Issue Paper 5
Session 2: February 17-19, 2016

Issue: Whether to revise the financial responsibility regulations, and whether to add disclosure requirements, to help protect students, the federal government, and taxpayers against potential school liabilities and risks.

Statutory cite: §§487(a) and (c), 498 of the Higher Education Act of 1965, as amended, 20 U.S.C. 1094(c), 1099c

Regulatory cite: 34 CFR Part 668 Subpart L, 34 CFR 668.41, and 668.90

Summary of Changes:

Under the HEA and the regulations in Subpart L, a school is financially responsible, in part, if it provides the administrative resources necessary to comply with the title IV program regulations and meets all of its financial obligations. In general, a school that is not financially responsible may (1) participate as a financially responsible school if it submits an irrevocable letter of credit (LOC) for an amount determined by the Secretary that is not less than 50% of the title IV funds it received during its most recently completed fiscal year, or (2) participate under a provisional certification and submit an LOC for an amount determined by the Secretary that is not less than 10% of the title IV funds it received during its most recently completed fiscal year.

We propose to amend the general financial responsibility standards in Subpart L to include actions and events that indicate or signal that (1) a school is likely to have to pay borrower defense claims, and (2) a school's ability to pay claims or continue its participation in the title IV programs is compromised. These actions and events would trigger a requirement that the school submit an LOC based on prior repayments or for an amount that is not less than 10%, for each action/event, of the amount of title IV, HEA program funds received by the school during the most recently completed award year. The Secretary may accept cash or agree to a set aside (reserve fund) in lieu of an LOC but for an equivalent amount. We are making conforming changes to Subpart G to update references in current regulations to refer as appropriate to Subpart L and to address the scope of appeals of financial responsibility determinations made under these revised regulations.

In addition, we are adding to the reporting and disclosure provisions in 34 CFR 668.41 a requirement that a school would have to warn enrolled and prospective students a) of any requirement to post a letter of credit to the Department or b) if it has poor repayment outcomes. Repayment rates could be calculated by evaluating the share of each borrower's debt that has been paid down over a period of five years and calculating the median rate of those borrowers. Assuming typical interest rates and a 20-year repayment period, a borrower would be expected to have repaid 15 percent of his original principal balance at the five-year mark. The threshold for the repayment rate could be set at 0 percent (below which the typical borrower is not repaying any of his principal balance within five years, i.e. is in negative amortization) or at 15 percent (below which the typical borrower is not repaying the expected amount within five years).

Changes: See attached regulatory language.

Subpart L Financial Responsibility

§668.171 General.

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

(2) ~~Administer properly the title IV, HEA programs in which it participates; and~~

~~(3)~~ Meet all of its financial obligations~~.~~; and

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

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

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

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

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

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

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

~~(4) The institution is meeting all of its financial obligations, including but not limited to—~~

~~(i) Refunds that it is required to make under its refund policy, including the return of title IV, HEA program funds for which it is responsible under §668.22; and~~

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

[see attached potential triggers]

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

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

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

(ii) Is not ~~in violation~~subject to a condition of ~~any past performance requirement under~~ §668.174.

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

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

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

(ii) Is not ~~in violation~~subject to a condition of ~~any past performance requirement under~~ §668.174.

(d) Audit opinions and past performance provisions. Even if an institution satisfies all of the general standards of financial responsibility under paragraph (b) of this section, the Secretary does not consider the institution to be financially responsible if—

(1) In the institution's audited financial statements, the opinion expressed by the auditor was an adverse, qualified, or disclaimed opinion, or the auditor expressed doubt about the continued existence of the institution as a going concern, unless the Secretary determines that a qualified or disclaimed opinion does not have a significant bearing on the institution's financial condition; or

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

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

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

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

§668.175 Alternative standards and requirements.

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

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

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

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

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

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

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

(2) Under this zone alternative, the Secretary—

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

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

(A) Any adverse action, including a probation or similar action, taken against the institution by its accrediting agency;

(B) Any event that causes the institution, or related entity as defined in the Statement of Financial Accounting Standards (SFAS) 57, to realize any liability that was noted as a contingent liability in the institution's or related entity's most recent audited financial statement;

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

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

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

(F) Any extraordinary losses, as defined in accordance with Accounting Principles Board (APB) Opinion No. 30.

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

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

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

(i) For any oversight or financial event described under paragraph (d)(2)(ii) of this section for which the institution is required to provide information, provide that information to the Secretary by certified mail or electronic or facsimile transmission no later than 10 days after that event occurs. An institution that provides this information electronically or by facsimile transmission is responsible for confirming that the Secretary received a complete and legible copy of that transmission; and

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

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

~~(e) Transition year alternative. A participating institution that is not financially responsible solely because the Secretary determines that its composite score is less than 1.5 for the institution's fiscal year that began on or after July 1, 1997 but on or before June 30, 1998, may qualify as a financially responsible institution under the provisions in §668.15(b)(7), (b)(8), (d)(2)(ii), or (d)(3), as applicable.~~

(e) (reserved)

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

(i) The institution is not financially responsible because it does not satisfy the general standards under §668.171(b) or because of an audit opinion described under §668.171(d); or

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

(2) ~~Under~~Except for a public institution, under this alternative, the institution must—

(i) ~~Submit~~For a violation of the general standards under §668.171(b)(x), submit to the Secretary cash or an irrevocable letter of credit that is acceptable and payable to the Secretary, for an amount determined by the Secretary that is not less than 10 percent of the title IV, HEA program funds received by the institution during its most recently completed fiscal year~~, except that this requirement does not apply to a public institution~~;

Note to negotiators: For each trigger or category of triggers, we would amend this section of the regulations to specify the amount of the LOC.

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

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

(3) If at the end of the period for which the Secretary provisionally certified the institution, the institution is still not financially responsible, the Secretary may again permit the institution to participate under a provisional certification, but the Secretary—

(i) May require the institution, or one or more persons or entities that exercise substantial control over the institution, as determined under §668.174(b)(1) and (c), or both, to submit to the Secretary financial guarantees for an amount determined by the Secretary to be sufficient to satisfy any potential liabilities that may arise from the institution's participation in the title IV, HEA programs; and

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

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(h) Set-aside. If an institution does not provide cash or the letter of credit for the amount required under paragraph (d) or (f) of this section within 30 days of the Secretary's request, the Secretary offsets the amount of title IV, HEA program funds that an institution has earned in a manner that ensures that by the end of a nine-month period, the total amount offset equals the amount of cash or the letter of credit the institution would otherwise provide. The Secretary maintains the amount of funds offset in a temporary escrow account, and either returns the funds to the institution when it is no longer subject to the letter of credit requirements under paragraph (d) or (f) of this section, or uses the funds to cover debts and liabilities owed to the Secretary.

§668.93 Limitation.

A limitation may include, as appropriate to the Title IV, HEA program in question—

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

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

§668.90 Initial and final decisions.

(a)(1) * * *

(2) The hearing official's initial decision states whether the imposition of the fine, limitation, suspension, or termination sought by the designated department official is warranted, in whole or in part. If the designated department official brought a termination action against the institution or servicer, the hearing official may, if appropriate, issue an initial decision to fine the institution or servicer, as applicable, or, rather than terminating the institution's participation or servicer's eligibility, as applicable, impose one or more limitations on the institution's participation or servicer's eligibility.

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

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

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

(iii) ~~If~~In an action brought against an institution or third-party servicer that involves its failure to provide ~~surety~~a letter of credit or other financial protection in the amount specified by the Secretary under §668.15 or subpart L of part 668, the hearing official finds that the amount of the ~~surety~~letter of credit or other financial protection established by the Secretary ~~was~~is appropriate, unless the institution can demonstrate that the amount was ~~unreasonable;~~not warranted because—

(A) The events or conditions identified by the Secretary as the grounds on which the protection is required no longer exist or have been resolved in a manner that eliminates the risk they posed to the institution's ability to meet its financial obligations; or

(B) The institution has proffered alternative financial protection that provides students and the Department adequate protection against losses resulting from the risks identified by the Secretary. Adequate protection consists of one or more of the following–

(1) A deposit with the Secretary of cash or a cash equivalent in the amount of financial protection demanded by the Secretary to be held by the Secretary in escrow; and

(2) An agreement with the Secretary that a portion of the funds earned by the institution under a reimbursement funding arrangement will be temporarily withheld in such amounts as will meet, by the end of a nine-month period, the amount of the required financial protection demanded;

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

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

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

(1) Upon proof of the conditions in §668.174(a), the hearing official finds that the limitation or termination is warranted unless the institution demonstrates that all the conditions in §668.175(f) have been met; and

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

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Potential Triggers for an LOC

Automatic triggers: Any of the following events or actions would automatically require a school to submit an LOC. The amount of the LOC would be (A) based on prior debts or repayments or (B) for each triggering event, at least 10% of the amount of title IV, HEA programs funds received by the school during its most recently completed fiscal year.

A: Prior debts and repayments: For these triggers, the amount of the LOC would be the total amount of associated debts and repayments for the school's prior three years' experience for each trigger.

- The school is required to repay the Secretary for losses from borrower defense claims
- The school is required to repay a debt or liability arising from an audit, investigation, or review conducted by a State or Federal entity, or accrediting agency, or the school resolves or settles a suit brought against it by that entity for violations of State or Federal law, regulations, or accreditation standards

B. Other actions or events: A school would be required to submit an LOC of at least 10% for each of the following triggers if it:

- Violates any existing loan agreement
- Fails to make a payment in accordance with existing debt obligations for more than 120 days
- Is not making refunds that it is required to make under its refund policy, including the return of title IV, HEA program funds for which it is responsible under §668.22
- Is required to repay the Secretary for debts and liabilities arising from its participation in the title IV, HEA programs
- At any time during the prior three years, its accrediting agency issued a show cause order or placed the school on probationary status, or the school was subject to a final decision by its accrediting agency to deny, withdraw, suspend, revoke, or terminate its accreditation or pre-accreditation
- As provided under §668.28(c), for its most recently completed fiscal year, the school did not derive at least 10 percent of its revenue from sources other than title IV, HEA program funds
- As determined under subpart N of this part, the institution's two most recent cohort default rates are 30 percent or greater
- Had its stock delisted involuntarily from the exchange on which the stock was traded, or the Securities and Exchange Commission (SEC) suspended trading on the institution's stock
- Fails to file a required annual or quarterly report with the SEC
- Discloses or is required to disclose in a report filed with the SEC an adverse action taken by a State or Federal entity
- Discloses or is required to note as a contingent liability in its audited financial statements any loss stemming from a State or Federal action that is possible or probable, or any event that causes the school, or related entity, to realize any liability that was previously noted as a contingent liability in the school's or related entity's audited financial statements

- If more than 50% of the students enrolled at the school are enrolled in gainful employment programs, as determined annually by the Secretary, and the number of students enrolled in GE programs that are passing under the D/E rates measure in §668.403(c) is less than 50% percent of the total number of students enrolled in all GE programs at the school
- Is being sued, or was sued during the prior 3 years, by one or more State or Federal entities
- If it is not financially responsible in a manner that results in any withdrawal of owner's equity from the school by any means, including by declaring a dividend

Discretionary triggers: The Secretary would have discretion to require a school to submit an LOC of at least 10% for any factor that is reasonably likely to have a material adverse effect on the financial condition, business, or results of operations of the school, including but not limited to whether the school:

- Has a significant number of outstanding or pending borrower defense claims
- Experiences in any year for which a determination is made, a significant fluctuation in Federal Direct Student Loan volume, or Federal Pell Grant award volume, or any combination thereof, compared to the year prior to such year, that cannot be accounted for by changes in the Federal Direct Student Loan program, the Federal Pell Grant program, or any combination thereof
- Is reported to have deficiencies or financial aid problems by the State licensing or authorizing agency, or by the appropriate accrediting agency or association
- Experiences high annual dropout rates

§668.41 Reporting and disclosure of information.

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(h) Enrolled students and prospective students—loan repayment rates and irrevocable letters of credit.

(1) An institution must, upon notification by the Secretary of a Federal student loan repayment rate of less than [0 percent or 15 percent] in any given year, and/or a requirement to post an irrevocable letter of credit, make disclosure of the applicable rate or irrevocable letter of credit to prospective and enrolled students.

(i) Repayment rate. Such repayment rate will be defined as the median proportion in reduction of the original principal balance of a school's borrowers between the date that borrowers enter repayment and the end of the fifth fiscal year from that date. The Secretary will determine the exclusions used in the calculation and the exact period of measurement for the calculation. Borrowers who are in default at the time of measurement will not be considered as having paid down the balance of their loans.

(2) Delivery to enrolled students. (i) An institution must provide the disclosures required by paragraph (h)(1) of this section by means of a notice in writing to each enrolled student no later than 30 days after being informed by the Secretary of its student loan repayment rate, and/or a requirement to post an irrevocable letter of credit by—

(A) Hand-delivering the disclosure notification as a separate document to the student individually or as part of a group presentation; or

(B) Sending the disclosure notification to the primary email address used by the institution for communicating with the student about the program; or

(ii) If the institution sends the disclosure notification by email, the institution must—

(A) Ensure that the disclosure notification is the only substantive content in the email;

(B) Receive electronic or other written acknowledgement from the student that the student has received the email;

(C) Send the disclosure(s) using a different address or method of delivery if the institution receives a response that the email could not be delivered; and

(D) Maintain records of its efforts to provide the required disclosure notification.

(3) Delivery to prospective students. (i) An institution must provide the disclosure required by paragraph (h)(1) of this section to each prospective student at the first contact between the institution and the student by—

(A) Hand-delivering the disclosure notification as a separate document to the prospective student individually, or as part of a group presentation; or

(B) Sending the disclosure notification to the primary email address used by the institution for communicating with the prospective student.

(ii) If the institution sends the disclosure notification to the prospective student by email, the institution must—

(A) Ensure the disclosure notification is the only substantive content in the email;

(B) Receive electronic or other written acknowledgement from the prospective student that the student has received the email;

(C) Send the disclosure notification using a different address or method of delivery if the institution receives a response that the email could not be delivered; and

(D) Maintain records of its efforts to provide the required disclosure notification.