ATTACHMENT To FP-06-15

# Explanation of Interim Final Rule on Special Allowance Payments on loans made or acquired with funds from tax-exempt obligations

The Higher Education Act (HEA) authorizes payment by the government of a subsidy, called a special allowance payment (SAP), on Federal Family Education Loan Program (FFELP) loans. 20 U.S.C. § 1087-1 (2006). Since FFEL interest rates are set by law and not by the market, this SAP payment, when added to interest paid by, or on behalf of, the borrower, is intended to give the lender a total yield on a FFELP loan that approximates the yield the lender could obtain by making a consumer loan at a market-based rate. However, the HEA provides a separate SAP rate for certain loans made or acquired with funds from a tax-exempt bond.[1] That rate is ordinarily one-half the rate payable on other loans, but not less than that needed to give the lender a total yield of 9.5 percent. 20 U.S.C. § 1087-1(b)(2)(B)(i), (ii)(2006). As we will explain below, whether this special SAP rate applies to a loan depends on when the tax-exempt bond that generated funds to acquire the loan was issued, on whether certain events subsequently occurred, on the status of the lender itself and its portfolio, and on the SAP status of the loan when acquired by the lender.

The SAP rules created by existing statutes and regulations can be explained by describing first the rules that govern how loans become eligible for SAP at the 9.5 percent rate, and then the rules that terminate that eligibility. Both sets of rules can be best described by first stating the "general rules," and then explaining changes made to those "general rules" by the Taxpayer-Teacher Protection Act of 2004, Pub. L. 108-409 (TTPA), and the Higher Education Reconciliation Act of 2005, Pub. L. 109-171 (HERA).

## General Rules

The minimum 9.5 percent return SAP rate applies only to loans that had been acquired by the lender using funds from a tax-exempt bond "originally issued" prior to October 1, 1993. Those acquired using funds from a bond "originally issued on or after October 1, 1993" receive SAP at the usual rate payable for loans from taxable funding sources. 20 U.S.C. § 1087-1(b)(2)(B)(iv)(2006). The statutory term "originally issued" is not a conventional bond term. In the context of the HEA provision for the payment of 9.5 percent SAP, the term "originally issued" refers to a bond issued to obtain funds to make or acquire loans – as opposed to a bond issued to obtain funds to repay an old bond. The latter is a refunding bond. The August 9, 2006 interim final rule articulates this distinction between a "new money" bond and a refunding bond. 34 C.F.R. § 682.302(f)(2)(2006).

[1] For convenience, we use the term "bond" in this explanation to describe the instrument used to borrow funds, instead of the term "obligation" used in the statute and regulations. Lenders may use notes or other instruments to raise funds, and references to "bond" here include any other form of borrowing.

**How loans become eligible for 9.5 percent SAP:**

The statute identifies, in two sentences, the specific sources of funds derived from a tax-exempt obligation that can be used to acquire loans that qualify for the 9.5 percent minimum SAP. 20 U.S.C. § 1087-1(b)(2)(B)(i)(2006). These sources are (1) funds obtained directly from issuing the bond itself or from investment earnings on the proceeds of the bond, and (2) funds obtained by repayments and income derived from loans made from those bond proceeds. *Id.* The regulations contain this same list of eligible funding sources, along with proceeds from the sale of certain of these loans. 34 C.F.R. § 682.302(c)(3)(i)(1993). The interim final rule makes no change to this list of sources that can be used to acquire a loan eligible for 9.5 percent minimum SAP.

**How refinancing and refunding affects continued eligibility for 9.5 percent SAP:**

To provide security to investors who buy a bond, lenders pledge the loans they acquire as collateral for the bond. As a bond matures and must be repaid, lenders often issue new bonds to obtain funds to repay (refund) the outstanding bond. When an old bond is refunded, the loans pledged as collateral for the old bond become available to serve as collateral for the new bond. Sometimes, rather than refunding the outstanding bond, lenders transfer to a different bond those loans that had been pledged to that outstanding bond. This transfer of loans from one bond to another has acquired the label of "refinancing" of the loans.[2] The regulations explain the SAP rate payable on loans involved in the refunding of a bond and the refinancing of loans.

All loans that were acquired using an eligible funding source – those listed in 34 C.F.R. § 682.302(c)(3)(i) - and that are part of a refinancing or refunding transaction can be divided into two groups. The groups can be distinguished by the source of the funds used in the refunding or refinancing process. The first group includes loans that have always been pledged to a tax-exempt refunding bond. That refunding bond may be the first such bond, or may be one in a series of tax-exempt refundings.[3] The second group includes all loans not in the first group.

Prior to the interim final rule which was published on August 9, 2006, the regulations had never expressly explained the SAP rate payable on loans in the first group - those that had been pledged at all times to a tax-exempt refunding bond. However, the Department did address this question in two 1993 Dear Colleague Letters. (DCL L-93-161 and L-93-163)

[2] Ordinarily, the term "refinance" is used to describe obtaining a new loan to pay off an old debt, and is simply a synonym for "refunding." The collateral for the old debt is then pledged as collateral for the new obligation. Thus, a homeowner "refinances" a mortgage, not a house. However, since at least 1996, the Department and lenders have used the term "refinance" to describe moving the collateral (student loans) from an old bond to a different bond, without connoting that the old debt is or is not paid off. The TTPA uses the term "refinance" to refer to this transfer of collateral (the loans) from one bond to another. The regulations make clear which sense of the word is intended, as appropriate (e.g., "a loan is refinanced when. . . . ") 34 C.F.R. § 682.302(f)(3)(2006).

[3] An example of such serial tax-exempt refunding was the practice of the New Mexico Educational Assistance Foundation, addressed in a 2005 Department Inspector General audit.

The interim final rule describes this group of loans in 34 C.F.R. § 682.302(e) (2)(i), and states that these loans retain eligibility for SAP at the 9.5 percent rate. We have received some comments that the interim final rule requires "continuous financing" by tax-exempt bonds as a condition for eligibility for 9.5 percent SAP. The interim final rule does not state that continuous financing by a tax-exempt source is a condition for eligibility for 9.5 percent SAP. The interim final rule acknowledges that some loans have been "financed continuously" by a tax-exempt bond, and the rule explains the SAP rate payable on these loans. Thus, although this language in the interim final rule is new, it simply articulates formal Department interpretation of the HEA and prior regulations, as provided in the 1993 letters, noted above.

The interim final rule next describes the SAP rate payable for loans in the second group, those that have not been "financed continuously" by a tax-exempt bond. 34 C.F.R. § 682.302(e)(2)(ii) (2006). The interim final rule restates the provisions of the 1985 regulation and the position stated in the 1996 Dear Colleague Letter (DCL L-96-186).

This second group of loans, those that had not been "financed continuously" by a tax exempt bond, can be divided into two groups, depending on whether or not the lender refunds the existing tax-exempt bond that had been used to acquire the loans.

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

- If the lender uses funds from a taxable bond to refinance the loans and pledges the loans to that taxable bond, but does not refund the tax-exempt bond used to acquire the loans, SAP continues to be paid at the special 9.5 percent rate. 34 C.F.R. § 682.302(e)(2) (ii)(B) (2006). This provision comes directly from the 1996 Dear Colleague Letter (DCL L-96-186).

**How the TTPA changes the general rules:**

The TTPA made significant changes to the general rules, for transactions that occurred after September 30, 2004, the effective date of the TTPA provisions. The interim final rule states the TTPA requirements in a new, separate subsection - 34 C.F.R. § 682.302(e)(3)(2006) ("Loans affected by transactions or events after September 30, 2004"). The interim final rule makes clear that the TTPA provisions take precedence, when they apply, over the "general rules." 34 C.F.R. § 682.302(e)(2) (2006).

The TTPA provided that loans that were eligible for 9.5 percent SAP lose that eligibility when any of three events occur. 20 U.S.C. § 1087-1(b)(2)(B)(iv), (v)(II) (2005). The new interim final rule closely paraphrases the language of the TTPA to describe these events. Thus, the interim final rule provides, in new 34 C.F.R. § 682.302(e)(3), that loans lose 9.5 percent SAP eligibility when any of the following occurs "after September 30, 2004"—

- The loan "is refinanced" from sources other than the eligible (pre-October 1, 1993), tax-exempt funding sources described in the HEA and regulations. 20 U.S.C. § 1087-1(b)(2)(B)(v)(II)(bb), and 34 C.F.R. § 682.302(e)(3)(i).

- The loan is "financed by a tax-exempt obligation that matures, is retired, is defeased," or "is refunded." 20 U.S.C. § 1087-1(b)(2)(B)(iv), (v)(II)(aa), and 34 C.F.R. § 682.302(e)(3)(iii).

- The loan is sold or transferred to any other holder. 20 U.S.C. § 1087-1(b)(2)(B)(v)(II)(cc), and 34 C.F.R. § 682.302(e)(3)(ii).

**How HERA changes the general rules:**

The HERA made two changes to then-existing law. First, HERA made the TTPA provisions permanent by removing the January 1, 2006 sunset date provisions. Second, and more significantly, HERA – with a limited exception as discussed below – barred loans not already eligible for 9.5 percent SAP on February 8, 2006 – its date of enactment – from ever becoming eligible for 9.5 percent SAP. 20 U.S.C. § 1087-1(b)(2)(B)(vi) (2006). As with the TTPA provisions, the interim final rule states these HERA requirements in a new, separate subsection – 34 C.F.R. § 682.302(e)(4)(2006). The interim final rule closely tracks the statutory language. It provides that SAP is paid at the normal rate (not the 9.5 percent minimum rate) on any loan that was acquired on or after February 8, 2006, or (if previously acquired by the holder) that was not already eligible for 9.5 percent SAP on that date. 34 C.F.R. § 682.302(e)(4)(2006).

**How HERA applies to governmental or non-profit holders with small portfolios:**

HERA includes a narrow "carve out" that delays until December 31, 2010 for certain holders the provisions barring new 9.5 percent SAP loans. 20 U.S.C. § 1087-1(b)(2)(B)(vii)(2006). The new interim final rule states this exception in a new, separate subsection - 34 C.F.R. § 682.302(e)(5)(2006). It closely tracks the statutory language by providing that the HERA limits on new loan eligibility for 9.5 percent SAP take effect after December 30, 2010, for a lender that –

- Both on February 8, 2006 and in the quarter for which it claims SAP, was either a governmental entity or a non-profit organization not affiliated with a for-profit entity, and

- Held a portfolio of $100,000,000 or less that was eligible for, and was paid, SAP at the 9.5 percent rate, in the most recent payment made prior to September 30, 2006.

34 C.F.R. § 682.302(e)(5)(2006).

Finally, the statute and prior regulations use a few terms that have acquired a common meaning, but have not previously been explained in the regulations. The interim final rule adopts explanations of two commonly used terms – "originally-issued" obligation, and "refinancing" of a loan. 34 C.F.R. § 682.302(f)(2), (3)(2006).

- The term "originally issued" obligation was adopted in the HEA in 1993 to describe a bond issued to obtain funds to make or acquire loans, as opposed to a bond issued to refund another bond. The Department has implicitly interpreted the term in this way since 1993.
- The Department has used the term "refinancing" – with reference to a loan – since at least 1996 to describe the transfer of a loan as collateral from one bond to another. The Department considered this readily-recognized action – transfer of a loan as collateral – to provide a useful way to identify those transactions that are "refinancings" of loans.