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Money for Nothing

Skyrocketing Waste
of Tax Dollars
on Student Loan Companies'
Scheme

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Executive Summary

A special class of student loans—financed by tax-exempt bonds issued before October 1993—has become a goldmine for the companies that now hold them. Even while borrowers pay today’s low, market interest rate of 3.37 percent, loans financed with these bonds are guaranteed an interest rate return of 9.5 percent for the companies that hold them, courtesy of the U.S. Treasury. The number and dollar value of pre-1993 student loans should be relatively small and dwindling thanks to a 1993 law ending them. However, new data acquired from the U.S. Department of Education reveal that these “old” loans are very much alive—and they are multiplying rapidly, in plain sight of federal regulators.

At the start of 2003 there was \$12 billion of 9.5 percent loans outstanding. Eighteen months later there is more than \$17 billion, an increase of 43 percent. Federal payments to the bondholders nearly doubled over the same period. Lenders are exploiting a federal rule that says even if a pre-1993 bond finances a loan only temporarily, that loan earns a 9.5 percent guaranteed return for life. Lenders use the bond funds to finance a set of loans for as little as one day, then shift them into other portfolios where they still earn the 9.5 percent interest. This allows a new set of loans to be financed with the bond funds and then shifted, as the process repeats over and over and over.

Even if this growth is stopped immediately, federal payments to the companies holding these loans will total an estimated \$6 billion or more over the life of the loans. Congressional leaders promise to curb the practice, but not until they renew the Higher Education Act . . . next year. If that delay is allowed to occur, the drain from the U.S. Treasury will approach \$9 billion.

Documents obtained through the Freedom of Information Act show that Department officials knew of lenders’ plans to take advantage of this loophole in June, 2003, or earlier, yet they did nothing to stop the

scheme. The president of the company that has most aggressively abused the 9.5 percent loophole is well-connected. He was appointed by the U.S. Secretary of Education to a committee that advises the Department and the Congress on student loan policy.

U.S. taxpayers are paying big money for nothing. All across the nation, the doors to a college education are slamming shut in the face of budget cuts and tuition increases. Students need these funds. The \$9 billion in taxpayer funds that that will be paid to student loan companies for these 9.5 percent loans could pay, instead, for a nearly \$2,000 grant to every low-income student in college today.

Recommendations in brief:

The Secretary of Education should take immediate action to halt and reverse the explosive growth in 9.5 percent loans. His first step should be to publish a clarification—tomorrow—that prohibits the serial refinancing of loans, and limits the volume of 9.5 percent loans to the size of the original tax-exempt bond.

The Secretary of Education should prepare to convert any remaining 9.5 loans to regular loans. This may require requesting new, emergency authority from Congress before the end of this legislative session.

Congress should refocus tax-exempt bond authority on areas of national need, such as school construction and low-income housing.

Congress and the Administration should restructure the student loan program so that it takes advantage of market forces in the determination of government subsidies for intermediaries.

Introduction to the Guaranteed Student Loan Program

Rather than setting aside a particular amount of money, entitlement programs allow the government to promise a benefit to a class of people or corporations no matter how many of them show up to claim it. The advantage of entitlement programs is that the beneficiaries can be told what they will get even when the government can't possibly know how many beneficiaries there will be. The downside is that the programs can cost much more than expected, either because there are more beneficiaries than predicted, or—of greater concern—because someone figures out how to exploit the design of the program.

At the time the Guaranteed Student Loan Program (now known as the Federal Family Education Loan Program, or FFELP) was created, federal budgeting procedures made it difficult for Congress to promise loans directly to students. Instead, Congress created entitlements for banks and other intermediaries—promising them certain types of payments if they made loans to eligible students.¹ This indirect structure created two problems. First, not all of the students who Congress intended to help were able to get the promised aid. Second, the rules, payments, and structures that Congress created to fill the gaps just made the program more complicated and vulnerable to abuse.

Today in the student loan program, thousands of corporate and government entities enjoy, by law, a contractual right of payment from the U.S. government—all part of the effort to lubricate the system with enough cash so that students ultimately get the loans they need. The current entitlements include the following:

- Thirty-six federally-backed “guarantee agencies” are entitled to a .4% “loan processing and issuance fee,” paid by the federal government. These agencies are also entitled to a .1% “account maintenance fee,” paid by the federal government, and they have the legal authority to charge students a 1% “guarantee fee.”
- Thousands of banks and secondary markets (which purchase loans from banks) are entitled to quarterly returns equal to the rates on commercial paper plus 2.34 percentage points during repayment and plus 1.74 percentage points during the in-school and grade period, assured by the federal government.
- If a borrower’s payments are late, the guarantee agency has an opportunity to encourage the borrower to make a payment. If successful, the agency is entitled to a 1% “default aversion fee.”
- If the borrower defaults, the lender or secondary market is entitled to receive a minimum payment of 98% of the principal and interest.
- If a loan defaults, the guarantee agency is entitled to keep 28% of any amounts it is able to collect.

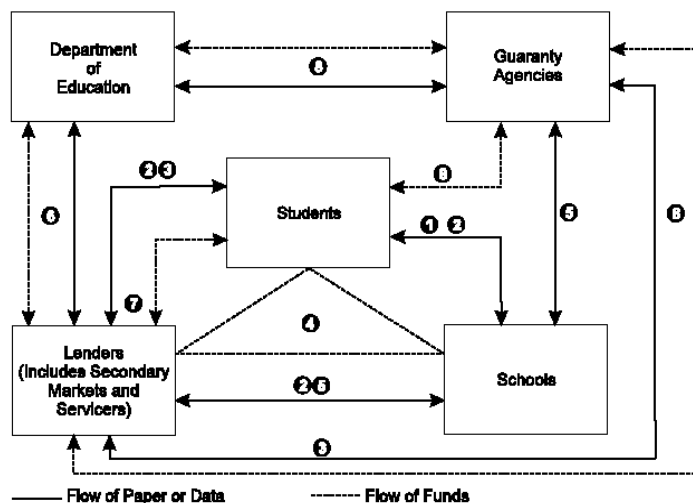
All of these provisions—and more—are set and adjusted through the political process, without the benefit of competitive market forces or even a regulatory check.

This patchwork quilt system leads to a second problem: unanticipated loopholes, requiring legislative repairs that further complicate the system. Over the years, the troubles have included lenders that timed their requests for federal payments in order to hide high default rates, guarantee agencies that had conflicts-of-interest with board members and affiliates, and schools that used multiple intermediaries in order to mask large increases in loan volume. All of these situations cost taxpayers. In one case, the collapse of a guarantee agency led to an expensive federal taxpayer bailout.²

The Government Accountability Office (known then as the General Accounting Office) has repeatedly labeled student aid as a creating a high risk of waste, fraud, abuse, and mismanagement.³ President Bush’s budget office describes the FFEL program as structurally flawed, with “unnecessary subsidies” and questionable cost effectiveness.⁴

Complicated Processes, Structural Flaws, and Management Shortcomings Cause Student Aid Program Problems

Figure 2: Applying for and Repaying an FFELP Loan



Source: U.S. General Accounting Office, *High-Risk Series: Student Financial Aid*, February 1997.

Tax-Exempt Student Loan Bonds: Not as Simple as Expected

As part of the effort in the 1970s to ensure that loans would be available for all eligible students, provisions were included in the Tax Reform Act of 1976 to encourage states to issue tax-exempt student loan bonds. In the years that followed, states established more than 30 student loan authorities. These authorities sell both tax-exempt and taxable bonds and use the proceeds to make loans to students. Investors are repaid with interest when students repay their loans. Authorities also buy loans from banks to encourage them to make new loans, instead of lending directly to students, and thereby encourage banks to make new loans to new students.

Like municipal bonds used to build roads, schools, and public housing, investors' interest income from tax-exempt student loan bonds is not subject to federal income taxes. As a result, investors accept lower interest rates, reducing state borrowing costs below market rates. In the 1990s, interest rates on tax-exempt bonds were about 25 percent lower than rates on equivalent corporate (taxable) bonds.⁵ The tax exemption for student loan bonds will cost the U.S. Treasury an estimated \$2 billion over the next five years.⁶

Congress did not intend for the student loan bonds to be immensely profitable—only profitable enough so that states would participate. But almost immediately after they were created in 1976, the bonds were earning huge profits for the loan authorities. Ever since, the Federal government has been trying to rein in the problem, but the efforts have often failed or even backfired, compounding the initial error.

The 1980 attempt at reform. In the 1976 legislation, Congress made states eligible for full federal subsidy payments, the same as all other student loan providers, even though the loan authorities would have the advantage of raising capital to be lent out to students from low-cost, tax-exempt bonds. Congress also gave states relief from the “arbitrage” tax rules. Typically, the federal government limits state profits on tax-exempt bonds by requiring state and local governments to rebate excess returns (above 2 percentage points for student loan bonds) to the federal government. However, in 1976 Congress excluded the federal payments from the arbitrage calculation. Legislators were apparently concerned that lenders

would not be able to cover administrative expenses without these special exceptions.⁷

Before long, states were issuing bonds at 6 percent interest while earning up to 16 percent interest on student loans. A Congressional Budget Office (CBO) study predicted that the bonds would cost taxpayers as much as \$500 million a year, including both tax benefits and federal interest payments. It noted that Congress could cut subsidies to eliminate surplus profits, while still allowing states to cover the costs of student loans.⁸

In 1980, Congress did just that. It halved federal subsidy payments to lenders on loans funded with tax-exempt bonds. States argued, however, that they make long-term commitments to bondholders. If interest rates dropped too low, they said the student loans would not bring in enough income to make payments on the bonds and to cover administrative expenses. So Congress guaranteed a minimum return of 9.5 percent. The 1980 formula cut subsidies in times of high interest rates. In 1979, lenders had received a 13.5 percent return. If the 1980 formula had been in effect a year earlier, it would have cut returns on these loans from 13.5 percent to 10.25 percent (see box).

The 1980 reforms were inadequate. A follow-up CBO study in 1986 found that “profits on bond issues... may still far exceed the needs of the state authorities operating student loan programs.” The 1986 CBO study concluded that student loan authorities were “substantially more profitable” than commercial banks. Between 1982 and 1985, commercial banks earned a guaranteed return on student loan assets that ranged from 0.53 percent to 0.7 percent. Student loan authorities' profits were several times higher, routinely exceeding 2 percent and reaching as high as 7.17 percent.⁹ More legislation was needed to eliminate wasted taxpayer dollars.

How the 1980 Formula Works

Intended to Cut Lender Subsidies, It Created a Windfall

In the guaranteed student loan program, lenders receive interest payments from both students and the government. Under the 1980 law, the government payments (known as “special allowance payments”) assured lenders a quarterly return on their guaranteed student loans equal to the average bond-equivalent yield on 91-day Treasury bills plus 3.5 percentage points. Any quarter when borrower payments were insufficient, the government would make up the difference. (Loans made today receive the 91-day commercial paper rate plus 2.34 percentage points during repayment.)

For loans backed by tax-exempt bonds, the 1980 formula cut subsidy payments in half but guaranteed at least a 9.5 percent return. In other words, lenders receive the greater of either (a) one-half the regular subsidy payments or (b) the amount necessary to provide a 9.5 percent return.

Example 1: In times of high interest rates, the formula reduces subsidies. Under interest rates prevalent in 1979, the new formula cuts lender returns from 13.5 percent to 10.25 percent.¹⁰

	<u>Regular Loans:</u>	
Student Rate	Special Allowance:	Lender Return:
7.0%	6.5%	13.5%
	<u>Loans Made with Tax-Exempt Bonds:</u>	
	Special Allowance:	Lender Return:
	3.25%	10.25%

Example 2: But with the lower rates that have been more typical in recent years, the 9.5 percent floor creates windfall profits. In the second quarter of 2004, regular loans earned a 3.57 percent return, including only 0.15 percentage points in federal subsidies. Loans eligible for the 9.5 percent floor collected 25 times more in federal subsidies.¹¹

	<u>Regular Loans:</u>	
Student Rate	Special Allowance:	Lender Return:
3.42%	0.15%	3.57%
	<u>Loans Made with Tax-Exempt Bonds:</u>	
	Special Allowance:	Lender Return:
	6.08%	9.5%

The 1993 Attempt to Repeal 9.5 Loans. In early 1993, the borrower interest rate on regular new student loans fell to 6.15 percent, highlighting the absurdity of guaranteeing a 9.5 percent return on tax-exempt loans.¹² Congress decided to try again to fix the problem. The Omnibus Budget Reconciliation Act of 1993 eliminated the 1980 formula for all loans financed with new student loan bonds. However, responding to arguments that bond investors need stable, assured returns, it kept the 1980 formula for loans backed by existing bonds, including loans made with collections from earlier loans. It seemed like a limited liability, confined only to pre-existing bonds, and involving non-profit and government entities.

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HIGHER EDUCATION ACT OF 1965

Sec. 438

(2) RATE OF SPECIAL ALLOWANCE.—(A) Subject to subparagraphs (B), (C), (D), (E), (F), (G), (H), and (I) and paragraph (4), the special allowance paid pursuant to this subsection on loans shall be computed (i) by determining the average of the bond equivalent rates of 91-day Treasury bills auctioned for such 3-month period, (ii) by subtracting the applicable interest rate on such loans from such average, (iii) by adding 3.10 percent to the resultant percent, and (iv) by dividing the resultant percent by 4. If such computation produces a number less than zero, such loans shall be subject to section 427A(f).¹

(B)(i) The quarterly rate of the special allowance for holders of loans which were made or purchased with funds obtained by the holder from the issuance of obligations, the income from which is exempt from taxation under the Internal Revenue Code of 1954 shall be one-half the quarterly rate of the special allowance established under subparagraph (A), except that, in determining the rate for the purpose of this division, subparagraph (A)(iii) shall be applied by substituting “3.5 percent” for “3.10 percent”. 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 interests 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. This subparagraph shall not apply to loans which were made or insured prior to October 1, 1980.

(ii) The quarterly rate of the special allowance set under division (i) of this subparagraph shall not be less than 9.5 percent minus the applicable interest rate on such loans, divided by 4.

(iii) No special allowance may be paid under this subparagraph unless the issuer of such obligations complies with subsection (d) of this section.

(iv) 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, 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.

(C)(i) In the case of loans made before October 1, 1992, pursuant to section 428A or 428B for which the interest rate is determined under section 427A(c)(4), a special allowance shall not be paid unless the rate determined for any 12-month

¹ So in law. Should refer to section 427A(i).

The 1993 provisions, still in effect today. A much simpler program when it was first enacted in 1965, the guaranteed student loan program now runs 164 pages of confusing text.

Two Loopholes, Working Together

Despite Congress's intention to end the special treatment of tax-exempt bonds, the way the Department implemented the grandfather clause for pre-existing bonds ended up having the opposite effect by (1) giving them extended lives, and (2) allowing them to grow without limit.

Loophole 1. Extended Life: If you refinance an old bond, it's still an old bond, but with a longer life. The first issue was the definition of bonds "originally issued" before 1993. This grandfather clause has been interpreted to allow the serial refinancing of pre-1993 bonds, preserving the 9.5 percent guarantee. In a "Dear Colleague" letter advising lenders of the provisions of the new law, the Department said that:

The minimum special allowance rate "floor" on new loans made or purchased, in whole or in part, with funds derived from tax-exempt obligations has been repealed. Accordingly, loans made or purchased with funds obtained by the holder from the issuance of obligations originally issued on or after October 1, 1993, or with funds derived from default reimbursements, collections, interest, or other income related to eligible loans made or purchased with such tax-exempt funds, no longer qualify to receive the minimum special allowance. *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.*¹³

Lenders have interpreted this clause as giving them an open-ended ability to give the old bonds new life as they near the end of their term, *ad infinitum*. The language is not exactly clear, and it was not a regulation, so it could be clarified or reversed by the Secretary with a simple letter. But so far that has not happened. As a result, what Congress clearly intended as a short-lived grandfather clause is being used by lenders as an open-ended loophole. Student loan companies are prolonging the life of their pre-1993 bonds, limited only by applicable state laws, to maximize interest payments from U.S. taxpayers.

Loophole 2. Allowing Growth: Even if a tax-exempt bond finances a loan only temporarily, that loan is permanently treated as if it was

financed by a tax-exempt bond. The second question was this: If a loan is purchased with pre-1993 bond funds, and then is acquired using other funds controlled by the same entity, does the loan retain the subsidy structure required for the pre-1993 bond funds? This question had actually been answered before the 1993 grandfathering occurred. New regulations issued in the final days of the first Bush Administration declared a loan funded through tax-exempt bonds would continue to be treated as if it was funded by tax-exempt bonds even after "the loan is pledged or otherwise transferred in consideration of funds derived from sources other than" tax-exempt bonds.¹⁴ The passage of the 1993 legislation certainly would have given the Department basis to revise the regulation. But in response to questions from lenders in 1996, the Department of Education affirmed the 1992 rule:

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).

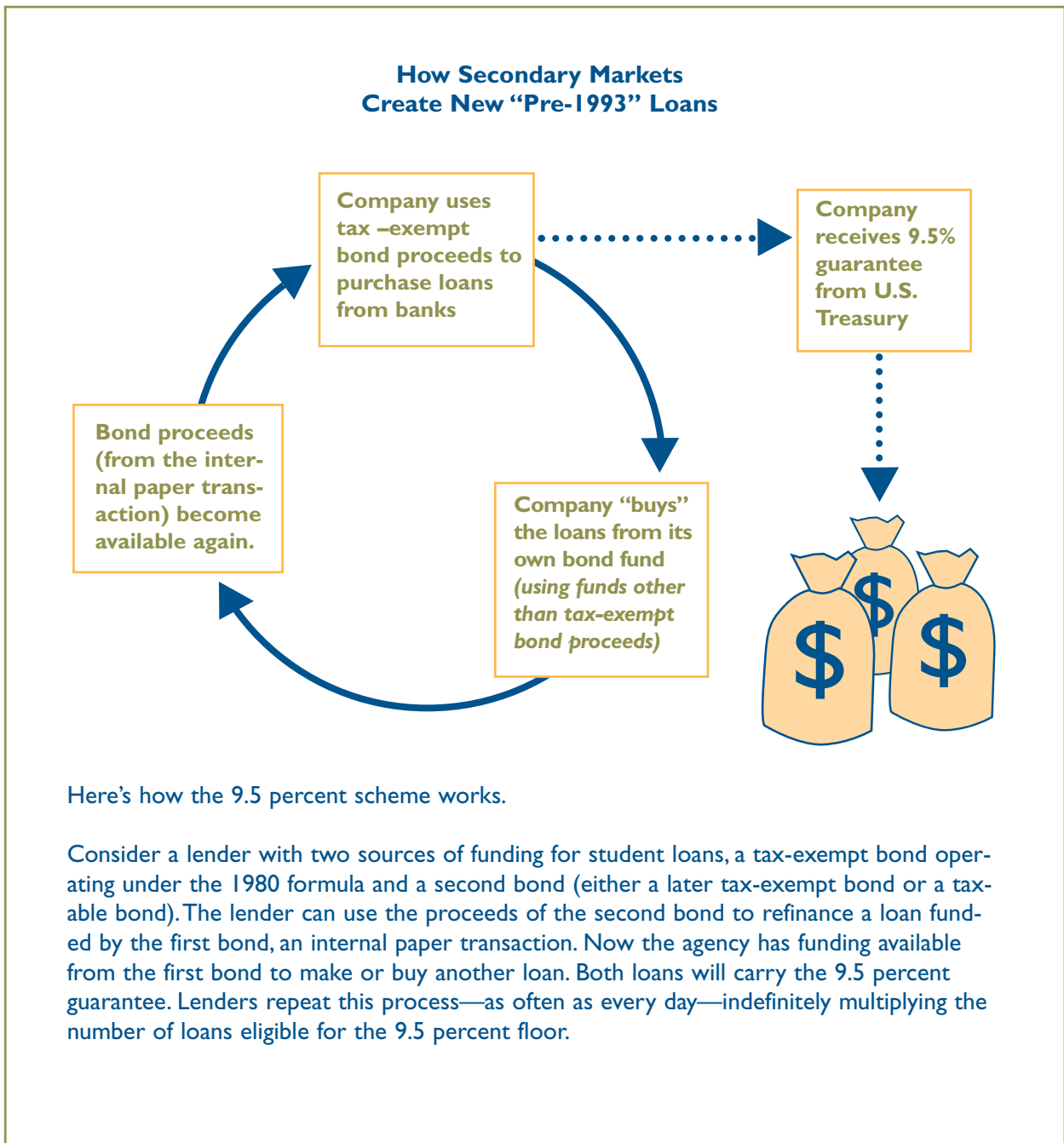
*This change is effective as of the effective date of the 1992 regulations, February 1, 1993, and applies to all loans transferred from a tax-exempt obligation to a taxable obligation on or after that date.*¹⁵

On this issue, the Department was between a rock and a hard place. Recall that a pre-1993 loan financed with tax-exempt bonds could receive only *half* of the special allowance that a regular loan qualified for (see Example 1 in the description of the 1980 formula). If the Department had reversed the 1992 regulation, then in times of high interest rates the loan companies would move loans out of the tax-exempt category in order to get the higher special allowance payment. In hindsight, that would have been a much smaller federal liability than we are now facing. But at the time, requiring them to abide by the 1992 rule was a logical way to prevent one type of potential abuse.

While the 1996 letter closed one potential loophole, it opened the door to another one that became very profitable as interest rates dropped: Lenders might use internal paper transactions to infinitely increase

the volume of student loans eligible for the guaranteed 9.5 percent floor. In the lenders' interpretation, if a guaranteed loan is ever held, even for just a day, with the proceeds from these tax-exempt bonds, it keeps the 9.5 percent guarantee for the rest of its life (as long as the original tax-exempt bond is outstanding, an issue addressed by the first loophole, allowing for "refinancing" of pre-1993 bonds).

For several years the second loophole lay mostly dormant. After the 1996 letter, total tax-exempt bonds hovered in the \$11 to \$12 billion range, suggesting that lenders were taking advantage of the first loophole—refinancing—but were not abusing the second potential loophole by multiplying their holdings.



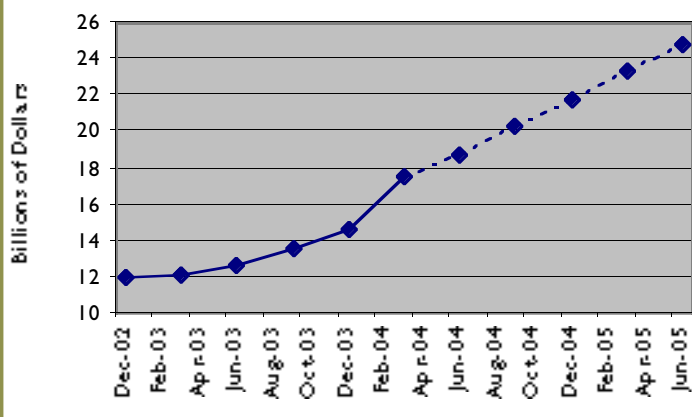
A Warning, and Then an Explosion of Pre-1993 Tax-Exempt Loan Volume

Documents obtained through the Freedom of Information Act show that Department officials knew of lenders' plans to take advantage of the growth loophole. On May 29, 2003, Nelnet Education Loan Funding, Inc., sent a letter to the Department of Education describing its intention to bill the government for interest on loans that were held only temporarily—as little as one day—by financing accounts that would earn the loans permanent 9.5 percent status. The letter, which included a schematic, indicated that the company had already discussed the plan with Department officials (see Appendix for a copy of the letter).

Rather than stop the problem before it started, the Department did not respond to the letter, and proceeded to pay the interest subsidies on the growing portfolios of 9.5 percent loans. By December 31, 2003, the total payments demanded by lenders had jumped 37 percent over amounts just six months earlier. The federal payments soon topped \$200 million in a single quarter, more than had been paid in an entire year during the 1990s. By the end of June of this year—13 months after the Department was warned—the volume of 9.5 percent loans had grown from \$12,159,153,575 to \$17,233,723,480, an increase of 42 percent.

The Department has done nothing to stop the rapidly increasing and completely unnecessary taxpayer costs of 9.5 percent loans. Indeed, the Department did not respond to the Nelnet letter for more than a year. But Nelnet needed to be able to tell cautious investors that the government-guaranteed 9.5 percent interest was for real. Even while the Department paid the bills sent by Nelnet, the company set aside the money, not counting it as earnings until it could get some type of confirmation from the Department that the invoices would not later be challenged.

Actual and Projected "Pre-1993" Loans Earning 9.5 Percent Government-Guaranteed Interest



On June 30, 2004, the Department replied to Nelnet with a brief letter that referred to the regulations and the 1996 Dear Colleague letter, without suggesting that there was anything fishy about Nelnet's plans. Two days later Nelnet reported to its investors that it would recognize the previously deferred income:

After consideration of certain clarifying information received in connection with the guidance it had sought, Nelnet has concluded that the earnings process has been completed. The company is recognizing the related income for the current period, and will recognize the related income for subsequent periods as earned.¹⁶

The news led Credit Suisse First Boston to upgrade its rating on Nelnet stock. Nelnet's stock price shot up more than 20 percent, and the company paid its employees \$20.7 million in bonuses.

Who Are We Paying and How Much Will It Cost Us?

Originally, all of these tax-exempt bonds were sold under the auspices of a state agency or a non-profit organization designated by a state. But since 1997, student loan charities have been allowed to sell their assets to for-profit entities, as long as the money from the sale is applied to charity (such as the creation of a grant-making foundation like the Nellie Mae Foundation). Through that process, some tax-exempt bonds are now owned by for-profit lenders. Even the bonds owned by so-called non-profits are not necessarily used for charitable purposes. While not true of all of the non-profit lenders, many of them have drifted from their public agency moorings and are not held accountable to the public.

Top 15 Holders of 9.5% Loans	Volume on June 30, 2004	Increase since Jan. 1, 2003
NELNET	\$3,444,525,936	818%
PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AUTHORITY	\$2,046,747,365	63%
SALLIE MAE	\$2,027,955,150	-18%
KENTUCKY HIGHER EDUCATION STUDENT LOAN CORPORATION	\$978,184,666	626%
CALIFORNIA HIGHER EDUCATION LOAN AUTHORITY	\$948,933,473	-22%
EDUCATIONAL FUNDING OF THE SOUTH (TENNESSEE)	\$836,143,174	1%
IOWA STUDENT LOAN LIQUIDITY CORP	\$706,512,283	92%
ARIZONA EDUCATION LOAN MARKETING-AELMAC	\$657,591,646	116%
VERMONT EDUCATION LOAN FINANCE PROGRAM	\$608,988,900	65%
NORTH TEXAS HEA	\$533,978,757	44%
PANHANDLE PLAINS HEA (TEXAS)	\$512,275,257	167%
UTAH STATE BOARD OF REGENTS	\$509,614,754	42%
MICHIGAN HIGHER EDUCATION STUDENT LOAN	\$489,440,209	-3%
BRAZOS GROUP (TEXAS)	\$467,932,440	65%
SOUTH CAROLINA STUDENT LOAN CORPORATION	\$284,444,600	31%

In only 18 months, Nelnet—the lender that has exploited 9.5 percent loans more aggressively than any other—increased its 9.5 percent holdings nearly tenfold from \$376 million in mid-2002 to \$3.6 billion in early 2004. In the year since Nelnet told the Department of Education that it would be exploiting the loans, the company has billed taxpayers for \$137 million in interest payments above the rates the borrowers are already paying.

NELNET FACTS

- Nelnet was formed in 1998 when the non-profit loan company NebHelp, led by Don R. Bouc, was sold to a new, closely-held company. When a reporter at the *Omaha World-Herald* started probing the deal, he got the run-around, as attorneys for the new company refused to say who its owners were. Later, the newspaper found records listing Nelnet’s sole officer and director as Don Bouc of Lincoln, the former president of NebHelp, which, as a tax-exempt, charitable organization, is not supposed to enrich its leaders.¹⁷
- Nelnet’s co-CEOs Stephen Butterfield and Michael Dunlap were each paid \$1.1 million in 2003. In addition, Nelnet paid its chief information officer \$1.3 million, and an executive director almost \$1 million.¹⁸
- Nelnet is second only to Sallie Mae in lender campaign contributions to the two congressmen in charge of higher education. Union Bank and Trust of Lincoln, which is closely affiliated with Nelnet, ranks fifth.²⁰
- Appointed by the Secretary of Education, Nelnet President Don Bouc serves on a federal panel that advises Congress and the Department of Education on student aid policy

The Secretary of Education needs to say “Stop.” The rules that the Education Department wrote are now having the opposite effect of what Congress intended in 1993. It is the agency’s rules that created the loopholes; it is the agency’s responsibility to fix them. Waiting for Congress to overturn the Department of Education is unnecessary, irresponsible, and costly.

Clarifying the rules is the first step. But if the reforms stop there, taxpayers could still be out billions of dollars. To estimate the costs, we used Congressional Budget Office projections of interest rates, and made

Federal payments to lenders if the Scheme is Ended Immediately	Federal payments to lenders if the Scheme Continues Until 2005
\$6,059,216,327	\$8,888,537,806

assumptions about the proportion of consolidation and regular loans that would be in the portfolio. We assumed that the total volume would be paid off in 15 years..

These costs can be reduced, but only if the Secretary and Congress take the actions we are recommending.

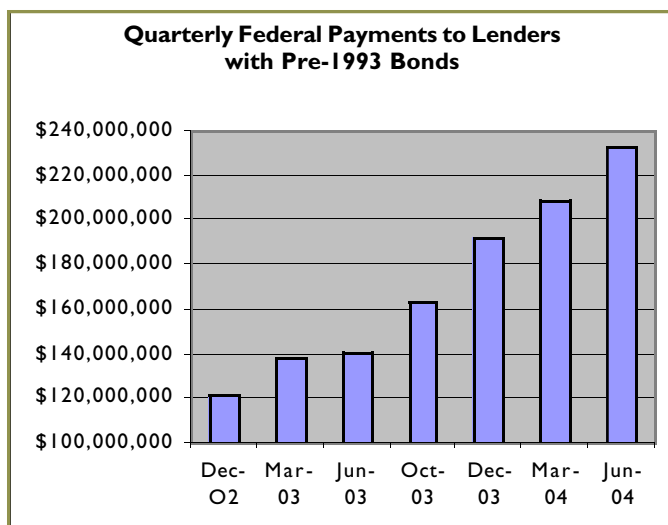
Recommendations

Each day of delay increases the federal deficit, wasting money that could be used help low-income students attend college. Immediate action to stem the waste of federal funds is an imperative.

The Secretary of Education should take immediate action to halt and reverse the explosive growth in 9.5 loans. His first step should be to publish a clarification—tomorrow—that prohibits the serial refinancing of loans and limits the volume of 9.5 percent loans to the size of the original tax-exempt bond. It is an outrage that this was not done 14 months ago when it was clear that the treasury was about to be raided. Every day of delay allows more loans to be converted to 9.5 percent loans.

The Secretary of Education should prepare to convert any remaining 9.5 loans to regular loans. This may require requesting new, emergency authority from Congress before the end of this legislative session. Even with congressional action it may not be possible to force the secondary markets to give up their 9.5 paper. If that is the case, the Secretary could offer incentives to borrowers to refinance into a portfolio that is then sold, or into the Direct Loan Program.

Congress should refocus tax-exempt bond authority on areas of national need, such as school construction and low-income housing. There is no longer a need for a tax-based subsidy to



increase the supply of student loans—a subsidy that will cost the U.S. Treasury an estimated \$2 billion over the next five years.²¹ There is no lack of capacity in the student loan market. Tax-exempt student loan bonds also represent a lost opportunity for state governments because each state can issue only a limited number of tax-exempt bonds. These resources would be better spent on more urgent public purposes, such as building affordable housing, repairing and expanding transportation, and modernizing crumbling school buildings.

Congress and the Administration should restructure the student loan program so that it takes advantage of market forces in the determination of government subsidies for intermediaries. The Direct Student Loan Program—which uses highly efficient Treasury auctions for the acquisition of loan capital and uses competitive contracting for servicing and collection—is one such approach.

FOOTNOTES

¹ When Congress started guaranteeing student loans in 1965, placing the full faith and credit of the United States behind a bank loan appeared to have no cost at all, because the defaults and interest subsidies would occur in later years and be someone else's problem. A direct loan, on the other hand, would appear as a 100% loss even though some of all of it would be repaid later. According to GAO, this budgeting procedure "distorted costs and did not recognize the economic reality of the transactions." So in 1990, President George H.W. Bush signed the Credit Reform Act, requiring government loan programs—whether guarantees of commercial loans, or loans made directly from a federal agency—to account for their full long-term expenses and income.

² See, for example, the Nunn Committee's hearings in 1990, "Abuses in Federal Student Aid Programs," S. Hrg. 101-659, Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate.

³ General Accounting Office, *High Risk Series: An Update*, January 2003.

⁴ Office of Management and Budget, FY2005 Budget: Program Assessment Rating Tool, U.S. Department of Education, page 34, 2004.

⁵ Congressional Research Service, 2002.

⁶ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008*, December 22, 2003.

⁷ Student loan bonds also received an exception from the rule that repayments of tax-exempt bonds cannot be directly or indirectly guaranteed by the federal government. See Internal Revenue Code subsections 144(b) and 148(g); Internal Revenue Service, *Tax Exempt Private Activity Bonds Compliance Guide*, undated, and Congressional Research Service, "9.5 Percent Floor Loans," October 8, 2003.

⁸ Congressional Budget Office, *State Profits on Tax-Exempt Student Loan Bonds: Analysis and Options*, March 1980.

⁹ Congressional Budget Office, *The Tax-Exempt Financing of Student Loans*, August 1986.

¹⁰ Author's calculations based on Congressional Budget Office, *State Profits on Tax-Exempt Student Loan Bonds: Analysis and Options*, March 1980.

¹¹ Author's calculations based on U.S. Department of Education, "Federal Family Education Loan Program Special Allowance Rates for the Quarter Ending June 30, 2004," July 6, 2004.

¹² General Accounting Office and U.S. Department of Education, *Final Report Regarding the Findings of the Study Group on the Feasibility of Using Alternative Financial Instruments for Determining Lender Yield under the Federal Family Education Loan Program*, January 19, 2001, pp. 120, 123.

¹³ U.S. Department of Education, Dear Colleague Letter 93-L-163 (LD), December 1993.

¹⁴ 34 CFR 682.302(e)

¹⁵ U.S. Department of Education, Dear Colleague Letter 96-G-287, March 1, 1996.

¹⁶ Nelnet, Press Release: *Nelnet Recognizes Income*, July 2, 2004.

¹⁷ Henry J. Cordes, "Student Loan Firm, Charity's Ties Probed," *Omaha World-Herald*, May 9, 1999.

¹⁸ Nelnet, *2004 Proxy Statement*, April 26, 2004.

¹⁹ Nelnet, *Annual Summary Report*, 2003.

²⁰ Stephen Burd, "Selling Out Higher-Education Policy?" *Chronicle of Higher Education*, July 30, 2004.

²¹ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008*, December 22, 2003.

APPENDIX

May 29, 2003 letter from Nelnet to the U.S.
Department of Education.

June 30, 2004 response from the Department to
Nelnet.

rowd 01/31/03

Nelnet Education Loan Funding, Inc.

121 South 13th Street, Suite 201
Lincoln, Nebraska 68508
402.458.2303

May 29, 2003

Angela Roca-Baker
United States Department of Education
Federal Student Aid
Union Center Plaza
830 First Street, NE
Room 52E4
Washington, DC 20202

Re: **LaRS Billing Statement Confirmation**

Dear Ms. Roca-Baker:

This letter is being written to confirm the proper way to submit Lender's Request for Payment of Interest and Special Allowance (LaRS) for the second quarter of 2003 by Nelnet Education Loan Funding, Inc. (NELF). Some background information may be helpful in your consideration of this issue. NELF is the successor in interest to a qualified scholarship funding corporation which converted to for-profit status in 1998 under § 150(d) of the tax Code. NELF is the issuer of tax exempt obligations pursuant to an Indenture of Trust dated November 15, 1985 (the 1985 Indenture) with Wells Fargo Bank Minnesota, National Association as trustee. NELF makes, purchases and finances student loans as part of its ordinary activities as a secondary market of student loans in the state of Nebraska. The trustee holds title to NELF's student loans and NELF holds 100% beneficial owner interest in its loans.

NELF is purchasing portfolios of FFEL loans with funds obtained from proceeds of the tax exempt 1985 Indenture in a series of acquisitions. Some of the portfolios will be purchased from third party non-affiliated sellers, and some will be purchased from affiliated sellers. Some of the portfolios will be transferred into the 1985 Indenture from the seller and some will be financed by a different NELF financing prior to being placed into the 1985 Indenture. As part of NELF's overall cash flow management plan, the purchased loans will be held within the 1985 Indenture and financed by the tax exempt obligations issued by NELF under that financing for a period of time depending upon cash management needs and other internal concerns, but in any event for at least one day or longer. Thereafter, loans will be refinanced and placed into financings which are taxable on a longer term basis; however, NELF will remain the 100% beneficial owner of the student loans that were previously funded in the tax exempt 1985 indenture. A flow chart is being sent with this letter to help illustrate.

We have reviewed applicable law, discussed with officials at the Department of Education the manner in which billing for special allowance should be handled in such circumstances and considered industry practices. During the time that the loans are held in the 1985 Indenture,

under 20 U.S.C. § 1087-1(b)(2)(B) and 34 C.F.R. § 682.302(c)(3), we intend to bill for special allowance at the quarterly rate of one-half the average of the bond equivalent rates of 91-day Treasury bill plus 3.5%, divided by 4, subject to a minimum of 9.5% minus the applicable interest rate on a loan, divided by 4. Since the loans thereafter will be refinanced under a taxable financing, NELF will maintain its 100% beneficial ownership interest in the loans previously purchased with proceeds of the 1985 Indenture, and the 1985 Indenture will not be retired or defeased, we intend to continue to bill for special allowance at such same quarterly rate (one-half of 91-day Treasury bill plus 3.5%, divided by 4, subject to the minimum of 9.5% minus the applicable rate on the loan, divided by 4) following such long term refinancing. We have based this upon 34 C.F.R. § 682.302(e)(2) as well as Dear Colleague Letter 96-L-186, 96-G-287 (Q&A No. 30), and our previous discussions with the Department on this matter. We intend to submit billings for special allowance at this same rate until such refinanced loans are either no longer beneficially owned by NELF (and are transferred to an unrelated or an affiliated purchaser), or until the 1985 Indenture is retired or defeased.

We would appreciate if you would consider our intended billing procedure summarized above and verify that it conforms to existing applicable laws and regulatory guidance at your earliest convenience, since we will be calculating the special allowance billings in the upcoming second quarter LaRS within the next few weeks. Please indicate your confirmation that our intended billing procedure is compliant with the Higher Education Act of 1965, as amended, and regulations promulgated thereunder, by signing below. We intend to proceed under the analysis described above and assume its correctness, unless we are otherwise directed by you. Thank you for your consideration of this matter.

Sincerely,

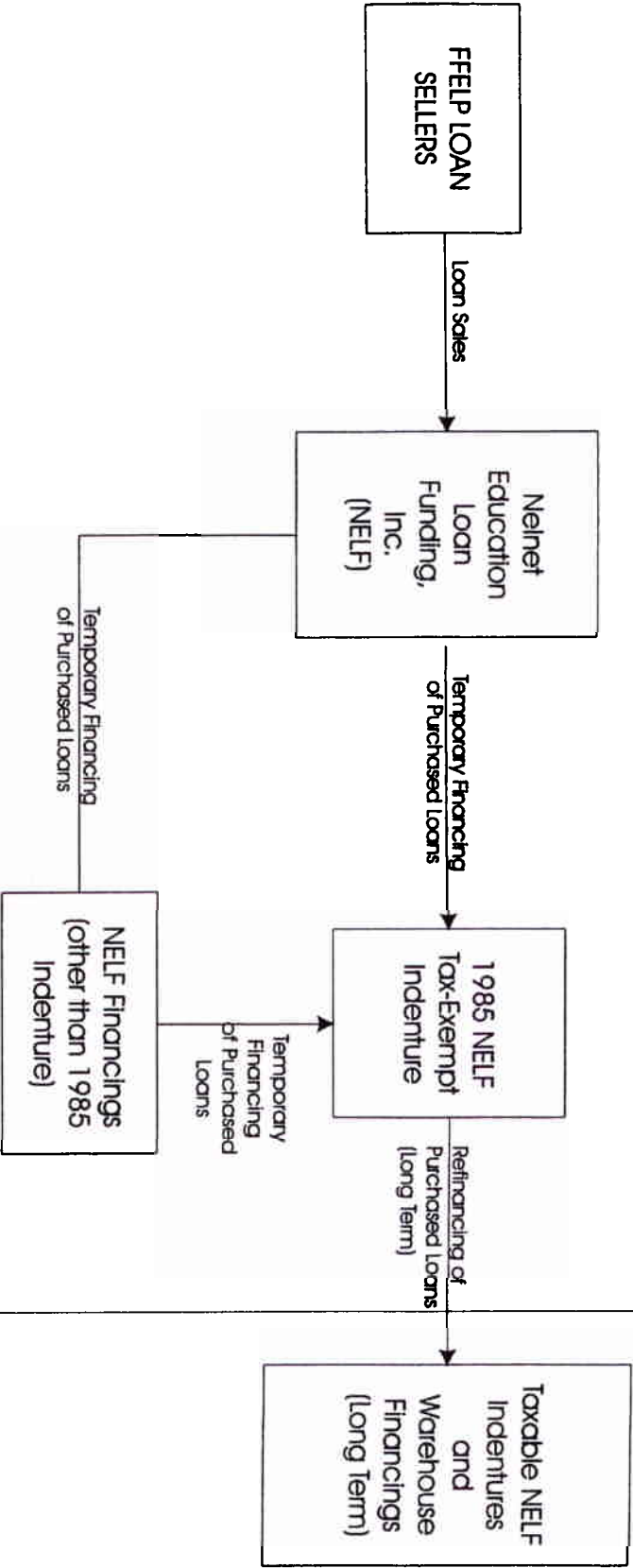


Terry J. Heimes
President of Nelnet Education Loan Funding, Inc.

I concur with the above.

Date

cc: Terri Shaw
Kristie Hansen
Frank Ramos
Sally Stroup



FFELP LOAN SELLERS

Loan Sales

Netnet Education Loan Funding, Inc. (NELF)

Temporary Financing of Purchased Loans

1985 NELF Tax-Exempt Indenture

Refinancing of Purchased Loans (Long Term)

Taxable NELF Indentures and Warehouse Financings (Long Term)

Temporary Financing of Purchased Loans

NELF Financings (other than 1985 Indenture)

Temporary Financing of Purchased Loans



FSA
FEDERAL
STUDENT AID

We Help Put America Through School

Mr. Paul Tone
Government and Industry Relations
Nelnet
3015 South Parker Road, Suite 400
Aurora, CO 80014

JUN 30 2004

Dear Mr. Tone,

This letter is in response to Nelnet's May 29, 2003 correspondence with regard to confirmation of the proper way for a lender to submit the Lender's Request for Payment of Interest and Special Allowance (LaRS) as it relates to portfolios funded from the proceeds of the tax-exempt 1985 Indenture.

34 C.F.R. Section 682.302(e) provides guidance with regard to special allowance payments for loans financed by proceeds of tax-exempt obligations. Additionally, the formulas for the calculations are provided in 34 C.F.R. Section 682.302(c). You can also refer to Dear Colleague Letter 96-L-186 for additional information.

Please let me know if you have any questions or concerns.

Sincerely,

A handwritten signature in black ink, appearing to read "V. Bateman", written over a light blue rectangular background.

Victoria L. Bateman, CPA, CGFM
Chief Financial Officer and
Acting General Manager, Financial Partner Services, FSA