 172,276,977	10.0%	$ 24,015,018	$ 2,391,269
September 30, 2004	$ 1,998,562,360	$ 181,159,740	9.1%	$ 28,610,513	$ 2,593,401
December 31, 2004	$ 2,048,022,077	$ 211,778,273	10.3%	$ 29,368,719	$ 3,036,909
March 31, 2005	$ 1,977,154,795	$ 180,527,831	9.1%	$ 28,216,680	$ 2,576,377
June 30, 2005	$ 1,848,016,694	$ 152,335,478	8.2%	$ 26,338,628	$ 2,171,142
September 30, 2005	$ 1,663,232,176	$ 105,851,875	6.4%	$ 17,295,890	$ 1,100,750
December 31, 2005	$ 1,614,794,344	$ 71,485,826	4.4%	$ 16,933,235	$ 749,623
March 31, 2006	$ 1,599,207,885	$ 65,099,060	4.1%	$ 16,929,735	$ 689,160
June 30, 2006	$ 1,519,325,101	$ 66,083,570	4.3%	$ 16,242,322	$ 706,465
			Totals	**$ 263,130,038**	**$ 21,304,489**

We calculated our estimate by—

- Identifying the loans funded by ineligible tax-exempt obligations ("ADB for Loans With SAP Paid in Ineligible Tax-Exempt Obligations");
- Dividing this amount by the amount of all loans billed by AES/PHEAA under the 9.5 percent floor on which special allowance payments were made ("ADB for All Loans With SAP Paid Under 9.5% Floor");
- Multiplying the resulting percentage ("Percent Ineligible ADB With SAP Paid") by the total amount of 9.5 percent special allowance paid to AES/PHEAA ("SAP Paid on Loans Billed"); and
- Adding the resulting amounts to estimate the total amount of improper payments made to AES/PHEAA under the 9.5 percent floor calculation ("Questioned SAP Paid on Ineligible ADB").

Recommendations

We recommend that the Acting Chief Operating Officer for FSA—

2.1 Instruct AES/PHEAA to exclude all loans funded by an ineligible tax-exempt obligation from its claims for payment under the 9.5 percent floor.

2.2 Require AES/PHEAA to calculate special allowance payments received for loans that were funded by ineligible tax-exempt obligations, and billed under the 9.5 percent floor calculation, for the quarters ended September 30, 2003, through June 30, 2006, (for which we estimate approximately $21.3 million in improper payments), and return all overpayments.

2.3 Require AES/PHEAA to calculate special allowance payments received for loans that were funded by ineligible tax-exempt obligations, and billed under the 9.5 percent floor calculation for the quarters after June 30, 2006, and return all overpayments.

AES/PHEAA Comments and OIG Responses

AES/PHEAA did not concur with Finding No. 2 and its recommendations. AES/PHEAA provided no evidence to cause us to revise our finding or recommendations. Summaries of AES/PHEAA's comments and our responses are provided below.[7]

<u>Criteria at 34 C.F.R. § 682.302(e)(2)</u>

- *AES/PHEAA Comment.* Section 438(b)(2)(B)(iv) of the HEA and 34 C.F.R. § 682.302(c)(4) do not bar floor loan treatment for loans refinanced with post October 1, 1993, tax-exempt obligations. The OIG's finding does not address requirements in 34 C.F.R. § 682.302(e)(2) in effect during the audit period, which provide that a loan remains eligible for the 9.5 percent floor after refinancing, as long as the authority retains an interest in the loan and the original tax-exempt bond is not retired or defeased. Pursuant to 34 C.F.R. § 682.302(e)(2)—

> (2) The Secretary pays a special allowance to an Authority at the rate prescribed in paragraph (c)(1) of this section on a loan described in paragraph (c)(3)(i) of this section—
> (i) After the loan is pledged or otherwise transferred *in consideration of funds derived from sources other than those described in paragraph (c)(3)(i) of this section*; and
> (ii) If the authority retains a legal or equitable interest in the loan—
> (A) The prior tax-exempt obligation is retired; or

[7] In addition to the comments summarized here, AES/PHEAA also argued that HEA and the IG Act preclude us from issuing this finding, that the Department stated in DCLs FP-07-01 and FP-07-06 that it will not seek repayment for prior 9.5 percent floor special allowance payments, and that our report includes an estimate rather than an actual calculation of the questioned special allowance payments. We have summarized and responded to these comments in the previous discussion under Finding No. 1.

(B) The prior tax-exempt obligation is defeased . . . . [Emphasis added by AES/PHEAA.]

The sources described in paragraph (c)(3)(i) include the proceeds of tax-exempt obligations originally issued prior to October 1, 1993. AES/PHEAA notes that tax-exempt obligations originally issued after September 30, 1993, are "sources other than those described in paragraph (c)(3)(i)." As a result, the "thrust" of the regulation is that 9.5 percent floor loans do not revert to the usual special allowance rates when a loan is transferred "in consideration of funds derived from sources other than those described in paragraph (c)(3)(i) of this section," if the bond authority retained an interest in the loan, and the eligible tax-exempt obligation was not retired or defeased.

- *OIG Response.* We see no ambiguity in Section 438(b)(2)(B)(iv) of the HEA:

  Notwithstanding clauses (i) and (ii), the quarterly rate of the special allowance for holders of *loans which are financed* with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993, or refunded after September 30, 2004, the income from which is excluded from gross income under the Internal Revenue Code of 1986, shall be the quarterly rate of the special allowance established under subparagraph (A), (E), (F), (G), (H), or (I) as the case may be. [Emphasis added.]

  This paragraph of the HEA specifically provides that all loans "which are financed with" ineligible tax-exempt obligations receive special allowance payments at the regular rate. While requirements in Section 438(b)(2)(B)(i) of the HEA, for determining a loan's eligibility for the 9.5 percent floor, are based on a funding event that occurred in the past (when the loans "were made or purchased"), this requirement uses different terms (when the loans "are financed") to base a loan's eligibility on its current financing source. The verb "are" is in the present tense, and as a result, it includes all loans that are currently financed by an ineligible tax-exempt obligation. AES/PHEAA does not dispute that the loans identified in this finding are currently financed by ineligible tax-exempt obligations. As such, those loans are not eligible for the 9.5 percent floor.

  The regulation cited by AES/PHEAA addresses only one particular circumstance under which a loan loses eligibility for the 9.5 percent floor. The language and structure of 34 C.F.R. § 682.302(e)(2) do not support a conclusion that this regulation defines the exclusive circumstance under which a loan loses eligibility for the 9.5 percent floor. Moreover, this regulation does not address any of the circumstances that could occur when loans are transferred in consideration of "sources other than those described in paragraph (c)(3)(i) of this section" and the prior, eligible tax-exempt obligations are not retired or defeased.

  Title 34 C.F.R. § 682.302(c)(4) specifically provides that loans purchased with funds obtained from the issuance of post-October 1, 1993, tax-exempt obligations do not qualify for the 9.5 percent floor. Given this specific regulation and Section 438(b)(2)(B)(iv) of the HEA (which applies "notwithstanding" the provisions of the HEA by which AES/PHEAA's loans originally derived their eligibility for the 9.5 percent floor), it is unreasonable for AES/PHEAA to rely on the alleged "thrust" of 34 C.F.R. § 682.302(e) to conclude that loans continue to qualify for the 9.5 percent floor after their sale to an ineligible tax-exempt obligation. AES/PHEAA's transfers of loans to its ineligible tax-exempt bonds were all conducted as sales, and the prior eligible tax-exempt bonds were not retired or defeased.

<u>Guidance in DCLs L-93-161, L-93-163, and 95-L-181</u>

- *AES/PHEAA Comment.* DCLs 93-L-161 and 93-L-163 (issued November and December 1993, respectively) reiterated the Department's "blanket policy" of retaining floor treatment when a loan is refinanced, because they stated, "Refinancing of obligations which were originally issued prior to October 1, 1993 does not alter the eligibility of loans made or purchased with funds obtained from the proceeds of the original financing to receive the minimum special allowance."

  This policy was repeated in DCL 95-L-181 (issued June 1995), which also established a single special allowance billing code for both taxable and ineligible tax-exempt bonds. AES/PHEAA states, "It is obvious that by establishing a single special allowance billing code for both categories of loans that the Department had no intent and no means to track these loans separately and, thus, could not have segregated them for purposes of computing special allowance rates."

- *OIG Response.* The guidance cited from DCLs 93-L-161 and 93-L-163 does not alter our conclusion. Contrary to AES/PHEAA's characterization, the DCLs do not state a blanket rule that a loan retains its eligibility for the 9.5 percent floor whenever it is refinanced. These DCLs only address a loan's eligibility when the original tax-exempt *bond* is refinanced by another tax-exempt obligation. The DCLs do not address eligibility when a *loan* is refinanced by an ineligible tax-exempt obligation. Furthermore, DCL 96-L-186 limited its application and addressed only the effect of taxable refinancing on 9.5 percent floor eligibility.

  DCL 95-L-181 did not establish a single billing code as AES/PHEAA contends. Instead it provided a special allowance category for loans that are funded by tax-exempt obligations but are not eligible for the 9.5 percent floor. It stated, "A new special allowance category (SH) has been added for loans made or purchased with funds obtained by the holder for the issuance of obligations issued on or after October 1, 1993 ('new money')." The special allowance category "SH" is paid under the usual rates, not the 9.5 percent floor.

<u>GAO Report/Department Position</u>

- *AES/PHEAA Comment.* An audit report issued in September 2004 by the Government Accountability Office (GAO-04-1070) supported AES/PHEAA's position that a loan remains eligible for the 9.5 percent floor after being refinanced by an ineligible tax-exempt obligation. The GAO report stated—

  > Given that lenders are increasing the volume of 9.5 percent loans based on *Education regulations that allow lenders to transfer 9.5 percent loans to taxable bonds and tax-exempt bonds issued after October 1, 1993* while retaining the special allowance payment provisions applicable to loans financed with pre-October 1, 1993 tax-exempt bonds, and the resulting increased costs for

> taxpayers, we recommend that the Secretary of Education *promulgate regulations to discontinue the payment of the special allowance applicable to loans financed with pre-October 1, 1993 tax-exempt bonds that are subsequently transferred to taxable bonds or tax-exempt bonds issued on or after October 1, 1993*. [Emphasis added by AES/PHEAA.]

The response from the Department, included with the GAO report, stated—

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

- *OIG Response.* GAO reported on practices used by the loan industry to increase or maintain 9.5 percent floor billings. While GAO's report included recommendations for future action, it did not analyze or reach definitive conclusions on the legality of specific lender billing practices. In particular, the report did not address the requirements of Section 438(b)(2)(B)(iv) of the HEA. The Department qualified its comment on the GAO audit report with the words "in general" and did not address the specific circumstances in our audit report.

Definitions in FSA's Response to AES/PHEAA's Appeal

- *AES/PHEAA Comment.* A footnote in FSA's response (dated April 10, 2007) to AES/PHEAA's pending appeal of the findings of a Program Review Report, recognizes that FSA consistently treats taxable bonds and ineligible tax-exempt bonds in the same manner. FSA's response stated—

> Loans which "are financed with funds obtained by the holder" from a tax-exempt bond "originally issued on or after October 1, 1993" receive SAP at the same rate paid on other loans (here, the "usual rate"), not the 9.5 percent minimum return rate. 20 U.S.C.A. 1087-1(b)(2)(B)(iv) (2006). The HEA thus treats funds from such bonds in the same way as funds from obligations that are not tax-exempt. *We use the term "taxable funds" or "taxable bond" to refer to any funding source other than a pre-October 1993 tax-exempt bond*. [Emphasis added by AES/PHEAA.]

AES/PHEAA contends that this position also supports a conclusion that ineligible tax-exempt financing must be treated like taxable financing.

- *OIG Response.* AES/PHEAA overstates the significance of a short-hand reference created for the fact that both taxable and ineligible tax-exempt financing receive the same rate of special allowance originally designated for taxable financing. The short-hand reference did not address the acquisition of existing 9.5 percent loans. In its comments, AES/PHEAA has not identified any specific statement by the Department that loans eligible for the 9.5 percent floor continue their eligibility after being purchased or acquired by an ineligible tax-exempt obligation.

FINDING NO. 3 – AES/PHEAA's *Lender's Interest and Special Allowance Request and Report* for the Quarter Ended March 31, 2006, Contained Billing Errors that Resulted in Improper Payments of Special Allowance.

AES/PHEAA's *Lender's Interest and Special Allowance Request and Report* (LARS), for the quarter ended March 31, 2006, contained two billing errors that resulted in improper special allowance payments of about $134,000.

First Billing Error: Non-Compliance with HERA

We compared quarterly LARS data files and identified 16,489 loans that were funded by eligible tax-exempt bond issues and billed under the 9.5 percent calculation for the quarter ended March 31, 2006, but not billed under that calculation for the quarter ended June 30, 2006. For the quarter ended March 31, 2006, the 16,489 loans had an ending balance of $83,499,131 and an average daily balance of $11,806,663.

From this population, we reviewed 30 randomly selected loans and found that all were made or purchased on or after February 8, 2006, and as a result, ineligible for special allowance payments under the 9.5 percent floor calculation. Based upon our review of the 30 loans, we are 95 percent confident that at least 90.5 percent (at least 14,924) of the 16,489 loans were ineligible for special allowance payments under the 9.5 percent floor calculation.

The billing of these loans was not in compliance with the HERA. Effective February 8, 2006, the HERA added a new Section 438(b)(2)(B)(vi) to the HEA. Under these new requirements, lenders do not receive special allowance under the 9.5 percent calculation for loans—

> (I) that were made or purchased on or after the date of enactment of the Higher Education Reconciliation Act of 2005; or
>
> (II) that were not earning a quarterly rate of special allowance [under the 9.5 percent floor calculation] as of the date of enactment of the Higher Education Reconciliation Act of 2005.

According to AES/PHEAA officials, the loans we identified as ineligible under criteria in the HERA were improperly billed because AES/PHEAA did not have enough time to implement the statutory changes. We do not agree that there was insufficient time to implement the HERA requirements: the HERA was enacted on February 8, 2006, and AES/PHEAA was not required to submit this bill to the Department until the end of June 2006.

For improper payments attributable to non-compliance with HERA requirements, we estimate an overpayment of $122,563, for the 16,489 loans with a total average daily balance of $11,806,663.[8]

Second Billing Error: Miscoding of Loans

We compared AES/PHEAA's LARS data files' average and ending principal balances against the Department's FSA Datamart files. The Department's systems showed that AES/PHEAA received special allowance payments under the 9.5 percent floor for the quarter ended March 31, 2006, based on an average daily balance that was about $9 million greater than the amount documented in AES/PHEAA's systems. AES/PHEAA attributed this discrepancy to a manual error. As a result of the error, about $9 million in consolidation loans was improperly billed under the 9.5 percent floor calculation. All of these loans had an interest rate of 9 percent and a special allowance category code of "XE" under the 9.5 percent floor calculation.

As a condition for the Department's payment of special allowance, the LARS submitted by lenders must be timely, accurate, complete, and conform with applicable laws, regulations, and policies:

- Under Section 438(b)(3) of the HEA, special allowance is paid "after receipt of an accurate and complete request for payment . . . .";

- Under 34 C.F.R. § 682.305(b)(5)(iii), "A request for interest benefits and special allowance is not considered accurate and complete if it . . . [d]oes not contain all information required by the Secretary . . . ."; and

- Management certifies on the LARS that "[t]he data that my organization or its agent, or its third-party servicer, will submit to the U.S. Department of Education is correct to the best of my knowledge and belief."

AES/PHEAA officials explained that the miscoding of the $9 million was a manual error that occurred when it was correcting the codes of a much larger group of loans. For improper payments attributable to miscoding of loans, we estimate an overpayment of $11,250, for loans with a total average daily balance of about $9 million.

As the result of the two billing errors for the quarter ended March 31, 2006, we estimate that AES/PHEAA was overpaid about $134,000.

Adjustments to LARS Billing

AES/PHEAA officials stated that it returned the overpayments for both of these billing errors in adjustments to its LARS submission for the quarter ended March 31, 2007. We obtained

[8] We based our estimate on the total average daily balance for all 16,489 loans because (1) AES/PHEAA did not bill these loans under the 9.5 percent floor calculation in the following quarter, which indicates the loans were ineligible, and (2) the results of our attribute sample of 30 loans. Our estimate of the overpayment may not be representative of the entire universe: it is not a statistically valid projection because it is based on an attribute sample and not a variable sample.

AES/PHEAA's LARS submission for the quarter ended March 31, 2007, but because LARS submissions do not include information on the underlying, individual loans, we were unable to verify that the appropriate adjustments were made.

To evaluate AES/PHEAA's adjustments for the—

- **First billing error (non-compliance with HERA)**, we judgmentally selected the largest 8 of 71 categories (e.g., combinations of loan type, interest rate, and special allowance category) associated with the 16,489 loans. These eight categories represent 80.5 percent ($9,505,276) of the total average daily balance of $11,806,663. Our review did show that, for its adjustments to the eight categories, AES/PHEAA's adjustments were greater than the amounts originally billed for the loans in question. According to AES/PHEAA officials, they had made an error in returning the overpayment for the loans not in compliance with HERA requirements. The adjustment amounts under the 9.5 percent floor calculation and under the usual special allowance rates were larger than needed to correct the overpayment.[9] AES/PHEAA officials stated that, because of this error, they over-refunded about $125,000 in special allowance to the Department.

- **Second billing error (miscoding of loans)**, we compared the amount of the adjustment with the $9 million improperly billed. The adjustment was about $7.2 million, about $1.8 million less than the required adjustment of $9 million.

AES/PHEAA Did Not Have Documented Policies and Procedures

AES/PHEAA may have been able to promptly detect and correct the two billing errors in its LARS submission, for the quarter ended March 31, 2006, if it had formal, documented policies and procedures in place. However, during our audit we confirmed with AES/PHEAA's management that, other than in the change request forms it used to update its Compass loan servicing system, AES/PHEAA had no documented policies and procedures for (1) qualifying loans for special allowance under the 9.5 percent floor calculation, (2) identifying loans eligible for special allowance under the 9.5 percent floor calculation, (3) preparing its quarterly LARS, or (4) any other processes to manage its student loan portfolio.

Formal, documented policies and procedures would have assisted AES/PHEAA with the consistent application of its policies by helping employees understand their roles and responsibilities; by making it easier to modify policies and procedures in response to regulatory or system changes; by assisting management in monitoring the organization's activities for compliance with established policies and procedures, including appropriate and timely corrective action on exceptions; and by supporting management's assertions to external parties regarding the effectiveness of the organization's internal controls or the accuracy and correctness of its LARS submissions.

[9] AES/PHEAA provided documentation of its adjustments for 12 of the 30 loans that we selected. The 12 loans had a total ADB of $12,363 billed under the 9.5 percent floor for the quarter ended March 31, 2006. For the 12 loans, both the adjustments to remove the 9.5 percent floor billings and the adjustments to bill under the usual special allowance rates totaled $80,073 in ADB. As a result, for the 12 loans, AES/PHEAA over-refunded the 9.5 percent floor billings and over-billed under the usual special allowance rates by $67,710 in ADB.

The impact of AES/PHEAA's lack of documented policies and procedures may not be restricted to the administration of its 9.5 percent floor calculation loans: it may impact other aspects of AES/PHEAA's participation in the FFEL Program. As of June 30, 2006, AES/PHEAA reported about $9 billion in student loans receivable, of which about $8.6 billion were FFEL Program loans (including about $1.4 billion in 9.5 percent floor calculation loans). AES/PHEAA also reported that it serviced $34.7 billion in loans for clients and an additional $17.6 billion in student loans were serviced by customers using AES/PHEAA's computer services.

Recommendations

We recommend that the Acting Chief Operating Officer for FSA require AES/PHEAA to—

3.1 Document and implement its policies and procedures for (a) qualifying loans for special allowance under the 9.5 percent floor calculation, (b) identifying loans eligible for special allowance under the 9.5 percent floor calculation, (c) preparing the quarterly LARS, and (d) managing its student loan portfolio.

3.2 Submit evidence showing the erroneous 9.5 percent floor calculation loan billings (for which we estimate an overpayment of about $134,000), in the quarter ended March 31, 2006, were corrected in subsequent quarters' LARS submissions to the Department.

AES/PHEAA Comments and OIG Responses

AES/PHEAA did not concur with Finding No. 3 and its recommendations. AES/PHEAA provided no evidence to cause us to revise our finding or recommendations. Summaries of AES/PHEAA's comments and our responses are provided below.

<u>Not a New Finding</u>

- *AES/PHEAA Comment.* OIG should withdraw this finding because "it is not a new finding, rather it is one already identified and being addressed by AES/PHEAA."

- *OIG Response.* AES/PHEAA did not notify us of these errors until we had independently identified them during our audit work, as described in our report. No prior audit report or program review identified these billing errors as a finding. Furthermore, AES/PHEAA has provided no substantive evidence that these billing errors have been resolved.

<u>Timeliness of Guidance</u>

- *AES/PHEAA Comment.* AES/PHEAA was unable to change the coding of its loans in time to comply with HERA amendments in its special allowance billing for the quarter ended March 31, 2006. The reason AES/PHEAA could not make these changes was that FSA did not issue timely guidance. AES/PHEAA discussed the required changes with FSA, verbally, and FSA understood that AES/PHEAA's billing for that quarter would not reflect the HERA changes.

- *OIG Response.* AES/PHEAA was not required to submit its bill to the Department until June 29, 2006. The Department issued guidance on implementation of the special allowance payment requirements in the HERA in DCL GEN-06-02, on March 10, 2006. This date is 111 days before AES/PHEAA's submission was due. We do not agree that this was insufficient time for AES/PHEAA to implement the HERA's special allowance requirements. We are unaware of any Departmental guidance that allowed or approved AES/PHEAA's untimely reporting.

Future Resolution of Billing Errors

- *AES/PHEAA Comment.* The "Second Billing Error: Miscoding of Loans" is scheduled to be resolved via a correction to the upcoming LARS billing for the quarter ended September 2007.

- *OIG Response.* We asked AES/PHEAA on January 17, 2007, about the miscoding of loans. On January 31, 2007, AES/PHEAA responded that it acknowledged the error, and that "this was an error that will be corrected during the LARS billing for the 1st quarter of 2007." AES/PHEAA's comment to the draft audit report indicates that the issue is still unresolved.

Lack of Documentation

- *AES/PHEAA Comment.* AES/PHEAA disagrees with the assertion that its lack of documented policies and procedures may have adversely impacted its participation in the FFEL Program. AES/PHEAA has strong and effective documented controls and procedures in place, in the form of the COMPASS servicing system. The OIG points to no exception establishing any weakness in its internal controls, and acknowledges that that there is no regulatory requirement for a lender to maintain formal, documented procedures.

- *OIG Response.* AES/PHEAA's comments do not offer any documentation of policies and procedures beyond that acknowledged in our report. We do not agree that a servicing system, by itself, constitutes the "formal, documented policies and procedures" we recommend. Our report's Objective, Scope, and Methodology section provides a list of exceptions that arise from AES/PHEAA's significant internal control weaknesses.

  The Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control – Integrated Framework* (September 1992) states, "The extent of documentation of an entity's internal control system varies with the entity's size, complexity and similar factors. Larger organizations usually have written policy manuals . . ." Based upon the amount of loans AES/PHEAA manages for itself and others, the regulatory environment it operates in, and its large workforce, AES/PHEAA is a large, complex entity. As a result, its internal control policies and procedures should be documented.

Work Paper Statements

- *AES/PHEAA Comment.* The OIG's work papers confirm the strength and effectiveness of AES/PHEAA's internal controls during the audit period and that AES/PHEAA's policies and procedures were documented. AES/PHEAA cites several examples, including the following statement from work paper D.3.PS—

> In general, AES/PHEAA has controls over the eligibility of loans for special allowance billing under the 9.5% floor; the transfer, sale and purchase or (sic) loans, the management of its loan portfolio and bond issues; the calculation of loans' average daily balances; and LARS/Form 799 reporting.

- *OIG Response.* The statements in our report are fully supported by our audit's work papers. In general, AES/PHEAA's comments ignore qualifying statements that support the report's language elsewhere within the work papers. For example, work paper D.3.PS also states—

> However, AES/PHEAA has no documented policies and procedures, manuals, etc. describing the control activities . . . . Based on the Memorandum of Understanding, between OIG and AES/PHEAA, AES/PHEAA has no written policies and procedures and agreed that our review and analysis of the information presented is materially accurate.
>
> In gaining an understanding of AES/PHEAA's controls to identify loans eligible for special allowance billing under the 9.5% floor calculation . . . we noted that AES/PHEAA's controls, as described to the audit team would, in certain circumstances, identify ineligible loans as being eligible for the 9.5% floor calculation . . . .

FINDING NO. 4 – A Significant Risk Exists That Loans Billed under the 9.5 Percent Floor Were Not Eligible First-Generation or Second-Generation Loans.

There is a significant risk that loans billed by AES/PHEAA under the 9.5 percent floor calculation, during the period July 1, 2003, through June 30, 2006, were ineligible for that calculation because they were not eligible first-generation or second-generation loans. However, we did not identify and quantify these ineligible loans in AES/PHEAA's billings for special allowance and estimate the special allowance paid on these loans.

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 calculation. 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: loans acquired with the proceeds of second-generation loans, or later-generation loans, are not eligible for the 9.5 percent floor calculation.

AES/PHEAA had no controls in place to ensure that the loans billed under the 9.5 percent floor calculation were funded by the eligible sources of funds identified in Section 438(b)(2)(B)(i) of the HEA and 34 C.F.R. § 682.302(c)(3)(i). Other than the bond issue(s) used to finance a loan, AES/PHEAA's Compass loan servicing system did not track the sources of funds required to determine if a loan was an eligible first-generation or second-generation loan. According to an AES/PHEAA official, it would be difficult to track the various sources of eligible funds (described in items 1 and 2 above) used to finance 9.5 percent floor loans and AES/PHEAA's records do not reflect the source of funds used to finance a loan.

We reviewed AES/PHEAA's Financial Activity (FACT) reports and Loan Purchases and Sales reports for its eligible tax-exempt obligations. These reports show that AES/PHEAA's eligible tax-exempt bond issues' principal payments on loans and proceeds from the sale or transfer of loans, in many instances, exceed the bond issues' amounts outstanding by a significant percentage. During our audit period, most[10] of these payments and proceeds were used to fund types of loans that were eligible for the 9.5 percent floor calculation, such as subsidized Stafford, unsubsidized Stafford, PLUS, and consolidation loans.

Specifically, the FACT and Loan Purchases and Sales reports showed—

- During the period July 1, 1996, through June 30, 2003,[11] the total amounts of principal payments, non-cash adjustments such as loan write-offs and forgiveness payments, and the proceeds of loan sales or transfers exceeded, in some cases by a significant percentage, the amounts outstanding for the eligible tax-exempt obligations. This information is presented in Table 4, below:

[10] A small portion (less than 10 percent) of the underlying obligations funded loan types that are not eligible for the 9.5 percent floor calculation, such as non-subsidized Stafford loans and Health Education Assistance Loan Program loans.
[11] This timeframe begins on the earliest date that electronic FACT reports were available and ends on the last day before our audit period.

Table 4 – Comparison of Loan Principal Payments and Proceeds July 1, 1996, through June 30, 2003, to Bond Amounts Outstanding			
Bond Issue (Year)	**Amount Outstanding**	**Principal Payments and Proceeds**	**Percent Amount Outstanding**
8803 (1988)	$ 75,000,000	$ 317,073,846	422.8%
8805 (1988)	$ 36,000,000	$ 128,960,807	358.2%
8801 (1988)	$ 100,000,000	$ 303,068,754	303.1%
8802 (1988)	$ 110,000,000	$ 285,649,571	259.7%
8804 (1988)	$ 75,000,000	$ 169,487,055	226.0%
9001 (1990)	$ 92,925,000	$ 181,103,088	194.9%
9201 (1992)	$ 150,000,000	$ 289,028,204	192.7%
9101 (1991)	$ 170,000,000	$ 305,919,766	180.0%
8601 (1986)	$ 50,000,000	$ 67,438,837	134.9%
Totals	**$ 858,925,000**	**$ 2,047,729,929**	**238.4%**
Source: AES/PHEAA FACT Reports			

- During the period July 1, 2003, through June 30, 2006, the principal proceeds from loan sales and transfers from the eligible tax-exempt bond issues exceeded, in some cases by a significant percentage, the amounts outstanding for the eligible tax-exempt obligations.[12] This information is presented in Table 5, below:

Table 5 – Comparison of Principal Proceeds July 1, 2003, through June 30, 2006, to Bond Amounts Outstanding			
Bond Issue (Year)	**Amount Outstanding**	**Principal Proceeds**	**Percent Amount Outstanding**
9001 (1990)	$ 92,925,000	$ 480,308,985	516.9%
8803 (1988)	$ 75,000,000	$ 334,231,380	445.6%
9101 (1991)	$ 170,000,000	$ 608,745,888	358.1%
9201 (1992)	$ 150,000,000	$ 474,427,706	316.3%
8601 (1986)	$ 50,000,000	$ 67,374,278	134.7%
8801 (1988)	$ 100,000,000	$ 124,081,029	124.1%
8802 (1988)	$ 110,000,000	$ 74,779,013	68.0%
8805 (1988)	$ 36,000,000	$ 13,609,778	37.8%
8804 (1988)	$ 75,000,000	$ 1,926,016	2.6%
Totals	**$ 858,925,000**	**$ 2,179,484,073**	**253.7%**
Source: AES/PHEAA Loan Purchases and Sales Reports			

[12]This analysis does not include the principal payments and non-cash adjustments that were included in Table 4.

Based on our analysis, there is a significant risk that loans billed by AES/PHEAA under the 9.5 percent floor calculation, during the period July 1, 2003, through June 30, 2006, were ineligible for that calculation. This conclusion is based upon our review of the FACT and Loan Purchases and Sales reports, AES/PHEAA's not tracking the sources of funds required to determine if a loan was an eligible first-generation or second-generation loan, and our finding that AES/PHEAA had no written policies or procedures, which may have provided internal controls for this process (see Finding No. 3).

The significantly high "Percent Amount Outstanding" during these periods for some bond issues—especially bond issue 9001 (516.9% in Table 5) and bond issue 8803 (422.8% in Table 4 and 445.6% in Table 5)—indicates that there is a significant risk that loans were acquired using third-generation or later-generation funds. If AES/PHEAA was only billing for eligible loans, we would expect the "Principal Proceeds" or "Principal Payments and Proceeds" that were used to fund eligible loans (second-generation loans) to be no greater than the amount of the bond principal plus the interest and special allowance payments that would accrue over the lives of the first-generation loans. Many of the amounts in Tables 4 and 5 are significantly higher than this amount.

We did not identify and quantify these ineligible loans in AES/PHEAA's billings for special allowance and estimate the special allowance paid on these loans. In an attachment to DCL FP-07-01, the Department provided an example of the letters it sent to lenders, requiring 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 letter example stated that the Department would not require lenders to repay prior improper payments if they complied with 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 . . . .

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 is to be performed by an independent accounting firm using the audit methodology established by the Department. Attached to this DCL was our *Auditor's Guide*: *For audits to ensure the accuracy of certain Federal Family Education Loan Program special allowance payments*.

On June 14, 2007, AES/PHEAA requested the Department make arrangements for the audit required in FP-07-01, because it intends to continue billing loans under the 9.5 percent floor calculation. Since the Department has stated that it will not seek repayment of prior improper payments, and since a separate audit is in process to identify AES/PHEAA's eligible first-generation and second-generation loans, we did not determine the extent to which AES/PHEAA's 9.5 percent floor billings included only eligible first-generation and second-generation loans.

On August 2, 2007, we were informed by AES/PHEAA that it was complying with the requirements of DCL FP-07-01 and FP-07-06, and it was being audited by FSA's contracted auditors to certify AES/PHEAA's eligible first-generation and second-generation loans.

Recommendations

We recommend that the Acting Chief Operating Officer for FSA—

4.1 Ensure that AES/PHEAA complies with the terms of DCLs FP-07-01 and FP-07-06 before any additional special allowance payment is made to AES/PHEAA under the 9.5 percent floor.

If AES/PHEAA does not comply with the terms of DCLs FP-07-01 and FP-07-06, we recommend that the Acting Chief Operating Officer for FSA require AES/PHEAA to—

4.2 Return all prior special allowance payments made under the 9.5 percent floor for any loan that AES/PHEAA cannot identify, by direct evidence, as having been funded by an eligible source, as defined in 34 C.F.R. § 682.302(c)(3)(i); and

4.3 Stop all billing for special allowance payments under the 9.5 percent floor.

AES/PHEAA Comments and OIG Responses

AES/PHEAA did not concur with Finding No. 4 and its recommendations. Except for minor changes to better explain the calculations we performed and those required to determine eligible first-generation and second-generation loans pursuant to the Department's DCLs FP-07-01 and FP-07-06, we have not changed our findings or recommendations. Summaries of AES/PHEAA's comments and our responses are provided below.[13]

<u>Department Has Agreed Not to Seek Repayment</u>

- *AES/PHEAA Comment*. In DCL FP-07-01, the Department stated that it "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 nor second-generation loans . . . ." Since AES/PHEAA is undergoing the audit required by DCLs FP-07-01 and FP-07-06, the "safe harbor" the letters provide bars any recovery of prior payments. As such, there is no basis for this finding. The issuance of this finding "would serve only to speculate unnecessarily on what the result might be if the Department reached a different interpretation."

[13] In addition to the comments summarized here, AES/PHEAA also argued that HEA and the IG Act preclude us from issuing this finding. We have summarized and responded to this comment in the previous discussion under Finding No. 1.

- *OIG Response*. Though DCL FP-07-01 provides that the Department will not seek to recoup special allowance payments already received "for loans that were neither first-generation loans nor second-generation loans," this provision is contingent upon a lender's compliance with all terms of the DCL. As our report notes, we were informed by AES/PHEAA that it is complying with the requirements of DCLs FP-07-01 and FP-07-06. However, such an assertion is not a guarantee that AES/PHEAA will continue to comply with the terms of the DCLs. If the Department determines that AES/PHEAA has failed to comply with the terms of the DCLs, the Department is free to seek recovery of prior payments on ineligible first-generation loans and second-generation loans. This is the reason our recommendations for recovery of prior payments are contingent on AES/PHEAA's compliance with the terms of the DCLs.

  Our finding is not "speculative." Our work fully supports our conclusion that there is a significant risk that loans billed by AES/PHEAA under the 9.5 percent floor were not eligible first-generation or second-generation loans. We cannot remove this finding from our report because (1) we cannot ignore a risk that AES/PHEAA may have received improper special allowance payments on loans that were not eligible first-generation or second-generation loans, and (2) until the process described in the DCLs is complete, there is no guarantee that AES/PHEAA will continue to comply with the terms of the DCLs and thus meet the criteria for the Department's offer.

  The calculations we performed do not conflict with the Department's methodology for identifying eligible first-generation and second-generation loans announced in DCL FP-07-06. The Department announced its methodology while we were performing our analysis of AES/PHEAA's portfolio. Since the Department established a separate process to audit the application of its methodology, it would have been duplicative for us to further develop this finding. In addition, the Department's methodology and the processes established under the OIG Audit Guide require the cooperation and participation of AES/PHEAA management.

  Our analysis was sufficient to conclude that there is a significant risk that AES/PHEAA billed loans that were not eligible first-generation or second-generation loans. As explained in the finding, the AES/PHEAA loan sales from the various bonds exceeded what would be expected if acquisition of eligible loans was limited to the specified eligible sources of funds or the cap amounts that would be generated under the Department's methodology. The actual loans eligible for future billing as first-generation or second-generation loans will be determined in the separate audit.

<u>Tracking Sources of Funding</u>

- *AES/PHEAA Comment*. AES/PHEAA "disagree[d] with the suggestion that AES/PHEAA or any other lender was required to track the sources of funds to determine whether loans were first, second or later generation loans inasmuch as these terms were not used in applicable law or guidance prior to 2007. AES/PHEEA did take steps to track loans to the bond issues used to finance the loans, which is what was required under the applicable law and guidance in effect at the time." AES/PHEAA did not agree that DCL FP-07-01 restated prior guidance or that the Department's interpretation could be applied retroactively.

- *OIG Response*. Under Section 438(b)(2)(B)(i) of the HEA, 34 C.F.R. § 682.302(c)(3)(i), and the DCLs cited in our report, only first-generation and second-generation loans are eligible for the 9.5 percent floor. Given that these requirements have been continuously stated in law and regulation, we disagree with AES/PHEAA's assertion that the Department cannot recover 9.5 percent floor payments received on later generation loans prior to the DCLs issued in 2007. Under 34 C.F.R. § 682.414(a)(4)(ii)(L), a lender is required to keep any "records that are necessary to document the validity of a claim against the guarantee or the accuracy of reports submitted under this part."

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to determine if AES/PHEAA 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 July 1, 2003, through June 30, 2006. As explained in Finding No. 4, we did not quantify the extent to which AES/PHEAA's 9.5 percent floor billings included only eligible first-generation and second-generation loans.

To achieve the audit objective, we—

- Reviewed applicable laws, regulations and guidance issued by the Department, including the HEA, 34 C.F.R. Part 682, and Dear Colleague Letters.

- Reviewed AES/PHEAA's annual financial and single audit reports, reports on compliance with FFEL Program requirements and selected servicing activities, compliance audits for lenders and lender servicers participating in the FFEL Program, reports on controls of the operating effectiveness of AES/PHEAA's Compass loan servicing system, and the Department's FSA Financial Partners reviews, applicable to the audit period.

- Held discussions with AES/PHEAA officials, including the Chief Financial Officer, the Vice-President of Public Finance, the Director of Business Support, and the Vice-President of Servicing and Secondary Markets.

- Reviewed documentation provided by AES/PHEAA, including—
  - A written explanation, created and provided at our request, of AES/PHEAA's position, understanding, policy, and implementation of special allowance payment billing under the 9.5 percent floor calculation;
  - A written description of how AES/PHEAA's Compass loan servicing system identified loans eligible for the 9.5 percent floor calculation;
  - Change Request Forms initiating code changes to AES/PHEAA's Compass loan servicing system to reflect changes in laws and regulations applicable to 9.5 percent floor calculation loans;

- Bond Prospectus Cover Sheets and Internal Revenue Service Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues*, for AES/PHEAA's tax-exempt obligations originally issued prior to October 1, 1993;
- A listing of AES/PHEAA's bonds funding 9.5 percent floor calculation loans, along with information related to each bond, including its taxable or tax-exempt status, the amount outstanding, and the average balance of 9.5 percent floor calculation loans funded in each quarter;
- Reports of AES/PHEAA's loan purchases and sales for the period July 1, 1996, to June 30, 2006; and
- AES/PHEAA's FACT Reports for the period July 1, 1996, to June 30, 2006, for the tax-exempt obligations originally issued prior to October 1, 1993.

Initial Selection and Review of Loans

We judgmentally selected and reviewed 3 of the 12 quarterly special allowance billings during the audit period. We selected the quarters ending June 30, 2004, and September 30, 2004 (because they occurred prior to the effective date of the TTPA and had the largest dollar amount increase and ending principal balance percentage increase from the prior quarter), and the quarter ending June 30, 2006 (because it was the first full quarter billed following the enactment of the HERA).

We randomly selected 20 loans from each of these three quarters (60 total) from AES/PHEAA's LARS data files: 5 loans for each quarter that were funded by an eligible tax-exempt bond issue, and 15 loans for each quarter that were funded by a taxable or ineligible tax-exempt bond issue during the period of the quarterly submission. The universes from which the loans were selected were as follows:

Quarter Ending	**Loans Funded by Eligible Tax-Exempt Bond Issues**	**Loans Funded by Taxable or Ineligible Tax-Exempt Bond Issues**
June 30, 2004	346,331	332,021
September 30, 2004	318,837	415,547
June 30, 2006	235,187	214,328

Compliance with the TTPA

We reviewed AES/PHEAA's quarterly LARS data files of loans billed under the 9.5 percent floor calculation for the quarters ending after September 30, 2004, to determine the amount of loans billed under the 9.5 percent floor calculation that were refinanced with ineligible funding sources after September 30, 2004:

- We used data analysis software to identify loans with two or more bond identification numbers associated with a loan, which indicated the loan was refinanced (i.e., transferred between bond issues).

- For these loans, we identified—
  - The bond issue that initially funded the loan during the period October 1, 2004, through June 30, 2006;

  - Any changes in the bond issue associated with the loan in subsequent quarters; and
  - Records (i.e., bond issue, average daily balance, and ending balance) contained in the LARS data files for subsequent quarters' special allowance billings.

- We determined if the subsequent bond issue(s) associated with a loan represented an eligible tax-exempt funding source, an ineligible tax-exempt funding source, or a taxable funding source.

- If a loan was transferred between bond issues, we classified a loan's subsequent billing records (e.g., average daily balance for the quarter) as ineligible for 9.5 percent floor calculation treatment if a record was associated with an ineligible tax-exempt or a taxable funding source.

- To estimate the amount of special allowance paid on the ineligible balances in each quarter, we determined the percentage of the total average balance billed under the 9.5 percent floor calculation that was ineligible, and multiplied this percentage by the total amount of special allowance paid under the 9.5 percent floor calculation.

<u>Loans Funded by Ineligible Tax-Exempt Bonds</u>

We reviewed AES/PHEAA's quarterly LARS data files of loans billed under the 9.5 percent floor calculation for the quarters ended September 30, 2003, through June 30, 2006, to determine the amount of loans billed under the 9.5 percent floor calculation that were funded by ineligible tax-exempt obligations originally issued on or after October 1, 1993:

- We used data analysis software to identify the loan records (i.e., bond issue, average daily balance, and ending balance) associated with an ineligible tax-exempt bond issue in the quarterly files.

- To estimate the amount of special allowance paid on these loans in each quarter, we—
  - Identified the loans on which special allowance was and was not paid,
  - Determined the ineligible percentage of the total average balance billed on which special allowance under the 9.5 percent floor calculation was paid, and
  - Multiplied this percentage by the total amount of special allowance paid.

<u>First Billing Error: (Non-Compliance with HERA)</u>

We compared quarterly LARS data files and identified 20,032 loans with an ending balance on March 31, 2006, that had no records in the LARS data file for the quarter ended June 30, 2006. Of these loans, 16,489 loans had a total average balance of $11,806,663, were funded by an eligible tax-exempt bond issue, and were initially billed under the 9.5 percent floor calculation in the quarter ended March 31, 2006. The remaining 3,543 loans had a total average balance of $14,127,988 and were initially billed under the 9.5 percent floor calculation prior to the quarter ended March 31, 2006. We randomly selected 30 of the 16,489 loans and 10 of the 3,543 loans. For these 40 loans, we reviewed the billing records for quarter ended March 31, 2006, and subsequent quarters, and documentation supporting their eligibility for the 9.5 percent floor calculation.

To accomplish the audit's objective, we relied, in part, on computer-processed data provided by AES/PHEAA. We obtained AES/PHEAA's LARS data files for the quarters ended September 30, 2004, through June 30, 2006. To determine the reliability of the data, we performed limited data testing. These tests included comparing the files' average and ending principal balances against the Department's FSA Datamart files, comparing information for the 60 randomly selected loans (described under "Initial Selection and Review of Loans") to AES/PHEAA's Compass loan servicing system, and applying logical tests to the data files for the three quarters we selected, including identifying loans disbursed after the close of the quarter, loans disbursed prior to the earliest date for which they could be eligible for billing under the 9.5 percent floor calculation, unsubsidized loans disbursed prior to the earliest date for which they could be disbursed, and loans disbursed after the date of enactment of the HERA. Based upon our preliminary assessment of the data, we concluded that the data was sufficiently reliable for use in achieving the audit's objective.

As part of our audit, we assessed AES/PHEAA's system of internal control significant to the audit objective and applicable to its billing for special allowance payments under the 9.5 percent floor calculation, the process used to identify loans eligible for special allowance billing under the 9.5 percent floor calculation. Our assessment disclosed significant internal control weaknesses that adversely affected AES/PHEAA's ability to accurately identify loans eligible for special allowance billing under the 9.5 percent floor calculation, including—

1. Billing for loans refinanced with ineligible funds after September 30, 2004;

2. Billing for loans funded by ineligible tax-exempt bonds issued on or after October 1, 1993;

3. Errors in its special allowance billing for 9.5 percent floor calculation loans for the quarter ended March 31, 2006 (this weakness and other weaknesses may have been caused by AES/PHEAA's lack of documented policies and procedures), and

4. Having no controls in place to ensure that the loans billed under the 9.5 percent floor calculation were eligible first-generation or second-generation loans.

As a result of its internal control weaknesses, AES/PHEAA's billing activities did not comply with laws, regulations and guidance for the 9.5 percent floor calculation. The weaknesses and their effects are fully discussed in the Audit Results section of this report.

We conducted on-site fieldwork at AES/PHEAA's office in Harrisburg, Pennsylvania, during the period September 19, 2006, through November 30, 2006. On August 2, 2007, we held an exit conference with AES/PHEAA. Our audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of the review described above.

Enclosure: AES/PHEAA Comments

- Letter from Mr. Richard E. Willey, AES/PHEAA's President and CEO, dated September 27, 2007. (5 pages.)

- AES/PHEAA's Supplement to the Informal Response to ED OIG's Draft Audit Report, dated September 28, 2007. (26 pages)

PHEAA POWERED BY aes

Office of the President and Chief Executive Officer
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Via Electronic Mail Delivery

September 27, 2007

Bernard Tadley
Regional Inspector General for Audit
United States Department of Education
Office of Inspector General
100 Penn Square East, Suite 502
Philadelphia, PA 19107

Dear Mr. Tadley:

Enclosed is the detailed response of American Education Services/Pennsylvania Higher Education Assistance Agency (AES/PHEAA) to the Office of Inspector General's Draft Audit Report (ED-OIG/A03G0014) provided to AES/PHEAA on August 6, 2007. It is our expectation that your office will carefully consider the arguments set forth in this response from a legal and public policy perspective. It is our belief that a full consideration of our views will persuade your office that many portions of the underlying Draft Audit Report are significantly flawed and that there is no reason to issue a Final Report based on the conclusions enunciated in the Draft Audit Report.

While we acknowledge that this outcome may be unusual, it is, in our view, fully justifiable. In fact, we believe that basing a Final Report on the "findings" included in the Draft Audit Report would, in itself, be unjustifiable and inconsistent with the high standards generally associated with such audits and the public's perception of the role of the Inspector General.

AES/PHEAA's formal response provides substantial new information and precise analysis and discussion of the items included in the Draft Audit Report. I would like to take this opportunity to summarize our views.

The three essential points that we wish to convey are:

1. No <u>new</u> "findings" have been unearthed by the Office of Inspector General as part of its audit of AES/PHEAA. The two areas in which AES/PHEAA has been cited as being out of compliance with U.S. Department of Education policy were well-documented and in various stages of resolution prior to the field work being performed by the Office of Inspector General.

2. Two of the "findings" are, in reality, areas in which AES/PHEAA has fully complied with guidance provided by the U.S. Department of Education - guidance that seems to draw objection from the Office of Inspector General. AES/PHEAA has no choice but to follow the rules and requirements issued by its regulator, the U.S. Department of Education.

3. All funds derived from payments on 9.5 floor loans were used to further AES/PHEAA's not-for-profit and state-mandated <u>public</u> mission to enhance postsecondary education opportunities for the citizens of Pennsylvania.

AES/PHEAA is confident that it has complied with the law, regulations and published guidance that existed at that time, and AES/PHEAA continues to comply with current law, regulations and published guidelines. That confidence is buoyed by the fact that we have a long track record of receiving "clean audits" regarding our federal billing statements and our handling of loans eligible for one-half the special allowance payment or a minimum yield of 9.5 percent from both the Department of Education and KPMG, which has audited AES/PHEAA's federal billing statements in accordance with standards included in audit guides published by the Office of Inspector General.

The first time AES/PHEAA was cited for an audit exception in this matter was in a March 2006 audit report issued by the Department of Education's Federal Student Assistance office. This came on the heels of a "clean" audit report covering the same issues and time-frames which was received by AES/PHEAA on October 13, 2005. AES/PHEAA appealed this finding on May 11, 2006, and it has yet to be resolved by the Department of Education. It is this same audit exception, already being addressed with the U.S. Department of Education, that is the basis for one of the Office of Inspector General's "findings" included in the Draft Audit Report.

AES/PHEAA was created more than 43 years ago by the Pennsylvania General Assembly to manage student financial aid programs for the Commonwealth of Pennsylvania. In fulfilling that public purpose, AES/PHEAA has been and remains a national leader in providing financial assistance to students and families, providing innovative, state-of-the-art technologies to institutions of postsecondary education, and providing information and guidance, along with financing options, to students and families to encourage them to pursue postsecondary education. Over that 43 year period, AES/PHEAA has grown into a fiscally self-sufficient organization that receives no state appropriations for administration. In fact, AES/PHEAA actually enhances the value of state appropriations for the Pennsylvania State Grant Program and for other state-funded student assistance programs by absorbing all expenses involved in administering those programs – a cost of more than $21 million in the most recent fiscal year and more than $135 million over the past 10 years.

Over the last decade, AES/PHEAA has contributed approximately $1 billion of its earnings to make the dream of postsecondary education possible for millions of Pennsylvania residents and students. Over the past two years, AES/PHEAA has subsidized legislative appropriations for the Pennsylvania State Grant Program with $150 million of its earnings to increase the maximum award by $1,200 and the average award by nearly $500; enhancing the purchasing power of the program for more than 163,000 students. Without AES/PHEAA's efforts, fewer students would have received State Grants and many more would have had to secure additional federal and private student loans to meet their costs of education.

It is critical to draw a distinction between AES/PHEAA and for-profit companies that have taken advantage of the financial benefits derived from loans eligible for one-half the special allowance payment or a minimum yield of 9.5 percent. Unlike the for-profit companies, AES/PHEAA's bottom line serves students, not stockholders. AES/PHEAA returns approximately 91% of its operating income back to the Commonwealth and its families, with the remaining 9% held in reserve for future student aid obligations.

We believe that the Inspector General must consider AES/PHEAA's public mission and its use of the funds that are the subject of this review in its evaluation of the Draft Audit Report and in its decision as to whether it is necessary to issue a Final Report.

We also believe that the Inspector General is viewing the entire issue of loans eligible for one-half the special allowance payment or a minimum yield of 9.5 percent in an economic vacuum. As the U.S. General Accounting Office reported in 2004, the Department of Education's policy regarding these loans, which was developed in the 1990s, was based on the assumption that prevailing interest rates would rise and that these loans would be subject to a reduced Special Allowance Payment because the "half-Special Allowance" provision would prevail. As we all know, the Department of Education lost that bet and interest rates fell to record low levels. Had the Department of Education's interest rate forecast been correct, would the Inspector General be writing the same report today? Would it be producing charts that show the amounts that AES/PHEAA under-billed the Department of Education and recommending that the Department of Education reimburse AES/PHEAA for its losses? We doubt that. It is only fair for the same policy judgments to be made regardless of prevailing interest rates. The rules are the rules, regardless of current economic conditions and the shape of the yield curve.

The following summarizes AES/PHEAA's responses to each "finding" and recommendation included in the Draft Audit Report. Each of these issues are discussed in greater detail and fully documented in the enclosure.

Finding #1:

This is one of two findings that merely restate an issue of which AES/PHEAA and the U.S. Department of Education are fully aware. Thus, we believe that the Draft Audit Report has mischaracterized this matter as a "finding". AES/PHEAA is, in fact, in full compliance with the Department of Education's interpretation of the applicable statute and regulation and ceased transfer activities in December 2005 when it was alerted that there was some question as to whether this practice was compliant, based on audit findings issued to other FFEL participants. AES/PHEAA received formal notification on March 28, 2006, when it received Federal Student Aid's audit exception report. In that report, the Department of Education acknowledged "confusion" in the student loan community regarding this guidance. That is a clear admission that AES/PHEAA was not alone in its interpretation of the provisions of the Taxpayer Teacher Protection Act and a clear admission that the Department of Education failed in its responsibility to fully inform the student loan community of its interpretation of the Act's provisions. Once notified of the Department of Education's interpretation, AES/PHEAA immediately complied with that guidance and ceased all transfers of loans that would be deemed improper under this new guidance. Thus, there is no basis for the Inspector General to characterize this as a "finding."

Finding #2:

AES/PHEAA believes that there is no statutory or regulatory basis for the Inspector General's interpretation that the transfers of loans from one tax-exempt bond issue to another are not permissible under the Omnibus Budget Reconciliation Act of 1993. This view is upheld by the Department of Education (as detailed in the enclosed comments) and by the U.S. Government Accountability Office (GAO). In fact, the GAO report recommends that the Department of Education revise its regulations and guidance to foreclose the very practice that the Inspector General's "finding" claims was not permissible at the time.

AES/PHEAA presents strong and indisputable legal evidence on this point. Furthermore, the public policy logic of the Inspector General's argument fails any test of plausibility. Why would the Department of Education permit loans to be transferred from a tax-exempt bond issue into a taxable issue, but not into another tax-exempt issue? If the Department of Education was going to draw a line in the sand, wouldn't it make logical sense that it would have prohibited transfers into taxable bonds? What possible policy justification is there for limiting transfers in the way the Inspector General imagines it should have been done? It is apparent that the Office of Inspector General is actually citing AES/PHEAA for its compliance with the policy guidance and position taken by the Department of Education throughout the 1990s. It is unfair, at best, to hold AES/PHEAA liable for fully and faithfully complying with guidance provided by its regulator, the Department of Education, regardless of the Inspector General's view of the appropriateness of such guidance.

If the Office of Inspector General has a contrary view of the policy guidance issued by the Department of Education during the 1990s, then it should raise that matter with the regulator, not with a regulated party that was in full compliance with the rules as they existed at the time. This approach of citing a regulated party for complying with its regulator seems wholly inconstant with any notion of fair and equal treatment under the law. Should this approach be applied without any restriction, then no regulated party could ever feel safe from reprisal merely for following guidance provided by its regulator. We strongly urge the Inspector General to remove Finding #2 from its report and, instead, to express its views regarding the policy guidance to the Department of Education.

Finding # 3

This is the second of the two findings that cannot be properly classified as a "finding". At issue here is a billing error by AES/PHEAA that was the result of a delay in programming its loan management system. AES/PHEAA was not only aware of this error well before the Office of Inspector General regional auditors began their audit, but proactively advised those auditors of this issue. AES/PHEAA had informed the Department of Education of this inadvertent error and had taken corrective actions to refund the amounts that it was overpaid back to the Department of Education. As is the case in "Finding" # 1, this cannot, in any sense of the word, be classified as a "finding." Rather it should be viewed as a self-correction that was properly and appropriately identified. The strength of AES/PHEAA's internal controls are well documented in the Inspector General's "work papers", but is not acknowledged in the Draft Audit Report. There is nothing that was "found" by the Office of Inspector General.

Finding #4

AES/PHEAA remains mystified as to why Finding #4 is included in the Draft Audit Report. The Draft Audit Report acknowledges that AES/PHEAA is in full compliance with the new Department of Education guidance regarding the audit process for so-called "first and second generation" loans. The only appropriate mention of this issue should be to indicate that AES/PHEAA has complied with the Department of Education's requirements and that this matter is now closed, in accordance with Department of Education policies.

It is, at best, inappropriate for a report of this nature to include speculation by the Inspector General that there is "significant risk" that some loans were "ineligible" for one-half the special allowance payment or a minimum yield of 9.5 percent. Speculative or judgmental statements have no place in a factually based report on the results of an audit. The field portion of the audit that was required by the Department of Education, as detailed in its April 24, 2007 Dear Colleague Letter (DCL-FP-07-06) has been conducted by the Department of Education's contractor and the report of that audit is due to be issued shortly. In fact, the Inspector General's regional auditors were aware that this audit was being conducted at the same time that the Draft Audit Report was being compiled. Further, the Draft Audit Report acknowledges that the Department of Education "has stated that it will not seek repayment of prior improper payments" on loans that were not identified as "first or second generation loans." What then is the purpose of such speculation by the Inspector General when, even if the Inspector General's "hunch" is correct, there is no penalty that can be imposed?

It is unreasonable for the Inspector General to address any matters beyond AES/PHEAA's full and faithful compliance with the Department of Education's guidance with regard to "first and second generation" loans. Finding #4, as included in the Draft Audit Report, has no substance or merit and should be excluded from any final document.

I respectfully request that your office take all necessary time to carefully review the materials that we are providing in response to the Draft Audit Report. A precipitous rush to judgment regarding the efficacy of issuing a Final Report, or the conclusions of such a report, will not serve either of us well. To assist in your deliberations, we highly recommend that the Office of Inspector General initiate further discussions with AES/PHEAA regarding the response to the Draft Audit Report so that the Inspector General fully understands our positions, our actions, and our recommendations. I remain hopeful that this matter will be resolved amicably.

Thank you for your attention to this matter. My staff and I are available to answer any questions you may have.

Sincerely,

/s/
Richard E. Willey

Enclosure

AES/PHEAA's Supplement to the Informal Response to ED OIG's Draft Audit Report
ED-OIG/A03G0014

September 28, 2007

FINDING NO. 1 – 9.50% Floor Loans Refinanced With Ineligible Funds After September 30, 2004

Comments regarding the Finding

A. Preliminary Matters Addressing Finding 1

1. Current Unresolved FSA Program Review.

As acknowledged in the draft audit report, this finding is already the subject of a Federal Student Aid (FSA) Program Review Report dated March 28, 2006. AES/PHEAA disagrees with the finding and, as the draft report also acknowledges, the finding is presently under appeal with the U.S. Department of Education (the Department). Accordingly, the Office of Inspector General (OIG) should withdraw Finding 1 because it is premised on matters that remain in dispute and under appeal and which are already under review by the Department under a separate report.

2. Previous FSA Program Review – No Findings.

AES/PHEAA was issued a clean program review report from FSA on October 13, 2005 containing no findings. The scope of the FSA Program Review included AES/PHEAA's compliance with the requirements of the Taxpayer-Teacher Protection Act of 2004 (TTPA). While we recognize that the March 28, 2006 audit report was issued subsequent to the October 2005 report, OIG should not ignore that report. The clean report of October 13, 2005 is indicative of the obvious confusion even within the Department regarding the TTPA and 9.5% floor loans generally. Indeed, the Department's March 2006 program review report expressly acknowledged at page 5 that the finding was "the result of confusion that exists within the lending community about the requirements of the TTPA."

3. Dispositive Departmental Guidance.

Any purported noncompliance in Finding 1 would not support any repayment obligation because the Department recently issued Dear Colleague Letters which confirm that it will not seek repayment of special allowance payments (SAP) prior to September 30, 2006 if, as the OIG concedes here in Finding 4, a party is complying with the requirements of those Dear Colleague Letters. This point is addressed in more detail below and under the comments to Finding 4.

4. Responsive Actions Taken.

AES/PHEAA ceased transferring 9.5% floor loans between taxable bond issues in December 2005 when it became aware that the Department questioned the practice based on audit findings issued to other FFEL participants. It is important to note that the Department first apprised AES/PHEAA of its interpretation of this portion of the TTPA in the March 28, 2006 Program Review Report.

As was stated in AES/PHEAA's program review response, AES/PHEAA recognizes that under the TTPA, loans transferred from a tax-exempt (floor eligible) issue to a taxable issue after October 1, 2004 lose 9.5% floor designation. After AES/PHEAA received the March 28, 2006 FSA Program Review Report, AES/PHEAA conducted an internal review of the AES/PHEAA portfolio to determine conclusively whether AES/PHEAA had engaged in any such transfer in violation of the TTPA. The audit did identify that in calendar year 2005 transfers of approximately $9.645 million in loans from a tax-exempt (floor eligible) issue to a taxable issue post October 1, 2004. This was voluntarily documented and reported to FSA as part of AES/PHEAA's August 18, 2006 supplemental appeal document.

B. AES/PHEAA's Position on Finding 1

1. Ambiguity in the statutory language and guidance.

AES/PHEAA disagrees with Finding 1, with the March 28, 2006 FSA Program Review Report, and with the interpretation that Section 438(b)(2)(B)(v) of the Higher Education Act (HEA) precludes floor loan treatment on 9.5% floor loans that were originated in a tax-exempt (floor eligible) issue prior to October 1, 2004, transferred to a taxable issue prior to October 1, 2004, and then moved again from one taxable issue to another taxable issue after October 1, 2004. AES/PHEAA acted in accordance with its internal established practices, which are consistent with the FFEL community's interpretation of the TTPA, the legislative history regarding the intended scope and effect of the TTPA, and the Department's guidance available to the lending community in the months immediately following the enactment of the TTPA.

Section 438(b)(2)(B)(v) and the related special allowance provisions are ambiguous on their face. Historically, the Department has changed its interpretation regarding the meaning of these provisions and for this reason the education lending community has looked to the Department for guidance, and to the pertinent legislative history and intent, to ascertain the precise interpretation of the statute. For example, the Department's original interpretation of Section 438(b)(2)(B)(i) provided floor loan treatment only to loans "made or purchased" with *current* funds or proceeds of a tax-exempt obligation. Dear Colleague Letter 96-L-186 stated:

> In the December 18, 1992 regulations, the Department changed this policy. Under the regulations, if a loan made or acquired with the proceeds of a tax-exempt obligation is refinanced with the proceeds of a taxable obligation, the loan remains subject to the tax-exempt special allowance provisions if the authority retains legal interest in the loan. If, however, the original tax-exempt obligation is retired or defeased, special allowance is paid based on the rules applicable to the new funding source (taxable or tax-exempt).

By this guidance, the Department reinterpreted the statute and thereby applied Section 438(b)(2)(B)(i) to loans that had *ever* been made or purchased with eligible tax-exempt bonds, not just to loans purchased with current tax-exempt obligations. Section 438(b)(2)(B)(v) contains the same ambiguous "made or purchased" reference, and, in the absence of any further guidance or interpretation from the Department, that language should be interpreted consistent with the Department's long-standing, published interpretive guidance and the available legislative history.

2. <u>Legislative history of the TTPA</u>.

As detailed below, the legislative history of the TTPA indicates that the statute was intended to prevent transfers of floor loans from tax-exempt bonds to taxable bonds in order to impede creation of new floor loans as a by-product of such transfers. Finding 1's contention that Section 438(b)(2)(B)(v) of the HEA bars transfers of floor eligible loans between taxable bonds or taxable to non-eligible tax-exempt bonds after October 1, 2004, is contrary to the intent of Congress because such transfers **do not create new floor loans**. What Congress intended was that Section 438(b)(2)(B)(v)(I) would apply only to loans that are *currently* made or purchased by the proceeds of a pre-1993 tax-exempt bond because transfers involving such loans could result in creation of new floor loans. For example:

- By its 2004 published report titled, "Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments" (GAO-04-1070), (the "GAO Report") the Government Accountability Office described the practice of transferring as the transfer of loans previously financed by a pre-1993 tax-exempt eligible bond to a taxable bond so as to enable lenders to use the proceeds from the sale to make or buy additional loans, also guaranteed floor loan treatment. The GAO Report concluded that by means of such transfers, "a lender can significantly increase its 9.5 percent loan volume…" GAO Report at page 4.

- The legislative history, which repeatedly references the GAO Report, demonstrates that the TTPA was designed to curtail the growth in volume of floor loans by curbing 'refunding' and 'transferring,' the practices identified in the GAO Report. *See* Statements of Senator Kennedy, 150 Cong Rec. S10918-10919, and Senator Gregg, 150 Cong. Reg. S10071. Senator Kennedy's comments focused in particular upon the need to curtail the practice of "growing the number of 9.5 percent loans through a process called 'transferring.'" 150 Cong. Rec. at S10918-01. (emphasis added). Senator Gregg characterized the impact of the TTPA by emphasizing transfers from tax-exempt to taxable bonds, as follows:

> The bill would protect taxpayers by shutting down the loophole in 2005 in a way that immediately halts the high subsidies for refunding, transfers of loans from *tax-exempt to taxable bonds* and other related transactions. It puts lenders and note holders on notice that Congress will permanently and quickly phase out all other aspects of the 9.5 percent guarantee without putting the federal government in jeopardy of costly litigation. See 150 Cong Reg. S10071. (emphasis added)

- Congress subsequently reaffirmed its purposes in enacting the TTPA. The legislative history of the Higher Education Reconciliation Act of 2005 (P.L. 109-171) described the impact of the TTPA **as preventing transfers of loans to taxable bonds that permitted holders to increase the number of loans eligible for 9.5 floor status**. *See* H.R. Rep. 109-276 at 218. *See also* H.R. Rep. 109-231 at 195 (report accompanying the College Access and Opportunity Act of 2005).

- Following the enactment of the TTPA, Congressional publications again affirmed that the TTPA was aimed at the **practice of transferring loans resulting in the growth in volume of 9.5 floor eligible loans**. *See* Congressional Budget Office, "2005 Budget Options Statement," February 2005, at page 158. See also, Congressional Budget Office publication, "HR 5186 Estimate" at page 3.

- Department publications also reflect that the TTPA only impacted **"new loans stemming from new refinancing of pre-1993 obligations."** *See* ED Press Release dated July 8, 2005, available at http://www.ed.gov/news/pressreleases/2005/07/07082005.html.

- While the TTPA was aimed at limiting growth in the volume of floor loans, Congress also intended to continue to permit certain aspects of the floor loan program in order to protect the legitimate activities of nonprofit student aid organizations, notify lenders regarding future limitations on the program, and preserve contractual obligations between lenders, note holders, and the government. *See* Senator Gregg Statement 150 Cong. Rec. S10071.[1] The OIG's

[1] Senator Gregg stated that the TTPA, "would protect taxpayers by shutting down the loophole in 2005 in a way that immediately halts the high subsidies for refunding, transfers of loans from tax-exempt to taxable bonds and other related transactions. It puts lenders and note holders on notice that Congress will permanently and quickly phase out all other aspects of the 9.5 percent guarantee without putting the federal government in jeopardy of costly litigation. The bill protects student benefits provided by non-profit lenders, including 0 percent interest rate student loans for on-time completion, lower interest rates for certain students and loan forgiveness for teachers, nurses and public safety personnel." Senator Gregg

interpretation of the statute as articulated in Finding 1 would undermine these legitimate policy aims of the statute.

AES/PHEAA's strategy to move 9.5% floor loans from one taxable issue to another taxable issue is a portfolio management strategy that does not involve the sale of the loans outside the authority. Moreover, AES/PHEAA, as a nonprofit student lending organization, employs such portfolio management strategies to enable the proceeds generated from its transfers to fund the legitimate borrower benefits that the TTPA was intended to protect. **The movement of 9.5% floor loans from one taxable issue to another taxable issue resulted in no additional 9.5% floor loans or increased SAP payments from the Department, and it was therefore reasonable for AES/PHEAA to believe that such transfers were not implicated by Section 438(b)(2)(B)(v). Note: the Department itself had not concluded otherwise when it issued its program review report in October of 2005.**

3. Lack of Regulatory Guidance.

As was noted in the program review response, the holders of loans affected by the TTPA received no timely interpretive guidance from the Department that the TTPA somehow prohibited transfers of loans from taxable to taxable financing vehicles where such transfers did not increase 9.5 percent loan volume. The Department had ample opportunity to provide such guidance to AES/PHEAA and the FFELP community at large. There were at least four instances, including three Dear Partner letters (DCL FP-05-01, DCL FP-06-01, DCL FP-06-04) and the audit report to AES/PHEAA dated October 13, 2005, where the Department had the opportunity and the responsibility to inform the FFELP community of its interpretation of the TTPA, but failed to do so. Moreover, the Department did not conduct negotiated rulemaking on the TTPA during the audit period, nor did it issue regulations on the TTPA until August 9, 2006. The Department cannot now retroactively seek to impose its interpretation, and the Inspector General should not endorse such an approach.

Furthermore, the TTPA did not define the term "refinance" used in Section 438(b)(2)(B)(v)(II)(bb) of the HEA, nor was the term defined in the regulations until the August 9, 2006 publication of 34 CFR § 682.302(f). The GAO Report refers to refinancing only with respect to the practice of transferring from tax-exempt to taxable obligations described above. *See* GAO Report, p. 4, 32-34. AES/PHEAA had no reason

criticized another proposed amendment on the special allowance provision noting that, "Because Senator Murray's amendment would have disrupted contractual obligations between the Federal Government and lenders and note holders, it could have exposed the Department of Education to costly litigation and risk a court order requiring the payments to be restored." 150 Cong. Rec. S10071.

to believe that the term "refinancing" referred to in the statute would include transfers of loans between taxable bonds.

4. <u>Application of DCL FP-07-01 and FP-07-06</u>.

We note that the OIG's recommendation that AES/PHEAA recalculate and return all overpayments identified in Finding 1 is not appropriate. As the OIG acknowledged in its report, AES/PHEAA is undergoing an audit pursuant to the requirements of DCL FP-07-01 and FP-07-06. These letters state that the Department will not seek repayment for SAP billings for quarters prior to September 2006 with respect to loans deemed not to have been first or second-generation. This safe harbor applies to AES/PHEAA and bars the repayment recommendations set out in Findings 1 and 2 because:

- AES/PHEAA is following the audit procedures outlined in DCL FP-07-01 and, therefore, the safe harbor applies.

- The loans at issue in Finding 1 are 9.5% floor loans originated in a tax-exempt (floor eligible) issue prior to October 1, 2004 which qualified as floor loans pursuant to 34 CFR § 682.302(c)(3)(i). The Department's 2007 first generation/second generation guidance, as developed by the OIG, is predicated upon the provisions of Section 682.302(c)(3)(i) and quotes the language of subsections (A) through (D) of that regulation as the basis for that guidance. AES/PHEAA disagrees with Finding 1 and contends that the loans retained their floor eligible status pursuant to Section 682.302(e)(2) and the Department's guidance under DCL 96-L-186. However, if Finding 1 were correct, it would necessarily constitute a determination that the loans at issue were not first generation or second generation loans under the Department's guidance and Section § 682.302(c)(3)(i). Accordingly, the repayment recommendations set out in Finding 1 contravene the Department's published guidance stating that the Department will not seek repayment for SAP billings for quarters prior to September 2006 with respect to loans deemed not to have been either first or second-generation.

5. <u>Reservation of AES/PHEAA's right and opportunity to address estimates</u>.

We note that the purported amount of questioned SAP payments referenced in Finding 1 is incorrect and speculative, and should be removed from any final audit report for multiple reasons including:

- Finding 1 concedes that the amount listed is an estimate and that the OIG did not conduct an actual calculation of questioned SAP payments (Draft Audit Report at page 8-9). Thus, the amount listed is incorrect. Additionally, the Department has

stated in two 2007 Dear Colleague letters that it will not seek repayment of prior SAP payments.
- For the reasons articulated in this response, Finding 1 is incorrect. Therefore, there is no basis for requiring repayment of the questioned SAP payments.

AES/PHEAA reserves the right to conduct any calculations in the future and to dispute any calculations in the draft audit report or any final audit report.

Comments regarding the Recommendations

1.1-1.3 AES/PHEAA disagrees with these recommendations and they should be withdrawn along with this finding for the reasons discussed in this response.

FINDING NO. 2 – 9.50% Floor Loans Funded by Tax-Exempt Bonds Issued On or After October 1, 1993

Comments regarding the Finding

AES/PHEAA disagrees with this finding and requests that it be removed from any final audit report for the reasons listed below:

The OIG is incorrect in its conclusion that the 1993 amendment to Section 438(b)(2)(B)(iv) of the Higher Education Act (20 U.S.C. § 1078-1(b)(2)(B)(iv)) and the Department's regulations at 34 C.F.R. § 682.302(c)(4) barred floor loan treatment for loans refinanced with post-October 1, 1993 tax-exempt bonds. This new and heretofore unknown interpretation in Finding 2 is based on the premise that floor loan eligibility was determined based upon a loan's current funding source during the audit period. However, that premise is contradicted by a key Departmental regulation and by accompanying guidance stating that floor loan eligibility was not based exclusively upon a loan's current funding source. More specifically, the regulations and guidance stated that loans refinanced with funds other than pre-1993 tax-exempt bonds retained floor loan treatment so long as the authority retained a legal interest in the loan, and the original tax-exempt issuance had not been retired or defeased. 34 C.F.R. §682.302(e)(2).

Finding 2 reads 34 C.F.R. §682.302(c)(4) in a vacuum while ignoring the accompanying provisions in Section 682.302(e)(2). Paragraph (e)(2) was in effect throughout the audit period and expressly stated that holders would retain floor loan status after refinancing so long as the authority retained an interest in the loans, and the original tax-exempt bonds were not retired or defeased. Finding 2 does not address the language of Section 682.302(e)(2). Throughout the audit period, the paragraph stated as follows:

> (2) The Secretary pays a special allowance to an Authority at the rate prescribed in paragraph (c)(1) of this section on a loan described in paragraph (c) (3)(i) of this section—
> (i) After the loan is pledged or otherwise transferred *in consideration of funds derived from sources other than those described in paragraph (c)(3)(i) of this section*; and
> (ii) If the authority retains a legal or equitable interest in the loan—
> (A) The prior tax-exempt obligation is retired; or
> (B) The prior tax-exempt obligation is defeased …
>
> 34 C.F.R. §682.302(e)(2) (emphasis added).

Paragraph (e)(2) specified when a refinancing would cause floor loans to revert to the "regular" SAP rates specified in paragraph (c)(i). The thrust of the paragraph was that loans would not revert to non-floor status when a transfer occurred "in consideration of funds derived from sources other than those described in paragraph (c)(3)(i) of this section," if the bond authority retained an interest in the loan, and the prior (pre-1993) tax-exempt bond was not retired or defeased. Finding 2 is focused upon transfers in consideration of funds derived from post-October 1, 1993 ("post-1993") tax-exempt bonds. These are "sources other than those described in paragraph (c)(3)(i)" referenced in paragraph (e)(2)(i).[2] Moreover, AES/PHEAA, as the Authority, retained an interest in the loans, and the prior tax-exempt bonds were not retired or defeased. (Finding 2 does not contend otherwise.) Therefore, under paragraph (e)(2), no reversion to "usual rates" was triggered by AES/PHEAA's transfers of floor loans to post-1993 tax-exempt issuances.

Instead of crediting paragraph (e)(2), Finding 2 argues that transfers to tax-exempt issuances were excluded, relying upon a 1996 Dear Colleague Letter, issued four years later, that stated that transfers to taxable bonds would retain floor loan status without specifically referencing post-1993 tax-exempt bonds. The inference drawn by the OIG indicated in the Draft Report at page 11 – which is unsupported by any actual Departmental statement to the effect that non-taxable issuances were intended to be excluded – is contradicted by paragraph (e)(2)'s express language applying the regulation to all transfers "in consideration of funds derived from sources other than those described in paragraph (c)(3)(i) of this section." The regulation does not limit continued floor loan status to loans transferred in consideration of funds derived from taxable bonds. Instead, it preserves floor loan status for all loans transferred in consideration of funds derived from <u>any source other than a pre-1993 tax-exempt bond</u>. That broad category includes, of course, post-1993 tax-exempt issuances. The plain meaning of this published regulation cannot be superseded by inferences drawn from the mere absence in sub-regulatory guidance of a reference to tax-exempt issuances. Moreover, Finding 2 focuses upon 34 C.F.R. §682.302(c)(4), to the exclusion of the accompanying regulatory provisions, but this reference is misplaced because it is paragraph (e)(2), not paragraph (c)(4), that addresses the impact of refinancing upon floor loan status.

The Dear Colleague letters issued contemporaneously with the 1993 OBRA amendments to the HEA reiterated the Department's blanket policy of retaining floor treatment when a loan is refinanced. DCL L-93-161 and DCL L-93-163 state: "Refinancing of obligations which were originally issued prior to October 1, 1993 does not alter the eligibility of loans made or purchased with funds obtained from the proceeds of the original financing to receive the minimum special allowance." This policy was repeated in DCL 95-L-181 which stated that "tax-exempt loans made or purchased with funds obtained by the holder from the issuance, or refinancing, of obligations originally issued prior to October 1, 1993 ('old money') will continue to be calculated" under the floor provisions. Similarly,

[2] Sources described in paragraph (c)(3)(i) include the proceeds of tax-exempt obligations originally issued prior to October 1, 1993 and income, including sales, on loans made with the proceeds of tax-exempt obligations originally issued prior to October 1, 1993. Finding 2 is focused upon transfers in consideration of funds derived from <u>post</u>-1993 tax-exempt bonds. These are "sources other than those described in paragraph (c)(3)(i)."

DCL 95-L-181 established a single special allowance billing code for both taxable and post-1993 tax-exempt refinancing bonds when submitting special allowance requests to the Department. It is obvious that by establishing a single special allowance billing code for both categories of loans that the Department had no intent and no means to track these loans separately and, thus, could not have segregated them for purposes of computing special allowance rates. This continuing sub-regulatory guidance reaffirmed the unequivocal and mandatory rule published in 1992 at 34 C.F.R. § 682.302(e)(2) stating that floor loans refinanced with the proceeds of post-1993 tax-exempt bonds remained floor loans.

The 2004 GAO Report again reaffirmed what the student loan community had understood all long – that refinancing floor loans from pre-1993 tax-exempt to post-1993 tax-exempt obligations did not trigger a change in floor loan status. The centerpiece of the GAO's report stated as follows:

> Recommendation for Executive Action
>
> Given that lenders are increasing the volume of 9.5 percent loans based on <u>Education regulations that allow lenders to transfer 9.5 loans to taxable bonds and tax-exempt bonds issued after October 1, 1993</u> while retaining the special allowance payment provisions applicable to loans financed with pre-October 1, 1993 tax-exempt bonds, and the resulting increased costs for taxpayers, we recommend that the Secretary of Education <u>promulgate regulations to discontinue the payment of the special allowance applicable to loans financed with pre-October 1, 1993 tax-exempt bonds that are subsequently transferred to taxable bonds or tax-exempt bonds issued on or after October 1, 1993</u>.
>
> GAO Report at pages 7-8. (emphasis added).

This passage contradicts Finding 2. It constitutes an express and authoritative confirmation that the Department's regulations allowed transfers from pre-1993 to post-1993 tax-exempt bonds and that this policy would remain in effect absent the promulgation of new regulations.

The Department, commenting upon the GAO Report, similarly confirmed that the 9.5 percent subsidy remained as long as the underlying pre-1993 tax-exempt obligation remained open. The Assistant Secretary wrote:

> In general, under the Department's regulations, loans that are eligible for the special 9.5 percent subsidy retain that eligibility as long as the tax-exempt bond whose proceeds were used to make or purchase the loans remains open. In other words, absent a change in the law, unless and until the original financing instrument is retired or defeased, the loans it supports qualify for the special subsidy.
>
> Letter dated September 14, 2004 from Sally L. Stroup, Assistant Secretary of Education, to Cornilia M. Ashby, General Accountability Office.

The Department's statement did not contain any qualification on how the loan is financed, whether by tax-exempt or taxable obligation. The Department's letter reaffirmed the GAO's conclusion, and the industry-wide understanding, that refinancing of loans from pre-1993 to post-1993 tax-exempt bonds did not impact floor loan eligibility.

Historical context further demonstrates that the new OIG interpretation in Finding 2 is incorrect. As explained by the Comptroller General in the 2004 GAO report, in the early 1990s, the Department expected that interest rates would rise, and that this predicted rise would result in a higher lender yield for loans not subject to the one-half SAP payment cap applicable to floor loans. The Department was concerned that holders would transfer loans out of floor loan-eligible issuances in order to obtain a higher yield, "thus resulting in higher special allowance payments for the government." GAO Report at page 5. To address these fears, on December 18, 1992, the Department amended 34 C.F.R. §682.302(e)(2), to prevent holders from avoiding the half-SAP cap by refinancing into non-floor loan eligible bonds. The Department accomplished this by including in paragraph 302(e)(2) a requirement that, if the authority retained a legal interest in those loans, and the original tax-exempt issuance remained outstanding, floor loan treatment would continue. This 1992 rule change departed from the Department's prior policy of basing floor loan eligibility on the current financing source. Stated differently, in order to achieve what was (incorrectly) expected to be SAP savings under the floor loan program, the Department changed its rules to preserve floor loan treatment when an authority moved loans out of its floor loan-eligible bond financings.

As it turned out, the rule change had precisely the opposite effect because the Department was mistaken in its expectation that interest rates would rise and that a new rule preserving the floor loan status of refinanced loans would reduce SAP payments. Interest rates went down, and stayed down, and 9.5 percent floor loans generated a higher SAP yield than loans not in the floor loan category. Consequently, the Department's change in its rules and guidance – which preserved floor loan status after loan portfolios were refinanced out of their original tax-exempt issuances – resulted in increases, not decreases, in SAP payments by the Department.

Finding 2 now seeks to reverse the unforeseen consequences of the mistaken interest rate predictions that prompted the Department's regulatory shift and to impose resultant costs upon AES/PHEAA and, in turn, upon the student borrowers who depend upon AES/PHEAA for education financing. The finding promotes the imposition of repayment obligations on AES/PHEAA on the grounds that loans transferred to post-1993 tax-exempt bonds (but not those transferred to taxable bonds) lost floor loan eligibility. However, as has been shown, the regulations and guidance stated the opposite, and this finding, which seeks to retroactively rewrite the regulations and guidance with the benefit of hindsight, should not be finalized. The Finding 2 position has not been advanced by the Department in any of its published guidance or in any of its oversight reviews of AES/PHEAA's floor loan compliance. Having followed the regulations then in effect, AES/PHEAA should not now be required to defend an OIG interpretation that is contrary to those regulations, contrary to the Department guidance, and contradicted by the 2004 GAO report. The finding must be excluded from any final OIG report.

Significantly, FSA's response to AES/PHEAA's pending appeal of the Program Review Report dated March 28, 2006 recognizes that FSA consistently treats post-1993 tax-exempt issues and taxable issues in the same manner. Each are treated as taxable for 9.5% SAP purposes. In footnote 7 on page 6 of the response, FSA states:

> Loans which "are financed with funds obtained by the holder" from a tax-exempt bond "originally issued on or after October 1, 1993" receive SAP at the same rate paid on other loans (here, the "usual rate"), not the 9.5 percent minimum return rate. 20 U.S.C.A. 1087-(b)(2)(B)(iv) (2006). The HEA thus treats funds from such bonds in the same way as funds from obligations that are not tax-exempt. **We use the term "taxable funds" or "taxable bond" to refer to any funding source other than a pre-October 1993 tax-exempt bond.** (emphasis added)

The Department's position confirms, yet again, that Finding 2 is incorrect. The Department and the OIG have acknowledged that loans transferred to taxable issues retain floor loan status. The foregoing confirmation that the term "taxable bond" refers to any funding other than a pre-1993 tax-exempt bond, including post-1993 tax-exempt issuances, reaffirms the application of the provisions of 34 C.F.R. § 682(e)(2) described in these comments.

The above-referenced regulations and guidance show that the Department has consistently treated post-1993 tax-exempt bond issues in the same manner as taxable bond issues or financings for the purpose of 9.5% eligibility.

Lastly, we note that any purported noncompliance in Finding 2 would not support any repayment obligation because the Department recently issued Dear Colleague Letters which confirm that it will not seek repayment of special allowance payments prior to September 30, 2006 if, as the OIG concedes in Finding 4, a party is complying with the requirements of those Dear Colleague letters. This point is addressed further under Finding 4.

As with Finding 1, the amounts referenced in Finding 2 are incorrect, speculative, and should be removed from any final audit report for multiple reasons including:

- Finding 2 also concedes that the amount listed is an estimate and that the OIG did not conduct an actual calculation of questioned SAP payments (Draft Audit Report at page 12). Thus, the amount listed is incorrect.

  - For the reasons articulated in this response, Finding 2 is incorrect and, therefore, there is no basis for requiring repayment of the questioned SAP payments.

- AES/PHEAA reserves the right to conduct any calculations in the future and to dispute any calculations in the draft audit report or any final audit report.

<u>Comments regarding the Recommendations</u>

2.1 – 2.3 AES/PHEAA does not agree with these recommendations. The finding should be withdrawn from any final audit report for the reasons discussed in this response.

FINDING NO. 3 – AES/PHEAA's LaRS for the Quarter Ended March 31, 2006, Contained Billing Errors That Resulted in Improper Payment of SAP

Comments regarding the Finding

This finding should not be noted in OIG's final audit report because it is not a new finding, rather it is one already identified and being addressed by AES/PHEAA. OIG is aware that AES/PHEAA has already addressed the situation described under "First Billing Error: Non-Compliance with HERA" with adjustments to the March 2007 LaRS billing as outlined below. It should be noted that the issue described under "Second Billing Error: Miscoding of Loans," is scheduled to be resolved via a correction to the upcoming LaRS billing for the quarter end September 2007. Should the OIG insist on including this finding in a final audit report, the misstatements in this finding must be corrected.

TIMELINESS

While HERA of 2005 became effective February 8, 2006, FSA did not issue guidance on the effects of HERA until it released DCL GEN-06-02 which was posted on March 10, 2006. Similarly, FSA released additional revised guidance on March 14, 2006 in the form of DCL GEN 06-03. Finally, FSA's March 30, 2006 release of DCL FP-06-04 provided additional operational guidance pertaining to the LaRS reporting and the implications of HERA of 2005 changes.

Due to FSA's delay in making guidance available to the industry, AES/PHEAA was unable to effectuate the necessary coding changes to its COMPASS loan servicing system in time to meet the March (1st quarter) 2006 filing. AES/PHEAA had verbally communicated with FSA regarding the changes required to be implemented and it was understood by FSA that the March 2006 LaRS billing would not reflect these changes. The goal was to ensure that the bulk of the changes were instituted in time for the June 2006 LaRS report filing with the understanding that additional cleanup would be required. As evidenced by DCL FP-06-10, the Department has acknowledged lenders' need to delay or postpone implementation of programming changes due to timing constraints. More specifically, this DCL states in part, "Lenders that are unable to modify their systems by the time they are ready to submit their quarterly billing in July, 2006 may continue to report these loans as 'XH.'"

The internal AES/PHEAA change request created and implemented to support necessary changes to the COMPASS servicing system was number 000489-09. This change request was implemented on May 25, 2006 to ensure the system billed correctly for June (2nd quarter) 2006 LaRS billing. Additionally, the population that reported incorrectly from March (1st quarter) 2006 was corrected as a prior period adjustment to refund at the tax-exempt rate and re-bill at the taxable rate on the March 2007 LaRS billing. The amount refunded was in excess of what was originally billed and the re-billing at the taxable rate created a difference of $125,000 that was <u>over-refunded</u> by AES/PHEAA to the Department.

It should be noted that the OIG's work paper G.5.PS requires a correction in the first sentence under the heading "*Discussion with AES/PHEAA*," where the incorrect reference to April 1, 200**7** should be changed to accurately reflect April 1, 2006. This is not an insignificant error.

<u>DOCUMENTATION</u>

AES/PHEAA strenuously disagrees with the assertion in Finding 3 that AES/PHEAA did not have documented policies and procedures. AES/PHEAA further disagrees with the finding's speculation that a purported lack of documented policies and procedures may have adversely impacted AES/PHEAA's participation in the FFEL Program, for the following reasons:

1. <u>AES/PHEAA has strong and effective documented controls and procedures in place, in the form of its COMPASS servicing system</u>. The AES/PHEAA COMPASS system is, in and of itself, a fully documented, well-defined process by which AES/PHEAA effectively administers the FFEL Program. COMPASS is an elaborate and sophisticated mainframe-based decision support tool, comprised of modules that store information in tables and make the information available as needed throughout the system. Regulatory requirements and other information are stored in tables, allowing for control and ease of modification. Changes to statutes and regulations are implemented in the COMPASS system through a process in which a Change Request is developed, vetted, and approved by appropriate personnel and the change is made to coding or tables, as appropriate through a controlled change process. The system facilitates effective performance of the full range of functions and activities related to the student loan life cycle, including activities relating to SAP billings for floor loans. The activities also include origination, asset acquisition and conversion, consolidation, grace period processing, billing and repayment, account adjustment, collections, claims, reinsurance and customer service.

The assertion that AES/PHEAA did not have documented policies and procedures is contradicted by the detailed documentation that is the foundation of the COMPASS system. The SAP billing process, including floor loan billings, is a key component of the policies and procedures that are documented and implemented within COMPASS. COMPASS has an automated LaRS reporting feature that creates the necessary documentation to bill the U.S. Department of Education on a quarterly basis for interest subsidy and SAP. In addition to the LaRS report, COMPASS produces a set of reasonability edit reports that conform to the LaRS edit checks performed by the

Department. Other ad hoc reports are created as needed to research potential issues to ensure accurate LaRS reporting.

The draft report at page 15 concedes that documented procedures exist for updating the COMPASS system to reflect changes in the applicable program requirements. The OIG work papers document the efficacy of the policies and procedures implemented through COMPASS, including the adequacy of AES/PHEAA's internal controls, including with respect to SAP billings and floor loan billings. Examples of corroborating work papers are cited immediately below.

2. The OIG's work papers confirm the strength and effectiveness of AES/PHEAA's internal controls during the audit period. Finding 3's speculation regarding the adequacy of internal controls at AES/PHEAA is inaccurate and contradicted by the OIG's own work papers and should be excluded from any final report. The results of testing reflected in the work papers repeatedly and consistently attest to the strength and effectiveness of those internal controls. The following are examples of such work papers:

> Work Paper D.3.1. This work paper reflects the result of the auditors' testing of the process of a loan transfer/sale/purchase in connection with the 9.5% SAP billing process. The OIG's conclusion states as follows: "We obtained an understanding of AES/PHEAA's loan sale process. Although AES/PHEAA did not have a policies and procedures manual detailing the loan sale process, they did have forms and other documents in place that are completed to execute each loan sale."
>
> Work Paper D.3.6. This detailed document was prepared by AES/PHEAA setting forth AES/PHEAA's floor eligibility criteria and was included in the work papers to substantiate the criteria utilized in determining 9.5% SAP eligibility. It contradicts any assertion that AES/PHEAA lacked documented policies, procedures, or other internal controls pertaining to 9.5% floor loan billings.
>
> Work Paper D.3.8. This work paper, prepared by the OIG to reflect its fieldwork, sets forth the following results: "AES/PHEAA explained and documented that within bond issues, not all of the loans are 9.5% floor eligible." (emphasis added). The OIG's conclusion in this work paper is that AES/PHEAA documented its practice of segregating non-floor loans – in direct contradiction of the speculation set out in Finding 3 of the draft audit report.
>
> Work Paper D.3.8. The same work paper separately states, in the Conclusion section that: "AES/PHEAA provided sufficient explanations enabling us to understand the negative average daily balances, … the variances between the average daily balances and the amount of the bond issues, and the variances between the outstanding tax-exempt issues to the average daily principal balances."

By this conclusion, the OIG affirmed that AES/PHEAA documented the balances attributable to its tax-exempt issues.

Work Paper D.3.9. This work paper details the OIG's assessment of LARS/Form 799 reporting, change request forms, and loan data. It sets forth a detailed recitation of the applicable documentation and information pertaining to loan sale criteria, LARS/799 reporting, and system changes attributable to regulatory changes. The work paper concludes that "AES/PHEAA has a process to enter loan-coding changes into their computer system. These changes are initiated by changes to the law, regulations and published guidance and are documented by a Change Request Form, which is created by … the affected department." This work paper presents the OIG's explicit conclusion that during the fieldwork AES/PHEAA established that it has in place systems for documenting and implementing system changes dictated by changes in the law and regulations. It directly contradicts Finding 3 in the draft audit report.

Work Paper D.3.10. This work paper reflects the OIG's testing of the Change Request Forms pertinent to 9.5% billings. It affirms that AES/PHEAA documented implementation of each in a sequence of regulatory changes affecting floor loan billings. The work paper states as follows:

> Conclusions:
>
> AES/PHEAA had modified the Compass system's functions that identify loans as eligible for billing at the 9.5% SAP rate in response to changes in regulations and statute. The Compass system was modified to reflect the following changes:
>
> - DCL 96-L-186, dated 3/1/96, which noted that loans initially funded by a T/E issue and refinanced with a taxable issue remain subject to the T/E SAP rates, provided the original T/E issue remains outstanding. While this change was effective as of 2/1/93 (the effective date of the regulations), AES/PHEAA did not implement changes to the Compass system until the LARS/799 billing for the 1st quarter 1999.
> - TTPA of 2004, which placed limits on loans' eligibility for the 9.5% SAP rate on/after 9/30/04
> - HERA of 2005, which placed additional limits on loans' eligibility for the 9.5% SAP rate on/after 9/30/04, and prohibits additional loans from becoming eligible for the 9.5% SAP rate on/after 2/8/06.
>
> Additionally, it appears that AES/PHEAA is modifying the Compass system in response to one of the issues raised in the ED FSA report issued in March 2006.

This work paper again confirms that, time and time again, AES/PHEAA documented the implementation of changes to SAP billing mandated by law. It directly contradicts Finding 3.

Work Paper D.4.2. The OIG prepared this work paper to reflect the results of the fieldwork it performed "to determine whether AES/PHEAA provided complete support documentation for the sampled loan sales." The OIG's conclusion states, "Based upon the results of our review of the 12 loans sales, we believe that the controls over loan sales described by AES/PHEAA … were functioning as intended and appear adequate." Once again, the OIG work paper confirms the strength of AES/PHEAA's internal controls, and contradicts Finding 3 in the draft audit report.

Work Paper D.3.PS. This work paper is highly significant. It is titled, "Understanding of Internal Controls," and its stated purpose is "To obtain an understanding of the internal control policies and procedures significant to the audit objectives." This work paper reflects the OIG's conclusions with respect to the adequacy of the AES/PHEAA internal control structure, and its conclusions are central to the assertions in Finding 3. It directly negates any negative speculation concerning the adequacy of internal controls. The conclusion section of the work paper states as follows:

> Conclusion:
> The audit team obtained an understanding of the internal controls significant to the audit objectives and other controls related to audit. In general, AES/PHEAA has controls over the eligibility of loans for special allowance billing under the 9.5% floor; the transfer, sale and purchase or (sic) loans, the management of its loan portfolio and bond issues; the calculation of loans' average daily balances; and LARS/Form 799 reporting."

These work papers reaffirm that, based upon its extensive field work and testing of the COMPASS system, the OIG concluded that AES/PHEAA had strong internal controls in place, and it was fully capable of documenting its compliant administration of the FFEL Program.

3. The OIG points to no exception establishing any weakness in AES/PHEAA's internal controls. In sharp contrast to the numerous work papers evidencing documentation of strong internal controls at AES/PHEAA, the OIG does not point to any substantial or material errors in the administration of the FFEL Program. Plainly, the two minor billing errors described in this finding do not substantiate a conclusion that AES/PHEAA lacked adequate controls, policies, or procedures. These are isolated instances that have been reported, are being corrected, involve nominal dollar amounts relative to the overall program funds administered, and resulted in a net overpayment by AES/PHEAA to the Department.

The OIG work papers identify no other error or exception to substantiate speculation and criticism of AES/PHEAA's policies, procedures, and internal controls on Finding 3. The work paper summarizing the OIG's assessment of internal controls makes reference to purported "management control weaknesses," but in support of that characterization it references only the two nominal instances already covered in Finding 3, along with the disputed regulatory matters at issue in Findings 1, 2 and 4. *See* OIG Procedure Standard Report, D.4.PS – Assessment of Internal Controls, Conclusion section. As has been detailed elsewhere in these comments, Findings 1, 2, and 4 involve disputed interpretations of the regulatory requirements, not errors or exceptions implicating any deficiency in internal controls. AES/PHEAA strongly disagrees with those findings, for all of the reasons stated elsewhere in the comments. In any event, disputed regulatory interpretations do not constitute errors or exceptions implicating internal controls.

4. The draft report acknowledges that the reference in Finding 3 to policies and procedures presents no regulatory violation. As previously noted, AES/PHEAA has in place sound policies and procedures for the administration of the FFEL Program, including SAP billing, and the draft audit report points to no errors or exceptions that prove otherwise. Moreover, as is acknowledged in the OIG's internal work papers, there is no regulatory requirement that AES/PHEAA document those policies and procedures in any particular way. Work Paper D.3.PS states as follows:

> The audit team notes that AES/PHEAA is not required (under regulations) to have such policies and procedures documented. Additionally, the ED OIG Lender and Lender/Servicer Audit Guide cites as criteria the *COSO's Internal Control-Integrated Framework.* To the audit team's knowledge, COSO's Integrated Framework does not require entities to have control activities documented.

Comments regarding the Recommendations

3.1 AES/PHEAA disagrees with this recommendation.

3.2 AES/PHEAA has already provided the OIG with verification that the first error condition was addressed on the LaRS submission for the quarter ending March 31, 2007. As indicated in the draft audit report, this information further acknowledged the fact that the correction resulted in an over-refund of SPAL in the amount of $125,000.00. Confirmation of the pending correction, to address and resolve the second billing error, will be provided directly to FSA upon request.

FINDING NO. 4 – A Significant Risk Exists That Loans Billed Under 9.5% Floor Were Not Eligible First or Second-Generation Loans

Comments regarding the Finding

AES/PHEAA disagrees with this finding and requests that it be withdrawn because: (1) the Department has stated that no repayments will be required of lenders like AES/PHEAA which, as the OIG concedes, are complying with the audit requirements of the applicable Dear Colleague letters, and (2) the redefined standards proposed in Dear Colleague Letters FP-07-01 and FP-07-06 do not provide any basis for imposing retroactive repayment requirements on lenders.

SAP Billings For Periods Through September 30, 2006 Are Subject To The Safe Harbor Under The Department's Dear Colleague Letters

- DCL FP-07-01 and FP-07-06 issued in January and April of 2007 redefined the standards for determining whether loans qualified for special allowance payments (SAP) at the 9.5 percent minimum return rate. Although characterized as a restatement of law that existed since 1993, this new guidance sought to rewrite long-established rules and guidance governing SAP payments.

- Significantly, the Department issued a letter to AES/PHEAA explicitly stating that it would not require repayment of SAP for periods prior to September 30, 2006 if it agreed to cooperate with certain audit and other requirements. Specifically, the January 24, 2007 letter to AES/PHEAA states:

  > 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… (emphasis added).

  The letter makes clear that AES/PHEAA will not have to return SAP received for quarters through September 30, 2006 if it complies with the Dear Colleague letters.

- The OIG acknowledges in the draft audit report that AES/PHEAA is complying with the requirements of the Dear Colleague letters. See Draft Audit Report at pages 19-20.

- The OIG also acknowledges in the report that the Department has stated it will not seek repayment of prior SAP payments and therefore that it did not conduct any calculations on this finding:

  > Since the Department has stated that it will not seek repayment of prior improper payments, and since a separate audit is planned to identify AES/PHEAA's eligible first-generation and second-generation loans, we did not determine the extent to which AES/PHEAA's 9.5 percent floor billings included only eligible first-generation and second-generation loans. Draft Audit Report at page 19.

- There is no basis for a finding because the OIG has conceded that the Department will not seek repayment of prior purportedly improper payments. The OIG did not quantify this finding because the Department established in its Dear Colleague letters that no repayments will be required. The issuance of the finding in this context would serve only to speculate unnecessarily on what the result might be if the Department reached a different interpretation. The Department's position on this matter is clear and the OIG has not made any finding of noncompliance with respect to the "safe harbor" requirements nor with the audit requirements. In any event, this matter is in the hands not of the OIG, but of the Department, which is responsible for handling the audit. Consequently, there is no basis for a finding and therefore this draft finding must be rescinded.

<u>The Redefined Standards for Determining SAP Do Not Provide Any Basis for Retroactively Rescinding SAP Payments</u>

- In particular, for the reasons described earlier in this response, the SAP billings complied with the requirements for 9.5 percent treatment under the provisions of 34 CFR 682.302(c)(3)(i)(A) and (D).[3]

- Contrary to the Department's suggestion that it was "restating" prior guidance, the 2007 Dear Colleague letters in reality announced new interpretations of these requirements by proposing to restrict the scope of subsections (A) and (D). Under prior interpretations, these subsections encompass and would provide floor treatment to loans that the Department now seeks to exclude from such treatment. The Department is now reversing prior guidance by redefining subsection (A) to mean and

[3] AES/PHEAA did take steps to ensure that its 9.5 percent billings complied with these requirements and we strongly disagree with the OIG's unsupported suggestion to the contrary. In particular, we disagree with the suggestion that AES/PHEAA or any other lender was required to track the sources of funds to determine whether loans were first, second or later generation loans inasmuch as these terms were not used in applicable law or guidance prior to 2007. AES/PHEAA did take steps to track loans to the bond issues used to finance the loans, which was what was required under applicable law and guidance in effect at the time.

include only "first-generation" loans and subsection (D) to mean and include only "second-generation" loans.

- We disagree with this interpretation that later generation loans could not receive floor treatment and, particularly, with any suggestion that this interpretation be applied retroactively to periods prior to the Dear Colleague Letters issued in 2007.

- In any event, the prior SAP payments cannot be rescinded under either interpretation. If the loans are treated as first or second-generation loans, then the floor treatment of those loans complied with applicable law. If the loans are treated as third or later generation loans, then they are subject to the safe harbor and the SAP payments are not subject to repayment. *See* January 2007 Department Letter to AES/PHEAA ("Therefore, the Department will not seek to recoup SAP … for loans that were neither first-generation loans nor second-generation loans …").

- This safe harbor is appropriate and, in view of the reversal of its prior position on this matter, reflects the Department's recognition that the interpretation announced in the 2007 Dear Colleague letter is subject to dispute and should not be applied retroactively. *See* Department Letter to AES/PHEAA ("The Department is committed to resolving without protracted dispute any potential objections both to the meaning and application of the statutory and regulatory requirements as restated in this letter … Therefore, the Department will not seek to recoup SAP already received …"). This view is consistent with well recognized principles of law that would prohibit the retroactive application of this newly announced guidance.

<u>Comments regarding the Recommendations</u>

4.1 – 4.3 The finding and recommendations should be withdrawn for the reasons stated above and in the section that follows.

Supplemental Comment: The OIG Is Prohibited By Statute From Issuing The Draft Report In Final.

Findings 1, 2, and 4 exceed the OIG's statutory authority. Therefore, the OIG must refrain from issuing any final audit report that contains those findings.

Two key statutory provisions constrain the OIG from issuing these three findings in any final audit report:

1. The Higher Education Act requires that any lender or guaranty agency audits conducted by the OIG must focus upon "rules and regulations prescribed by the Secretary, in effect at the time that the record was made, and in no case shall the …. Inspector General apply subsequently determined standards, procedures, or regulations to the records of such agency …" 20 U.S.C. § 1082(f)(4).

2. The Inspector General Act of 1978 states that "there shall not be transferred to an Inspector General … program operating responsibilities." 5 U.S.C. App.3 §9(a)(2). The legislative history of that Act makes clear that Congress intended to precluded the OIG from assuming responsibility for audits "constituting an integral part of the programs involved." H.R. Rep. No. 95-584, at 12-13 (1977). Federal courts and the U.S. Department of Justice have confirmed that Inspectors General may not conduct audits that carry out agency functions that are integral or central to the basic operations of such agency. *Truckers United for Safety v. Mead*, 251 F.3d 183, 189 (D.C. Cir. 2001); *Burlington Northern Railroad v. Office of Inspector General, Railroad Retirement Board*, 983 F. 2d 631, 640, 642 (5th Cir. 1993). *See also*, U.S. Department of Justice, Office of Legal Counsel Opinion dated March 9, 1989, by Douglas W. Kmiec, Assistant Attorney General, 1989 OLC LEXIS 4, 13 Op. O.L.C. 63.

Accordingly, when conducting an audit of a lender or a guaranty agency, the Inspector General's authority is constrained in at least two key aspects:

- It may not impose new Department standards upon prior audit periods; and
- It may not conduct audits that assume program operating responsibilities that are integral or central to the Department's functions.

The findings and recommendations in the draft audit report violate both of these express statutory prohibitions, for the following reasons:

1. <u>Finding 1.</u>

The assertion in Finding 1 – that floor-loan eligible loans transferred to taxable bonds prior to the enactment of the TTPA lost such eligibility if transferred to a different taxable bond post-TTPA – is at odds with the legislative history of the Higher Education Act, Department guidance, and the widespread understanding of the student loan community. The Department acknowledged this as a source of confusion during the audit period, and this issue is currently the subject of unresolved administrative proceedings with the Department.

The OIG is prohibited by statute from assuming the Department's key program operating responsibilities and from conducting audits that apply new standards to prior periods. As the OIG is prohibited by statute from applying new standards to prior audit periods, it is similarly prohibited from applying yet-undetermined standards to prior audit periods. The OIG is barred by statute from presuming the outcome of the unresolved administrative appeal proceeding and from applying that presumed outcome to a prior audit period. If finalized, Finding 1 would effectively substitute the OIG's judgment for that of the Department, before the matter has been decided, and would directly violate the express requirement in Section 432(f) of the HEA that "in no case" shall the OIG apply subsequently promulgated standards to prior audit periods.

Finding 1 similarly violates the Inspector General Act prohibition against the OIG assuming of key program operating functions. The review and disposition of an open issue of regulatory interpretation that is the subject of a separate and unresolved program review proceeding is an integral program operating function of the Department that cannot lawfully be predetermined, presumed, or otherwise assumed by the OIG.

The Department's program operating regulations state that "the Secretary's decision to require repayment of funds … does not become final until the Secretary provides the lender, agency, or servicer with written notice of the intended action and an opportunity to be heard." 34 C.F.R. § 682.413(e)(1)(i). This administrative process is presently underway with the Department, and Finding 1 unlawfully assumes integral program operating responsibilities reserved to the Department in violation of section 9(a)(2) of the Inspector General Act of 1978.

2. <u>Finding 2.</u>

Final issuance of Finding 2 is barred by the same statutory prohibitions. As previously established in these comments, the regulatory interpretation advanced in Finding 2 – that floor loans transferred to post-1993 tax-exempt bonds did not retain floor loan eligibility – is contradicted by Department's regulations and sub-regulatory guidance in effect during the audit period. Furthermore, detailed in the September 2004 GAO Report, the Department, the student loan community, the Comptroller General, and the Congress all understood, based upon the prevailing guidance and regulations, that loans transferred to post-1993 tax-exempt bonds retained floor loan eligibility.

This consensus in understanding prompted the GAO to recommend executive action to address what the Comptroller General referred to as "[e]ducation regulations that allow lenders to transfer 9.5 percent loans to taxable bonds and tax-exempt bonds issued after October 1, 1993." GAO-04-1070 at page 7.

Finding 2 contradicts the published regulations and guidance, in direct violation of the statutory prohibition against OIG assumption of Departmental program operating responsibility and in violation of section 9(a)(2) of the Inspector General Act of 1978. The finding also violates the requirement Section 432(f) of the HEA that any lender or guaranty agency audits by OIG must abide by the rules and regulations of the Secretary that were in effect at the time that the record was made, and that in no case shall the Inspector General apply subsequently determined standards, procedures, or regulations to prior audit periods.

3. <u>Findings 1, 2, and 4</u>.

Findings 1, 2, and 4 further violate the statutory constraints on OIG authority by directly contradicting the published safe harbor guidance relied upon by AES/PHEAA and the student loan community as a whole. By letter to AES/PHEAA dated January 24, 2007, which was sent to all affected agencies pursuant to the Secretary's published Dear Colleague guidance in FP 07-01, the Secretary informed AES/PHEAA that, for agencies that accept newly prescribed floor loan audit procedures, the Department will not seek to recoup excess SAP for quarters ending on or before September 30, 2006 for loans that were neither first-generation loans nor second-generation loans.

Finding 4 expressly acknowledges this published guidance and further acknowledges that AES/PHEAA is protected by the safe harbor because it has agreed to abide by the Department's audit procedures. Draft Report at page 19. Despite the acknowledged application of the safe harbor guidance to AES/PHEAA, draft Findings 1 and 2 recommend potential repayments that are covered by the safe harbor. AES/PHEAA disagrees with Findings 1 and 2 and contends, for all of the reasons previously stated, that the loans at issue in those findings qualified for floor loan treatment. However, if the findings were correct, they would necessarily constitute a determination that the loans at issue were neither first-generation loans nor second-generation loans, and the Department's safe harbor guidance would preclude any repayment. Similarly, Finding 4, while refraining from repayment recommendations, ignores the

Department's published guidance on first-generation/second-generation criteria by auditing retroactive time periods that are ultimately the subject of the safe harbor.

Because the OIG findings are directly at odds with the published guidance that the Department has sent to AES/PHEAA regarding the repayment policies with respect to SAP payments made on or after December 2006, the OIG is barred by statute from proceeding. The three findings cannot be reconciled with the Department's recent and unequivocal published guidance. They purport to rescind explicit published guidance issued to AES/PHEAA and others, and the findings thereby constitute the unlawful assumption by OIG of the Department's program operating responsibility, in violation of section 9(a)(2) of the Inspector General Act of 1978. Similarly, the findings violate the HEA's requirement that OIG lender and guaranty agency audits comply with the rules and regulations of the Secretary that were in effect *at the time that the record was made*. The findings' circumvention of safe harbor guidance in effect for the audit period is barred by the HEA's express requirement that "in no case shall the Inspector General apply subsequently determined standards, procedures, or regulations" to prior audit periods.

For all of these reasons, the OIG should refrain from finalizing its findings and should instead close the audit without any final report.

Note: These Comments, in their entirety, constitute a preliminary statement of AES/PHEAA's position in response to the items cited in the OIG Draft Audit Report issued August 6, 2007. AES/PHEAA reserves the right to supplement, expand, and modify these comments and to respond further to any future related or modified findings as may be included in any future OIG report or other OIG or Departmental issuance.