California State Auditor

BUREAU OF STATE AUDITS

# California Student Aid Commission:

*Changes in the Federal Family Education Loan Program, Questionable Decisions, and Inadequate Oversight Raise Doubts About the Financial Stability of the Student Loan Program*

April 2006
2005-120

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CALIFORNIA STATE AUDITOR

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April 20, 2006

2005-120

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the California Student Aid Commission's (Student Aid) administration of the Federal Family Education Loan (FFEL) Program.

This report concludes that changes in the federal laws governing the FFEL Program raise concerns about whether Student Aid will be able to remain competitive with other guaranty agencies. Specifically, one change requires guaranty agencies to either charge borrowers a 1 percent federal default fee on the principal amount of all FFEL Program loans issued after July 1, 2006, or transfer an equal amount from nonfederal sources into the Federal Student Loan Reserve Fund. Guaranty agencies with sufficient resources can elect to pay the fee on behalf of borrowers while agencies such as Student Aid that have limited resources will have to charge the borrowers the fee.

The report also concludes that ongoing tensions between Student Aid and EDFUND, its auxiliary organization, have been costly and have delayed the completion of critical tasks. For example, these tensions, as well as turnover in leadership at EDFUND, hampered Student Aid's ability to renegotiate a revenue agreement with the U.S. Department of Education. At least $24 million more may have been generated in federal fiscal year 2005 if the agreement had been finalized. This same lack of cooperation has delayed attempts to expand and diversify EDFUND's financial services and possibly generate additional revenue that could have been used for California students.

Finally, Student Aid has maintained poor oversight over EDFUND. For instance, Student Aid approved sizable bonuses for EDFUND's executive staff despite the fact that the FFEL Program had an operating deficit, and its policy for setting executive salaries does not meet federal requirements. Student Aid also has not ensured that EDFUND travel and business expense policies are fiscally conservative, which results in less funding available for Student Aid to fulfill its mission.

Respectfully submitted,

Elaine M. Howle

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# SUMMARY

*Audit Highlights . . .*

***Our review of the California Student Aid Commission (Student Aid) and EDFUND's administration of the Federal Family Education Loan (FFEL) Program revealed the following:***

- ☑ ***Changes in federal laws governing the FFEL Program raise doubts that the State will be able to sustain the program.***
- ☑ ***Ongoing tensions between Student Aid and EDFUND have hampered Student Aid's ability to renegotiate a revenue agreement with the U.S. Department of Education, which may have cost the State at least $24 million in federal fiscal year 2005. These tensions also have delayed attempts to expand and diversify EDFUND's financial services.***
- ☑ ***Student Aid approved sizeable bonuses for EDFUND executive staff even when the FFEL Program had an operating deficit.***
- ☑ ***Student Aid has maintained poor oversight over EDFUND. For example, Student Aid has not ensured that EDFUND travel and business policies are fiscally conservative, which results in less funding available for Student Aid to fulfill its mission.***

## RESULTS IN BRIEF

The California Student Aid Commission (Student Aid) administers state and federal financial aid programs for students attending universities, colleges, and vocational schools in California and throughout the nation. In fiscal year 2004–05, it awarded $720 million in state grants to more than 240,000 students. During federal fiscal year 2005, it guaranteed new loans totaling more than $6.5 billion under the Federal Family Education Loan (FFEL) Program.[1] EDFUND, a nonprofit entity incorporated in 1997 as Student Aid's auxiliary organization, provides operation and administrative services to Student Aid for its participation in the FFEL Program. One of Student Aid's major responsibilities is to oversee EDFUND's operation of the FFEL Program.

Student Aid's FFEL Program lost about $8.3 million in federal fiscal year 2005, and it may barely break even in federal fiscal year 2006. It is presented with a number of challenges that could severely impair its operations and put the State's FFEL Program and its ability to supplement Student Aid's other services and programs at risk.

First, changes in federal laws governing the FFEL Program raise doubts that the State will be able to sustain the program. Student Aid must begin charging borrowers a fee in October 2006. This fee could make it less competitive and reduce the revenues it earns under the FFEL Program because other guaranty agencies will not be charging the fee. EDFUND officials indicated that, had the Legislature not appropriated $197.5 million from the Student Loan Operating Fund (Operating Fund) to support the Cal Grant program, there would have been more funds available to postpone charging the default fee beyond October 1, 2006. Additionally, EDFUND has relied too heavily on defaulted loan consolidations as its main source of revenue, placing the State in a possible position to be affected more severely by federal changes than other guaranty agencies.

[1] EDFUND's fiscal year coincides with the federal government's fiscal year, which is October 1 through September 30. Student Aid's fiscal year coincides with the State's fiscal year, which is July 1 through June 30.

Second, ongoing tensions between Student Aid and EDFUND have been costly. The general lack of cooperation, as well as turnover in EDFUND leadership, has hampered Student Aid's ability to renegotiate a revenue agreement with the U.S. Department of Education (Education). At least $24 million more may have been generated in federal fiscal year 2005 if the agreement had been finalized. This same lack of cooperation has delayed attempts to expand and diversify EDFUND's financial services and possibly generate additional revenue that could have been used for California students. Ultimately, if the two entities are unable to resolve their fundamental differences and if EDFUND is unable to demonstrate that it can generate an operating surplus that is sufficient to sustain the FFEL Program and support Student Aid's other services and programs, in our opinion there is little reason to believe that the State benefits from having an auxiliary to assist in the administration of the FFEL Program.

Student Aid has maintained poor oversight over EDFUND as well. It approved sizable bonuses for EDFUND executive staff even when the FFEL Program had an operating deficit, and its policy for setting executive salaries is inconsistent with federal regulations. It also has not ensured that EDFUND travel and business expense policies are fiscally conservative, which results in less funding available for Student Aid to fulfill its mission. EDFUND has in some cases paid more for meals and lodging than its own policies allowed, and it has sponsored costly events for employees and their families. Finally, Student Aid does not independently verify reports received from EDFUND that are used to make policy decisions.

## RECOMMENDATIONS

The Legislature should do the following:

- Closely monitor Student Aid and EDFUND to ensure that they are able to remain competitive with other FFEL Program guaranty agencies.

- Closely monitor the Operating Fund to ensure that the FFEL Program is generating a sufficient operating surplus so it can supplement funding for other Student Aid programs and services. If it is unable to generate a sufficient operating surplus, the Legislature should require Student Aid to dissolve EDFUND and contract with another guaranty agency to administer the FFEL Program. The contract should include, among other things, a provision that allows Student Aid to receive a share of the revenues generated by the guaranty agency, which then could be used to supplement funding for Student Aid's other financial aid programs. In addition, the contract should include a provision for Student Aid to hire external auditors to ensure that the guaranty agency is complying with federal laws and regulations. Alternatively, the Legislature could reconsider the need for a state-designated guaranty agency.

- Closely monitor Student Aid's progress toward completing critical tasks, including the renegotiation of its revenue agreement with Education and the development of a business diversification plan.

To ensure that it maximizes the amount of funds available to fulfill its mission and to administer the FFEL Program effectively, Student Aid should:

- Continually reassess the financial impact on the FFEL Program caused by federal changes and the recent announcements by some large guaranty agencies that they will not charge borrowers the fee.

- Ensure that critical tasks, including the renegotiation of its revenue agreement with Education and the development of a diversification plan, are completed.

- Modify its policy to ensure that EDFUND's executive staff does not receive bonuses if the FFEL Program has an operating deficit.

- Ensure that EDFUND complies fully with federal regulations governing salary setting for its executives.

- Ensure that EDFUND establishes travel and business policies that are consistent with the State's more fiscally conservative policies and that its employees adhere to those travel policies.

- Closely monitor EDFUND expenses for conferences, workshops, all-staff events, travel, and the like.

- Require staff to independently verify the accuracy of the reports submitted by EDFUND.

## AGENCY COMMENTS

Student Aid generally agrees with our recommendations and some of our conclusions. However, it does not agree with other conclusions. For example, Student Aid disagrees with our conclusion that its ability to generate sufficient revenues to justify its continued status as a guaranty agency may be in jeopardy because of federal changes governing the FFEL Program. Student Aid also disagrees with our conclusion that it cannot determine what, if any, impact its tactics for minimizing the effect of the federal changes will have on its ability to remain competitive in the student loan guaranty market. ■

# INTRODUCTION

## BACKGROUND

The California Student Aid Commission (Student Aid) is the principal state agency responsible for administering state and federal financial aid programs for students attending public and private universities, colleges, and vocational schools in California. Student Aid administers the state Cal Grant program and the Federal Family Education Loan (FFEL) Program, which are the two major programs available to California students. In fiscal year 2004–05, it awarded $720 million to more than 240,000 students under the Cal Grant program. Additionally, during federal fiscal year 2005, which covers the period of October 1, 2004, through September 30, 2005, Student Aid, through its auxiliary organization, guaranteed new loans totaling more than $6.5 billion under the FFEL Program. As of September 30, 2005, outstanding FFEL Program loans guaranteed by Student Aid totaled more than $24.7 billion.

The Cal Grant program offers three types of grants: Cal Grants A, B, and C. Cal Grant A is for eligible students who attend school at least half-time and whose course of study is at least two academic years. Cal Grant B is for eligible students from disadvantaged or low-income families whose course of study is at least one year. Generally, Cal Grant A and B awards may be received for up to four years if they are awarded to first-year students. However, students enrolled in specialized degree programs that require five years or teaching credential programs may receive their award for up to five years. Cal Grant C awards are for students who want to attend a career, occupational, or vocational program. Training must lead to a recognized career goal—a diploma, associate degree, license qualification, or certificate—which indicates at least an entry-level job skill. Cal Grant C award funding is available for up to two years, depending on the length of the program, if students maintain satisfactory progress.

The federal government provides aid in the form of work study, grants, and loans to students to help cover the cost of attending school. The U.S. Department of Education (Education) offers loans under two programs: the FFEL Program and the William D. Ford Federal Direct Loan (Direct Loan) Program. The loans offered under each of these programs have the same eligibility rules and

**Types of Loans Available Through Both the Direct Loan and FFEL Programs**

**Subsidized Stafford** loans that are awarded to students who demonstrate financial need. The U.S. Department of Education subsidizes the interest and borrowers are not charged interest while they are enrolled in school at least half time and during grace and deferment periods.

**Unsubsidized Stafford** loans that are awarded to students regardless of financial need. Borrowers are responsible for paying the interest that accrues during any period.

**PLUS** loans that allow parents to borrow on behalf of their dependent undergraduate children who are enrolled at least half time. Borrowers are responsible for interest that accrues on PLUS loans throughout the life of the loan.

**Consolidation** loans that allow a borrower to combine one or more federal education loans into a single loan to facilitate repayment. The process of consolidating loans involves the consolidating lender purchasing qualifying student loans from other lenders.

Source: The *U.S. Department of Education 2003–04 Federal Student Aid Handbook.*

the same annual and aggregate maximum amounts. The primary difference between the two programs is the source of funds. The federal government provides the funds for the Direct Loan Program, while the loans made through the FFEL Program are provided by private lenders, insured by guaranty agencies, and reinsured by the federal government.[2] The federal guarantee on the FFEL Program loans replaces the collateral usually required for long-term loans from financial institutions. The text box shows the types of loans available through both the Direct Loan and FFEL programs.

According to Education, it made $56.8 billion in new loans of these types available to students nationwide in federal fiscal year 2005. Of this amount, $13.9 billion was under the Direct Loan Program and $42.9 billion was under the FFEL Program. The Direct Loan Program is managed by Education and the FFEL Program is administered by one of 36 guaranty agencies throughout the nation, including Student Aid. Schools select which program to use, and most schools typically elect to participate in only one of the two programs; however, some schools participate in both.

## STUDENT AID'S ROLE IN ADMINISTERING THE FFEL PROGRAM

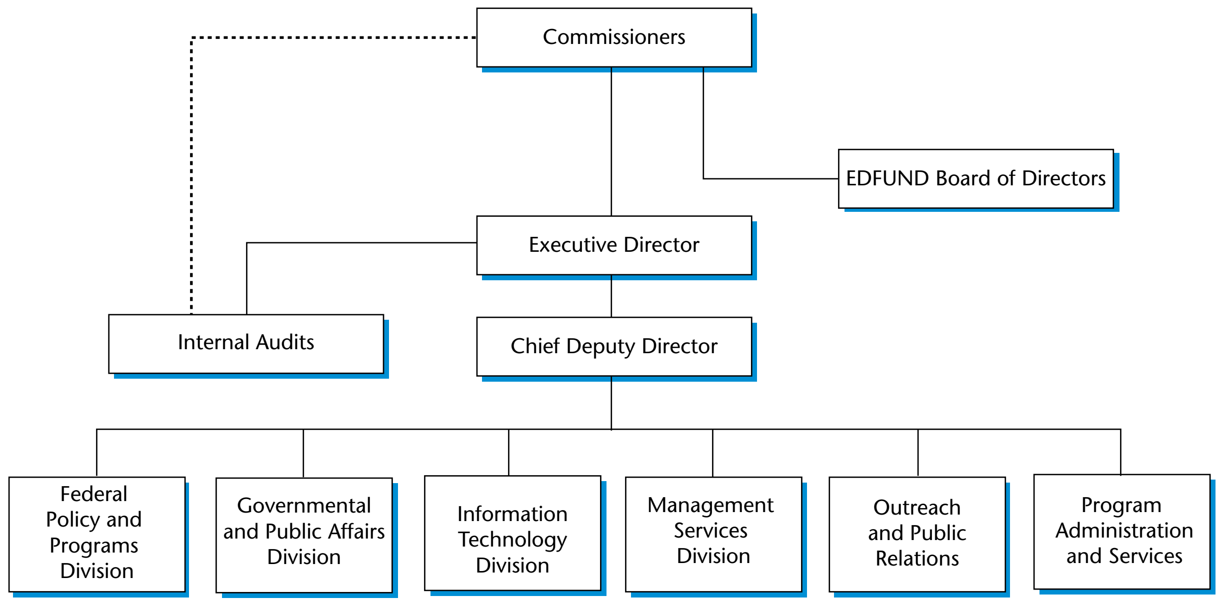
In 1955, the Legislature created state competitive scholarships that award winners could use to pay for tuition and fees associated with their undergraduate higher education study. State law also created the State Scholarship Commission to administer the scholarships. The name of the State Scholarship Commission ultimately was changed to the California Student Aid Commission. Figure 1 presents an abbreviated organizational chart that shows those divisions within Student Aid that administer the FFEL Program.

Student Aid is composed of 15 members who generally serve for four years. The governor appoints 11 commissioners who are subject to confirmation by the Senate. By law, the members must include a specific number of representatives from the general public; students; California's universities

[2] The reinsurance agreement is defined with other technical terms in the Appendix.

**FIGURE 1**

**California Student Aid Commission Abbreviated Organizational Chart**




Source: California Student Aid Commission.

and community colleges; and public, proprietary, nonprofit, independent, and secondary schools located in California. Additionally, the speaker of the Assembly and the Senate Rules Committee each appoint two commissioners. State law also requires the commission to appoint a director who shall be its chief executive officer.

In 1977, the Legislature enacted legislation to establish a state guaranteed loan program consistent with federal law, rules, and regulations, and to authorize Student Aid to serve as a state student loan guaranty agency. According to Student Aid, its administration of the FFEL Program has varied over the years. Between 1977 and 1992, it opted to contract with outside vendors to provide the required loan-processing services and established a contracts management unit. In 1993, with the development of its financial aid processing system, Student Aid opted to perform FFEL Program operations in-house. According to the chief of Student Aid's management services division, this action was intended to unify student financial aid programs and modernize program administration and delivery. However, in late 1995, Student Aid's then-executive director recommended that the part of the organization administering the loan program be shifted to a nonprofit corporation, primarily due to a 31 percent decline in Student Aid's market share. In November 1995, the Department of Finance (Finance) created a work group to analyze the executive director's recommendation.

**Alternative Delivery Mechanisms for Student Loan Guarantee Services**

**State Agency**
State agency with potential administrative delegation of control agency oversight.

**State Agency With Statutory Exemptions**
State agency with statutory exemptions from control agency oversight.

**State Agency With Auxiliary Organization**
State agency with a state-authorized auxiliary organization subject to Student Aid oversight and control.

**State Established Nonprofit Organization**
State established independent nonprofit organization with no direct link to Student Aid.

**Non-State Guarantor**
Existing or new national or regional non-state guarantor designated to provide loan guarantee services.

Source: *An Analysis of Alternative Structures for the Delivery of Student Loan Guarantee Services in California*, dated January 31, 1996, and prepared by the California Department of Finance Workgroup.

Based on its review, the work group identified operational factors restricting the competitiveness of Student Aid's loan guaranty services in the areas of financial management, technology, personnel, and procurement. For instance, significant delays in passing the State's budget resulted in costly penalties for Student Aid because it did not have the spending authority to pay lender claims within the federally mandated time frame of 90 days. The work group also determined that constraints on recruiting and hiring outside the State's civil service system imposed a burden on Student Aid's ability to recruit highly qualified personnel from lending institutions and college financial aid offices. Finally, the work group believed the time constraints associated with the State's contracting requirements appeared to hamper Student Aid's competitiveness. Although the work group evaluated the five alternatives shown in the text box, it did not formally recommend one.

In September 1996, state law was amended to authorize Student Aid to establish an auxiliary organization to provide operational and administrative services for the FFEL Program. It required the auxiliary organization to be established as a nonprofit public benefit corporation. This auxiliary organization, known as EDFUND, was incorporated on January 1, 1997. As stated in its articles of incorporation, EDFUND's purpose is to promote and assist Student Aid's programs in conformity with state law and the operating agreement between it and Student Aid. In the event of EDFUND's dissolution, any assets remaining after payment or provisions for payment of all debts and liabilities shall be distributed to Student Aid. State law also dictates certain actions to be taken by Student Aid to oversee its auxiliary organizations as shown in Figure 2.

## FIGURE 2

**Responsibilities of the California Student Aid Commission and EDFUND**

**California Student Aid Commission Responsibilities:**

- Administer the financial aid program.
- Perform policy leadership program evaluations.
- Develop and coordinate information.
- Conduct regular performance evaluations of EDFUND's operations.
- Approve an operating agreement that governs EDFUND's operations and provide a copy to the Department of Finance and the Joint Legislative Budget Committee for their review and comment.
- Oversee the development and operation of EDFUND in a manner that ensures broad public input and consultation with representatives of the financial aid community, colleges and universities, and state agencies.

**EDFUND Responsibilities:**

- Provide operational and support services essential to the administration of the FFEL Program and other permitted activities related to student financial aid.
- Carry out operations so as to enhance the administration and delivery of Student Aid's programs and services.

Source: California Education Code, Section 69522.

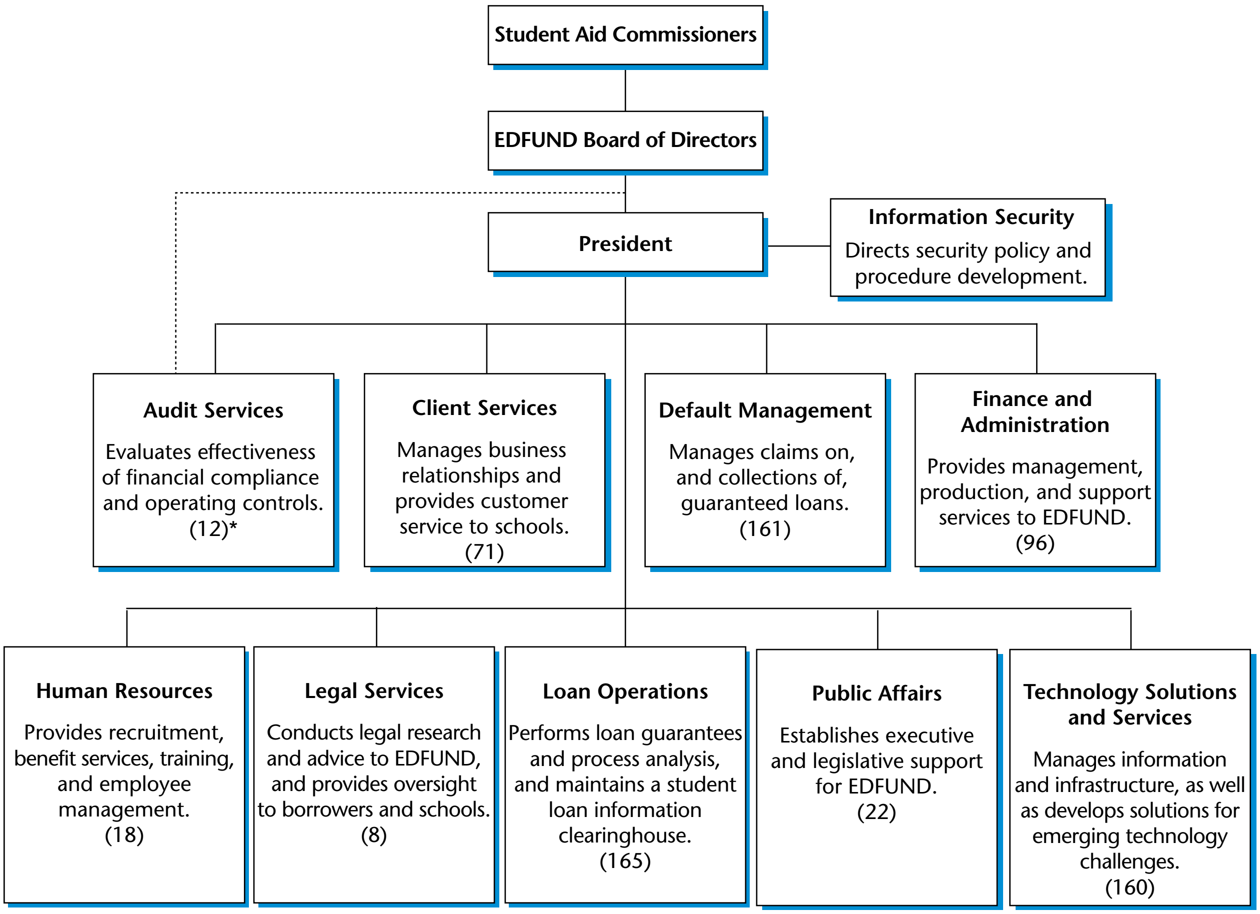
## EDFUND'S ORGANIZATIONAL STRUCTURE

EDFUND offers a variety of services to schools, lenders, and students including financial aid, debt management, and loan default prevention. Initially, Student Aid was limited to providing a source of loans only to eligible students in California. However, in 1999, state law was amended to allow it to provide loans to eligible students outside of California. As a result of Student Aid's expanded authority, EDFUND established regional offices in Arizona, Florida, and Washington. Figure 3 on the following page presents EDFUND's abbreviated organizational chart.

Student Aid is charged with nominating and appointing EDFUND's board of directors (board). State law requires that one member of the board be an EDFUND employee and one member be a student enrolled in a public or private postsecondary educational institution. State law does not

**FIGURE 3**

**EDFUND Abbreviated Organizational Chart**




Sources: EDFUND *The Almanac, 1st Quarter 2006* and the EDFUND Federal Fiscal Year 2006 Budget Proposal (October 2005).
* The numbers in parentheses represent the number of staff.

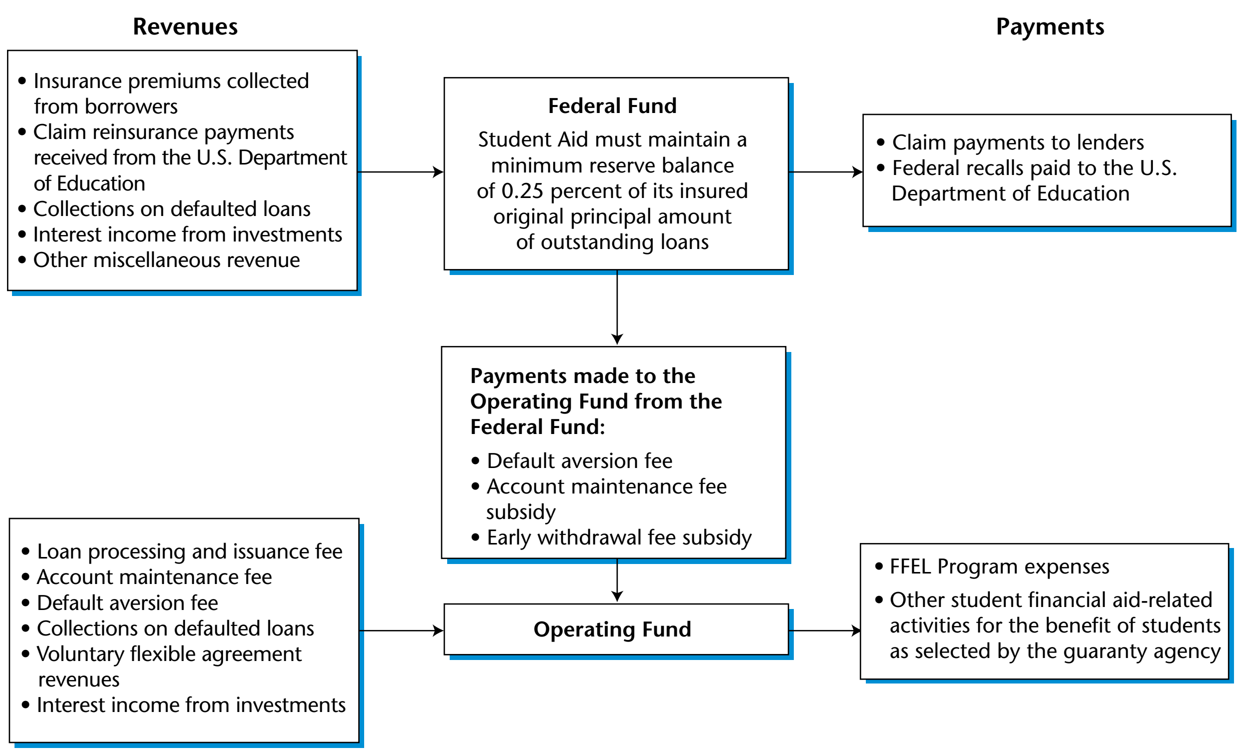
dictate the remaining composition of EDFUND's board; thus, Student Aid has wide discretion in determining its size and composition. As of March 2006, the board consisted of 10 members, including representatives from various postsecondary institutions in California and private businesses; one student representative; the executive director of Student Aid; an employee of EDFUND; and the president of EDFUND, who is a non-voting member.

## REVENUES RELATED TO THE FFEL PROGRAM

Based on federal requirements, state law created the Federal Student Loan Reserve Fund (Federal Fund) and the Student Loan Operating Fund (Operating Fund) in the State Treasury in 1999. Federal law establishes the percentage of the fees to be allocated to each of these two funds. The assets of the Federal Fund and the earnings on those assets are the property of the federal government. Conversely, with a few exceptions, money in the Operating Fund is the property of the guaranty agency. Consequently, money deposited in Student Aid's Operating Fund may generally be used in accordance with state laws, regulations, and policies and procedures governing the activities of Student Aid. For example, in fiscal years 2004–05 and 2005–06, because of state budget concerns, the Legislature appropriated a total of $197.5 million from the Operating Fund to support the Cal Grant program. Figure 4 shows the basic flow of FFEL Program revenue received by Student Aid.

## FIGURE 4

**Flow of Federal Family Education Loan Program Funds**




Sources: California Student Aid Commission and relevant federal laws.

**Primary responsibilities of guaranty agencies include:**

- Loan administration.
- Borrower repayment assistance.
- Continuous improvement of delinquency and default rates.
- School and lender oversight and program compliance.
- Counseling, outreach, and community service.

Sources: Federal law and regulations.

As a guaranty agency, Student Aid's customers and stakeholders are students and their families, schools, lenders, Education, and taxpayers. As shown in the text box, Student Aid and other guaranty agencies have common responsibilities. In return, as shown in Figure 4, they receive account maintenance fees, loan processing and issuance fees, default aversion fees, payments made by either Education or borrowers after the claim on a defaulted loan has been paid, and revenues from a voluntary flexible agreement with Education. A description of the fees can be found in the Appendix.

## SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) requested that the Bureau of State Audits (bureau) review Student Aid's governance and oversight of EDFUND, including EDFUND's financial management and business practices. The audit committee was interested in ensuring the proper use of state assets in maximizing support for financial aid purposes.

To understand Student Aid and EDFUND's responsibilities regarding the FFEL Program, we reviewed state and federal laws and regulations governing the program and EDFUND's articles of incorporation and bylaws. Additionally, we reviewed the FFEL Program operating agreement between Student Aid and EDFUND to determine whether it delineated the roles and responsibilities for the organization in accordance with state and federal laws, rules, regulations, and policies and procedures.

To examine and evaluate Student Aid's policies, procedures, and practices related to overseeing the FFEL Program and monitoring EDFUND's administration of the program, we reviewed various policies, procedures, and directives developed by Student Aid. We also reviewed Student Aid's procedures for ensuring compliance with its policies, procedures, and state and federal laws and assessed the adequacy of the actions it would take if it identified instances of noncompliance. Finally, we reviewed the FFEL Program activities performed by both organizations to determine whether there was any duplication.

To determine the relationships between the Federal Fund and Operating Fund we reviewed relevant federal laws and regulations governing the funds. We also reviewed Student Aid's funding structure to determine if there was a relationship between the Operating Fund and the Cal Grant program.

To determine whether EDFUND provides Student Aid with periodic reports regarding the FFEL Program, we reviewed the operating agreement to identify the reports it requests from EDFUND. We then requested a copy of selected reports. Additionally, we reviewed and evaluated the procedures used by Student Aid to ensure the accuracy of these reports.

To determine the types of expenditures allowed for the Operating Fund, we reviewed relevant federal and state laws and regulations and Student Aid's and EDFUND's policies and procedures. We also reviewed a sample of expenditures to ensure that they were reasonable and for allowable purposes. In assessing whether the salaries paid to EDFUND's executive management team were reasonable, we attempted to compare the salaries to similar organizations. Specifically, we researched 10 guaranty agencies, including two state agencies and eight nonprofit organizations. Due to limited public data, we were not able to obtain executive salary data from these guaranty agencies to compare with EDFUND compensation. We were only able to obtain compensation data from these entities that is otherwise available publicly, and this information was aggregated in a manner that did not allow for an adequate comparison.

To assess the reasonableness of EDFUND's budgeting process and cost estimates, we examined its budget documents. We also examined Student Aid's role in reviewing and approving EDFUND's budget. Additionally, we reviewed the impact on EDFUND's revenues of changes recently approved by the federal government for the administration of the FFEL Program.

To determine whether Student Aid and EDFUND have made measurable progress toward diversifying the activities of EDFUND, we interviewed key staff, commissioners, and board members and reviewed available documentation of their diversification efforts. We also determined the amount of funds that had been spent on these efforts.

We reviewed conflict-of-interest policies for Student Aid and EDFUND to determine whether they extended to key employees, commissioners, and board members and assessed the procedures for ensuring compliance with these policies. We also reviewed selected transactions to determine whether any potential conflicts existed.

Finally, we reviewed the laws related to conducting closed-session meetings and examined available board and subcommittee meeting minutes to determine if EDFUND complied with its newly granted closed-session meeting requirements. ■

# CHAPTER 1

## *Federal Changes and Delayed Implementation of Key Activities Cause Concern About Continuing the State's Participation in the Federal Family Education Loan Program*

### CHAPTER SUMMARY

The State's ability to sustain the Federal Family Education Loan (FFEL) Program is uncertain because of changes recently made to the federal laws governing the program. How the California Student Aid Commission (Student Aid) and, more importantly, its competitors choose to implement these changes could reduce Student Aid's share of the FFEL Program market significantly. For example, effective October 1, 2006, Student Aid will begin charging borrowers a fee for new loans it guarantees. If other large guarantors elect not to charge the fee—and evidence suggests this will be the case—borrowers and schools may choose to use an agency other than Student Aid to guarantee loans. This action, in turn, could affect Student Aid's ability to earn sufficient revenues to continue operating the FFEL Program and to use excess proceeds from the loan program to supplement its other programs and services.

Additionally, ongoing tensions between Student Aid and EDFUND have hampered efforts to complete essential tasks and Student Aid may have lost the opportunity to receive $24 million in revenue for the FFEL Program and had the potential to generate even more. Student Aid was required to renegotiate an agreement with the U.S. Department of Education (Education) that would earn revenue for performing activities related to improving FFEL Program services to borrowers and schools. Despite working on a new agreement since June 2004, Student Aid does not yet have an approved agreement.

Another major area affected by the tensions between Student Aid and EDFUND is business diversification. In spite of their efforts over the last eight years, the two entities do not have a viable plan for business diversification. The Legislature transferred to the Cal Grant program $51 million of the $70 million it set aside for business diversification in the Budget

Act of 2005, and the Budget Act of 2006 set aside no funds to support Student Aid business diversification. Finally, lack of agreement between the two entities on the appropriate roles for each has made it impossible for them to forge an operating agreement for the FFEL Program.

## FEDERAL CHANGES WILL AFFECT STUDENT AID'S ABILITY TO EARN SURPLUS FUNDS FROM THE FFEL PROGRAM

***Student Aid will be at a competitive disadvantage because it will have to charge borrowers a 1 percent fee, while some other guaranty agencies will pay the fee on behalf of borrowers.***

Student Aid's ability to generate an operating surplus from the FFEL Program will be affected significantly by changes in the federal laws governing the program. How Student Aid and its competitors choose to implement one change in particular ultimately could determine whether the State should continue to participate as a guaranty agency in the FFEL Program. The change requires guaranty agencies to charge borrowers a 1 percent federal default fee on the principal amount of all FFEL Program loans issued after July 1, 2006, and deposit the proceeds into the Federal Student Loan Reserve Fund (Federal Fund) or transfer an equal amount from nonfederal sources into the Federal Fund. Guaranty agencies with sufficient resources can elect to pay the fee on behalf of borrowers, while agencies with limited resources, such as Student Aid, will have to charge borrowers the fee. These guaranty agencies will be at a distinct competitive disadvantage and may experience a reduction in their market share. Additionally, although less severe, other revisions to the FFEL Program could reduce the revenues Student Aid earns from administering the program, making it necessary for the Legislature to monitor closely the continued generation of resources for the FFEL Program and state grant programs.

### The Federal Higher Education Reconciliation Act of 2005 Could Make It Difficult for the FFEL Program to Generate an Operating Surplus

Student Aid's ability to generate sufficient revenues to justify its continued status as a FFEL Program guaranty agency may be in jeopardy because of a change required under the Federal Higher Education Reconciliation Act of 2005 (Reconciliation Act) contained in the Federal Deficit Reduction Omnibus Reconciliation Act of 2005. Specifically, its future as a guaranty agency may rest on how other guaranty agencies choose to implement one specific change to the laws governing the FFEL Program. Other guaranty agencies, especially those with a national presence, could gain a considerable portion of Student

*Changes in the federal laws governing the FFEL Program could result in other guaranty agencies gaining a considerable portion of Student Aid's FFEL Program new loan volume.*

Aid's FFEL Program new loans by charging borrowers lower fees than Student Aid is planning to charge. A significant loss in new loan volume would reduce Student Aid's revenues. Given that Student Aid's FFEL Program lost $8.3 million in federal fiscal year 2005 and may barely break even in federal fiscal year 2006, any reduction in revenues could severely impair its ability to continue operations.[3]

The Reconciliation Act requires Student Aid to collect and deposit into its Federal Fund a federal default fee equal to 1 percent of the principal amount of loans issued on or after July 1, 2006. Guaranty agencies can elect to charge the 1 percent fee to borrowers or use their own nonfederal funds to cover the fee. Student Aid has elected not to begin charging the default fee until October 1, 2006. EDFUND points out that had the Legislature not appropriated $197.5 million from the Student Loan Operating Fund (Operating Fund) to support the Cal Grant program there would have been more funds available to postpone charging the default fee beyond October 1, 2006.

Federal law also requires Student Aid to maintain a minimum amount of funds in its Federal Fund equal to 0.25 percent of its insured original principal amount of loans outstanding.[4] As shown in Figure 4 in the Introduction, money in the Federal Fund is used to pay lenders for their claims on defaulted loans and to pay for account maintenance and default aversion fees earned by the guaranty agency.[5] However, Student Aid's Federal Fund balance at the end of federal fiscal years 2004 and 2005 was not sufficient to meet the minimum requirement. Consequently, Student Aid had to transfer $9 million and $42.2 million, respectively, from its Operating Fund to the Federal Fund at year-end to meet the minimum reserve levels. EDFUND officials estimate they will need to transfer $45.1 million from the Operating Fund to the Federal Fund in federal fiscal year 2006 to meet the minimum reserve requirement.

However, beginning October 1, 2006, Student Aid will charge borrowers for the federal default fee and deposit the fees into the Federal Fund to satisfy the minimum reserve requirement. Therefore, if it generates enough revenues from the federal default

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[3] EDFUND's fiscal year coincides with the federal government's fiscal year, which is October 1 through September 30. Student Aid's fiscal year coincides with the State's fiscal year, which is July 1 through June 30.

[4] This requirement existed before the passage of the Reconciliation Act and remains unchanged.

[5] Account maintenance and default aversion fees are defined, with other technical terms, in the Appendix.

fee, the amount Student Aid will need to transfer, if any, from the Operating Fund could be reduced significantly. Conversely, should Student Aid's new loan volume be drastically reduced because it charges borrowers for the federal default fee while other guaranty agencies do not—a very real possibility—it would have to continue to make transfers from the Operating Fund.

**Ten Guaranty Agencies by Largest Dollar Volume (Listed in Order of Size)**

1. USA Funds
2. Student Aid
3. Great Lakes Higher Education Guaranty Corporation
4. Texas Guaranteed Student Loan Corporation
5. Pennsylvania Higher Education Assistance Agency
6. National Student Loan Program
7. New York State Higher Education Services Corporation
8. American Student Assistance
9. Illinois Student Assistance Corporation
10. Kentucky Higher Education Assistance Authority

Source: EDFUND unaudited data as of September 30, 2005.

EDFUND staff performed two analyses to determine the impact on FFEL Program operations depending on whether or not other guaranty agencies elect to pay the federal default fee on behalf of borrowers. However, EDFUND's legal counsel asserts that these analyses are confidential and proprietary. Thus, we cannot discuss the specific details of the analyses. Nevertheless, recent announcements by some of the guaranty agencies shown in the text box indicate that four will not charge borrowers the fee. For example, Great Lakes Higher Education Guaranty Corporation (Great Lakes) announced on March 2, 2006, that it would pay the fee on the majority of loans it guarantees through June 30, 2007. Similarly, on March 24, 2006, the Pennsylvania Higher Education Assistance Agency (PHEAA) announced it would pay the federal default fee for borrowers. Furthermore, the Texas Guaranteed Student Loan Corporation (TG™) announced on April 8, 2006, that it would not charge borrowers the fee through June 30, 2007. Like Student Aid, Great Lakes, PHEAA, and TG™ have the authority to market their guaranty services nationwide. Three of the 10 guarantors, including Student Aid, announced they would charge borrowers the fee. However, although USA Funds announced it would charge the fee, on March 13, 2006, Sallie Mae announced that it would pay the federal default fee on its loans guaranteed by USA Funds and the Northwest Education Loan Association, eliminating the needs for borrowers to do so on those loans. Three of the remaining 10 guarantors had not announced their plans as of April 8, 2006.

Because of the recent announcements by Great Lakes, PHEAA, TG™, and other guarantors, it will be necessary for EDFUND to revise its forecasts for federal fiscal years 2006 and 2007. It is our belief that FFEL Program revenues could be reduced to the point where EDFUND's role as an auxiliary organization assisting Student Aid in administering the program is no longer warranted.

*Three guaranty agencies with the authority to market their services nationwide recently announced they would pay the federal default fee for borrowers.*

EDFUND states that it has many tactics to minimize the impact of any changes in its competitive position. These tactics include strategies it and other guarantors in the industry use to maintain effective relations with and competitive services for schools, and to work with lenders to strike new relationships that include payment of the default fee. However, EDFUND cannot determine what, if any, impact these tactics will have on its ability to remain competitive in the student loan guaranty market.

### Other Federal Changes Caused EDFUND to Shift Its Strategy for Collecting on Defaulted Student Loans

The Reconciliation Act imposes other changes that likely will reduce Student Aid's FFEL Program revenues. Specifically, on or after October 1, 2006, the Reconciliation Act prohibits guaranty agencies from charging borrowers collection costs that exceed 18.5 percent of the outstanding principal and interest of a defaulted loan that is paid off through consolidation by the borrower. It also requires the agencies to remit to Education 8.5 percent of the collection charge.[6]

Effective October 1, 2009, the Reconciliation Act will require guaranty agencies to remit to Education the entire amount of collection costs for each defaulted loan that is paid off with excess consolidation proceeds, which are the proceeds of consolidated defaulted loans that exceed 45 percent of the guaranty agency's total collections on defaulted loans in each federal fiscal year. Because it has relied so heavily in the past on using consolidations to collect on defaulted loans, these changes will almost certainly result in a decrease to the portion of Student Aid's net recoveries on loan defaults that result from this collection method.[7] Although these changes in federal law do not become operative until federal fiscal year 2010, according to EDFUND it is aggressively reducing its use of consolidations to collect on defaulted loans.

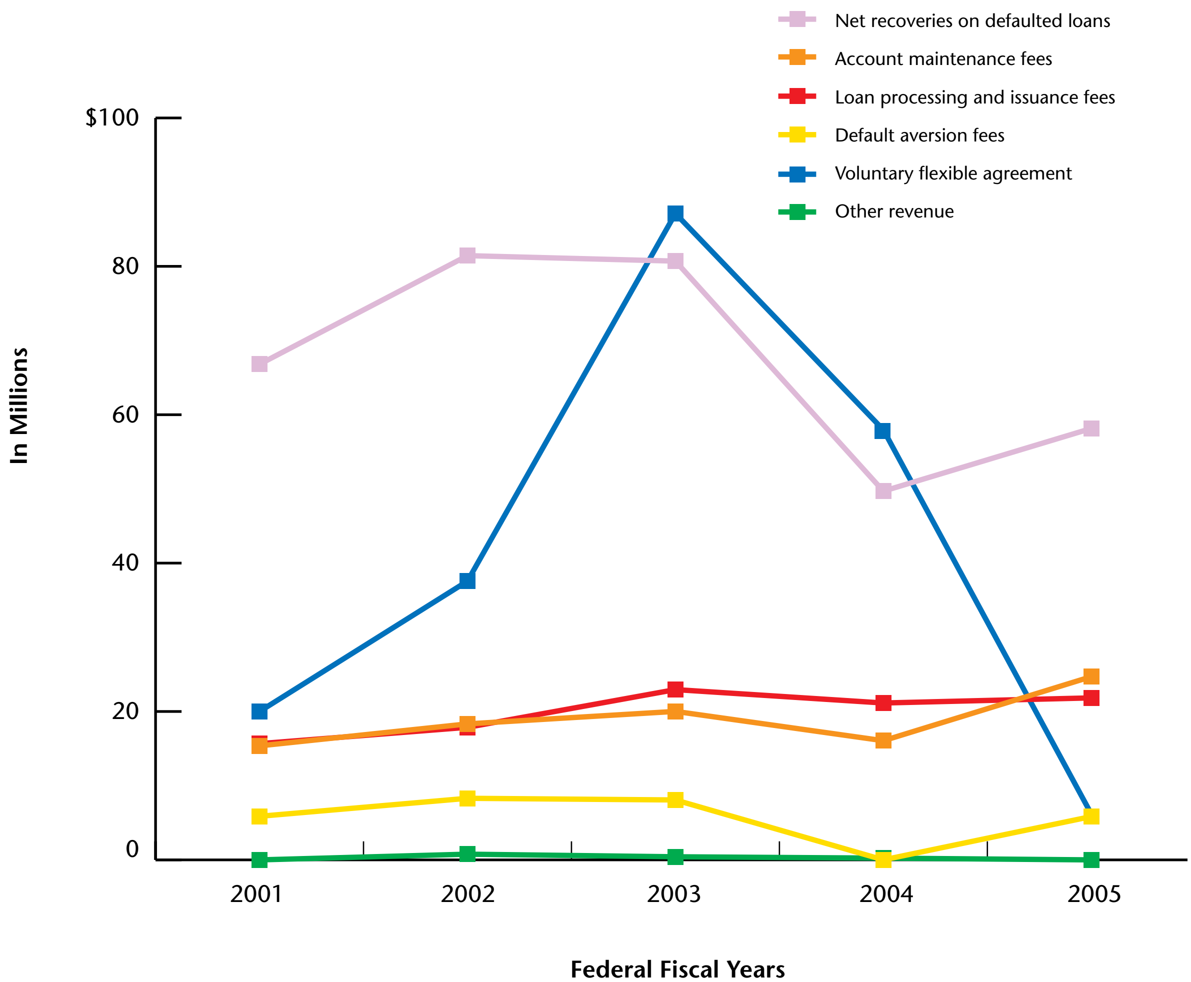
As discussed in the Introduction, the revenue Student Aid receives from its participation in the FFEL Program includes collections on defaulted loans, loan processing and issuance fees, account maintenance fees, default aversion fees, and receipts under the terms of Student Aid's voluntary flexible agreement (VFA) with Education. Figure 5 on the following page shows the amount of these revenues received under the program during

[6] Consolidated loans are defined with other technical terms in the Appendix.

[7] Net recoveries on defaulted loans are defined with other technical terms in the Appendix.

## FIGURE 5

### FFEL Program Annual Revenues by Type




Source: California Student Aid Commission Unaudited Revenues and Expenses Variance Reports for the 12 months ending September 30, 2001, through 2005.

federal fiscal years 2001 through 2005. Additionally, Figure 5 shows that revenues from the net recoveries on defaulted loans represent a significant portion of Student Aid's total revenues over the last five federal fiscal years.

According to Education's data, Student Aid's gross collections on defaulted loans in federal fiscal year 2005 were $409 million, roughly 78 percent of which came from defaulted loan consolidations. In contrast, according to Education's data, the average rate of defaulted loan consolidations for the remaining 35 guaranty agencies was 43.8 percent. Its acting chief financial officer stated that EDFUND's collection strategies have included a gradual shift from consolidating borrowers' FFEL Program defaulted loans to the William D. Ford Federal Direct Loan (Direct Loan) Program beginning in federal fiscal year 2005. This strategy was based on preliminary information that suggested the Reconciliation Act would limit the percent of a guaranty agency's defaulted loan recoveries resulting from consolidations and that the change would be effective in federal fiscal year 2010. He also stated that prior to December 2005 there was no indication that there would be any additional sanctions or changes affecting a guaranty agency's consolidation retention or its other collection recoveries. Further, he states that as soon as the Reconciliation Act became public on December 21, 2005, detailing a significant reduction in guaranty agencies' retention from Direct Loan Program consolidations, EDFUND immediately shifted to a more aggressive collection strategy. Finally, he stated that EDFUND's collections for January 2006 and February 2006 reflect a dramatic increase in nonconsolidation activity, which if extrapolated for the rest of federal fiscal year 2006 would result in an increase in net recoveries on defaulted loans from federal fiscal year 2005 and that EDFUND's federal fiscal year 2006 forecasts include this continued growth in net recoveries.

We question why it was necessary for EDFUND to focus primarily on Direct Loan Program consolidations to increase revenues when its competitors appear to be using a more balanced strategy toward their collection efforts. Moreover, because it relied so heavily on Direct Loan Program consolidations as a means of collecting on defaulted loans, EDFUND has placed California in a position to possibly be affected more severely than other states by the federal changes. Finally, EDFUND correctly states that its January 2006 and February 2006 collections reflect an increase in its nonconsolidation activity. However, EDFUND fails to mention that its consolidation collections for February 2006 were roughly 37 percent more than its January 2006 consolidation collections and 8 percent more than the average monthly consolidation collections for the first quarter of federal fiscal year 2006. This trend does not indicate that EDFUND is aggressively reducing its use of consolidations to collect on defaulted loans. If it does not do so by October 1, 2006, EDFUND will realize reductions in revenues because of the collection charges that must be remitted to Education, which will result in a corresponding decrease in the Operating Fund.

***Because it relied so heavily on Direct Loan Program consolidations as a means of collecting on defaulted loans, EDFUND has placed California in a position to possibly be affected more severely than other states by the federal changes.***

## TENSIONS BETWEEN STUDENT AID AND EDFUND HAVE DELAYED CRITICAL ACTIVITIES, RESULTING IN LOST REVENUE

The inability of Student Aid and EDFUND to agree on the role of each organization and the general lack of cooperation between the two has hampered efforts to renegotiate an important agreement with Education that may have resulted in a lost opportunity to receive at least $24 million in federal fiscal year 2005. Further, these same problems have hindered attempts to expand the financial aid services provided by EDFUND, thereby preventing it from generating additional revenues that could have been used for students. Finally, Student Aid and EDFUND have yet to clarify the roles and responsibilities of each organization despite several attempts to do so.

**Services Student Aid Must Implement Under Its VFA With Education**

**Outreach Services:**

Develop and implement early intervention, debt management, and scholarship programs designed to promote educational opportunity, responsible borrowing, and default prevention.

**Default Aversion:**

- Work with one or more lenders and servicers to promote the use of a single entity to perform delinquency servicing now being performed by the lender and Student Aid simultaneously. Also, determine whether focusing contact to a particular borrower through one source reduces the rate of delinquency and default.
- Develop and implement a comprehensive early withdrawal program on a selected basis that is designed to avert defaults by borrowers who withdraw from school before completing the educational program. Under the counseling program, Student Aid or its agent shall contact borrowers upon their withdrawal from school and provide appropriate information about debt management, repayment options, employment counseling, and other services.
- Identify borrowers at high risk of default and, in cooperation with lenders, facilitate consolidation of such borrowers' loans to the extent that consolidation will help avert default.

**Claims and Post-Default Servicing:**

- Develop and implement performance-based collections standards for its internal and external collectors designed to increase collections measurably.
- Seek to exchange defaulted accounts with other guaranty agencies according to established exchange criteria designed to increase the potential for collection due to factors such as geographic location or state-specific enforcement authority.
- Seek to reduce the number of school and lender program reviews by establishing cooperative agreements with other guaranty agencies to eliminate duplication.

Source: Voluntary flexible agreement between the U.S. Department of Education and the California Student Aid Commission, dated March 15, 2001.

### Student Aid May Have Lost the Opportunity to Receive Millions in Federal Revenue Because It Failed to Renegotiate Its VFA Promptly

Student Aid failed to renegotiate its VFA with Education in a timely manner. According to a representative from Education, most new agreements are negotiated in eight to 10 months. Disputes between Student Aid and EDFUND, along with turnover in EDFUND's executive management team, have contributed to delays in Student Aid's submission of a VFA proposal to Education for negotiation. As a result, Student Aid may have lost the opportunity to receive at least $24 million in VFA revenues in federal fiscal year 2005.

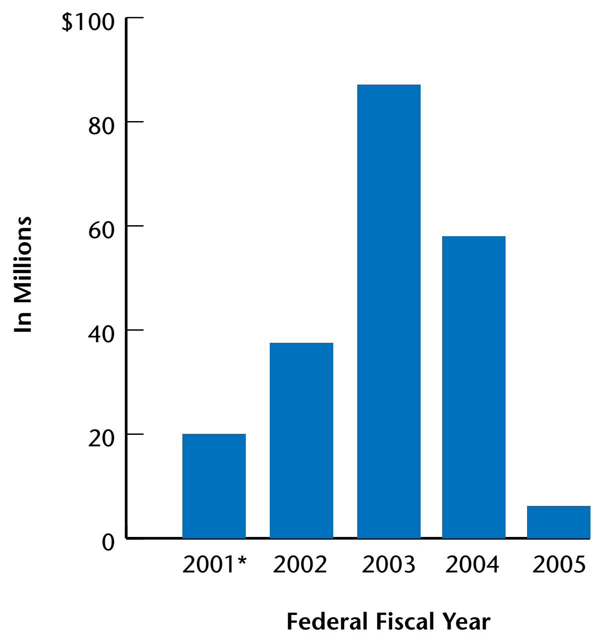
On March 15, 2001, Student Aid and Education signed an agreement that allows Student Aid to implement the activities shown in the text box to improve services to borrowers and students. The purpose of the VFA is to promote activities that will benefit the FFEL Program and will be either cost neutral—that is, the fees paid to Student Aid under the VFA in no case may exceed the cost that would be recognized by Education in the absence of the VFA activities—or will result in savings to

Education. As Figure 6 shows, between federal fiscal years 2001 and 2004, Student Aid's average VFA revenues were roughly $50 million, and peaked at $87 million in federal fiscal year 2003.

In its January 2002 report titled *Federal Student Loans Flexible Agreements With Guaranty Agencies Warrant Careful Evaluation*, the U.S. Government Accountability Office (GAO) reported that its analysis based on Education's estimates shows that California's VFA incentive payment for federal fiscal year 2001 was about $17.3 million—$2.6 million greater than the estimated total the federal government saved due to the lower volume of defaulted loans. Consequently, the GAO recommended that the secretary of Education renegotiate the California VFA as soon as practicable to obtain changes necessary to ensure that it did not increase projected federal costs.

## FIGURE 6

**Student Aid Voluntary Flexible Agreement Revenues**




Source: Student Aid's Unaudited Revenues and Expenses Variance Reports for the 12 months ending September 30, 2001, through 2005.

* Because the voluntary flexible agreement was signed on March 15, 2001, the revenues do not represent a full year.

In a meeting held on November 21, 2003, Student Aid adopted a policy placing the ultimate authority for EDFUND operations with Student Aid's executive director and stated that all actions of EDFUND should be carried out with this line of authority in mind. According to the executive director, this included giving her the authority to renegotiate the VFA with Education. According to Education's state agency liaison director, in June 2004 Education informed Student Aid and EDFUND that California's VFA needed to be renegotiated. It appears that Student Aid and EDFUND initially tried to work together to renegotiate the VFA with Education.

***Disputes between the executive director and the former president regarding which entity had the authority to renegotiate the VFA with Education caused delays of almost four months.***

However, in October 2004, EDFUND's former president attempted to coordinate a meeting to discuss the next steps in the renegotiation with Education. Student Aid's executive director became aware of the meeting and reminded the former president that Student Aid delegated the authority to renegotiate the VFA to the executive director. In addition, the executive director reminded the former president of her commitment to hold any conversations with Education in the presence of Student Aid staff. This dispute between the executive director and the former president regarding which entity had the authority to renegotiate the VFA with Education caused delays of almost four months. Between January 24, 2005, and February 20, 2005, the executive director did not participate in the VFA renegotiations with Education due to her absence. According to the executive director, in her absence Student Aid and the EDFUND board of directors (board) met in a closed session at a January 2005 workshop and delegated the authority to renegotiate the VFA to the former president of EDFUND.

In February 2005 and March 2005, EDFUND staff worked on renegotiating the VFA with Education. However, Student Aid's attempts to participate in the process were unsuccessful. For example, Student Aid's former chief of the Federal Policy and Programs Division (oversight division) made several attempts to include its staff in the VFA renegotiation process. Although EDFUND's former vice president of public affairs agreed that Student Aid and EDFUND staff should collaborate on the review and approval of the proposal to be submitted to Education, he restricted access to the decision-making aspects of the renegotiation process, and only offered Student Aid staff briefings. When the former chief first requested access, he was told that EDFUND was still in a "number-crunching" stage, and that staff needed to do more modeling before they would understand what proposals might generate the best results.

EDFUND's former vice president of public affairs played down Student Aid's former chief's second request by stating that it was not practical to ask EDFUND staff to set aside their priorities to try to bring new staff up to speed when attempting to get VFA negotiations back on track. The former vice president of public affairs instead offered Student Aid staff an opportunity to attend a briefing on the ideas and models currently being tested. Student Aid's former chief's concerns were dismissed in his third attempt to gain access to the decision-making process. Specifically, EDFUND's former vice president of public affairs ignored the former chief's request and instead discussed the planning of a high-level conference.

It was not until April 2005 that Student Aid assigned a research manager with consulting experience, who is now the current president of EDFUND, to assist in the VFA renegotiations. In July 2005 and August 2005, EDFUND experienced turnover in three senior management positions. In August 2005, the research manager became EDFUND's interim president. He then worked with Student Aid and was able to develop a VFA proposal that was submitted to Education in October 2005.

***As of April 18, 2006, Student Aid and Education still had not executed a new VFA.***

As of April 18, 2006, Student Aid and Education still had not executed a new VFA. According to Education's state agency liaison director, the changes in EDFUND's executive management team, as well as changes made to the initial proposal by the new leadership, contributed to delays. He further stated that Education's goal is to renegotiate a VFA that will allow Student Aid to receive payments for the work performed in federal fiscal year 2006. However, he believes it is unlikely that Education will be able to make payments to Student Aid for its federal fiscal year 2005 performance.

In federal fiscal year 2005 EDFUND budgeted $30 million in VFA revenues. However, Figure 6 on page 23 shows that in federal fiscal year 2005, Student Aid received only $6 million. These revenues were related to one component of the VFA's activities, and were transferred from the Federal Fund to the Operating Fund by Student Aid at EDFUND's request. It should be noted, however, that due to the status of Student Aid's Federal Fund, these same revenues ultimately would be transferred back to the Federal Fund to meet the federal minimum reserve requirement.

According to Education's state agency liaison director, he informed Student Aid and EDFUND in June 2004 that they would not receive any VFA funding beyond federal fiscal year

*Student Aid may not receive $24 million in VFA revenues because it did not complete the negotiation for a new VFA.*

2004 until the agreement was renegotiated to obtain cost neutrality. Thus, Student Aid may not be able to receive the additional $24 million that EDFUND budgeted for federal fiscal year 2005 or any other additional funds it may have been eligible to receive. In early February 2006, he informed us that he expected the new VFA to be executed by April 2006.[8] If Education and Student Aid are unable to complete their renegotiations and comply with the VFA notice requirements before September 30, 2006, Student Aid also risks losing the opportunity to receive the $31.4 million that EDFUND budgeted for federal fiscal year 2006.

### Efforts to Increase Revenue Through Business Diversification Have Not Succeeded

As discussed previously, depending on whether or not other guaranty agencies elect to pay the federal default fee on behalf of borrowers, Student Aid may experience a significant reduction in new loan volume that could affect its account maintenance and loan processing and issuance fees. Additionally, if EDFUND is unable to aggressively reduce its use of consolidations to collect on defaulted loans, there could be further reductions in revenues. Thus, the State's ability to continue to generate sufficient FFEL Program revenue to support its other programs and services may rely upon Student Aid's and EDFUND's ability to obtain additional sources of revenue from a diverse set of student loan-related business activities. Figure 7 shows EDFUND currently participates in two of five such activities.

Not ensuring that the legal authority existed for EDFUND to engage in business activities unrelated to the administration of the FFEL Program in the early planning stages hindered the ability of Student Aid and EDFUND to plan effectively for business diversification activities. Moreover, once the legislative authority was obtained, Student Aid and EDFUND were unable to ensure that they retained control of $70 million in Operating Fund money set aside for business diversification. Currently, neither Student Aid nor EDFUND has a formal plan that specifically identifies the business diversification opportunities they will target.

[8] Federal law requires the secretary of Education to notify the chairperson and the ranking minority member of the Committee on Labor and Human Resources of the Senate, and the Committee of Education and the Workforce of the House of Representatives not later than 30 days *prior* to concluding a VFA.

## FIGURE 7

### Examples of Student Financial Aid Business Activities

**Guaranteed Federal Student Loans**

Federal student loans are extremely low-risk loans, as compared with other types of unsecured loans, in part because the federal government guarantees them against default. Guaranty agencies insure student loans, on behalf of the federal government, against default. If the borrower defaults, dies, or becomes totally and permanently disabled, the guaranty agency reimburses the lender for the remaining balance on the loan.

EDFUND guarantees Federal Family Education Loan Program (FFEL Program) loans for various lenders.

**Alternative Education Loans**

Alternative loans, also referred to as private loans, are available to students who have received the maximum award amounts under the FFEL Program and require additional funding. These loans are available from a variety of private lenders, such as banks and financial institutions, and are not federally guaranteed. Thus, they tend to cost more.

**Student Loan Servicing**

Servicers are companies that collect payments on loans, respond to customer service inquiries, and perform other administrative tasks associated with maintaining a loan portfolio. Servicers disburse loan funds, monitor loans while the borrowers are in school, collect payments, process deferments and forbearance, respond to borrower inquiries, maintain loan records, and ensure all loans are administered in compliance with federal regulations and guaranty agency requirements.

**Secondary Markets**

Secondary markets insure the liquidity of the FFEL Program by buying student loans from education lenders. This provides education lenders with fresh capital they can use to originate new student loans. Selling loans is a common practice among lenders, so the bank a borrower sends his or her payments to may change during the life of the loan. Typically, a loan will be sold when it enters into repayment. Secondary markets often offer repayment incentives on the loans they hold. These incentives can include principal rebates and interest rate reductions for signing up for automatic direct debit of monthly loan payments and for making consecutive monthly payments on time.

**Collections**

Collection agencies are companies that focus on receivables management, helping lenders recover funds from borrowers who default on their loans. Some collection agencies specialize in student loans.

When EDFUND pays a lender for a defaulted FFEL Program loan that it has guaranteed, it then attempts to collect reimbursement from the borrower. EDFUND's internal collections unit seeks repayment for 180 days; after that, it may send the loan to outside collection agencies.

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Sources: FinAid*!* and the California Student Aid Commission's *Annual Report to the California State Legislature on EDFUND,* dated April 1, 2005. FinAid*!* is a registered service mark of FinAid Page, L.L.C.

### *Delays in Resolving Legal Issues and Seeking Legislation Thwarted Early Attempts at Diversifying*

**_Student Aid needs to develop other lines of business or face a generally uncertain future in the FFEL Program._**

As early as 1998, Student Aid and EDFUND discussed the future of the FFEL Program and business diversification. In a November 10, 2000 meeting, the EDFUND board discussed long-term business strategy. As a result of these discussions, the board authorized EDFUND to enter into a contract with a consultant to gain some expertise about its long-term strategy options. Also during this meeting, EDFUND's vice president of finance and administration presented data that reinforced the need to develop other lines of business during the next several years or face a generally uncertain future beyond federal fiscal year 2004.

On November 15, 2000, EDFUND contracted with a consultant to work with its management and board.[9] In July 2001, EDFUND extended the existing contract with the consultant to evaluate several potential business expansion opportunities. According to the current chair of the EDFUND board, Student Aid, the board, and various committees met throughout 2002 to discuss business diversification options. For example, in July 2002, Student Aid and the board jointly agreed to form an ad hoc committee to develop a business plan that included alternatives for new lines of business and other options for diversification of revenue.

It was not until its November 21, 2003, meeting that Student Aid authorized staff to discuss with leaders in the Legislature and the administration the feasibility of pursuing legislation to expand EDFUND's authority beyond its current FFEL Program support activities to include services for other student financial aid activities, to provide clear legal authority to pursue business diversification options, and to create new business enterprises. Therefore, almost a year passed before Student Aid sought to clarify its legislative authority to enter into other lines of business.

Student Aid and EDFUND suspended actively planning for business diversification until September 21, 2004, when the governor signed legislation that specifically precludes Student Aid from allowing EDFUND to issue bonds, originate loans, or participate in loan capitalization activities. State law does not preclude Student Aid or EDFUND from undertaking other permitted activities related to student financial aid in partnerships with institutions that conduct loan origination

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[9] EDFUND's legal counsel asserts that the specific details of its business diversification strategies are confidential and proprietary. Thus, we cannot discuss its strategies in our report.

or loan capitalization activities. However, state law requires Student Aid to provide the director of the Department of Finance (Finance) and the Joint Legislative Budget Committee with at least 45 days notice in writing before amending an existing operating agreement or entering into any new agreement with EDFUND for the purpose of adding the new services or activities. The notice must include a description of the proposed operating agreement. Almost 19 months had passed by the time Student Aid received its legislative authority to diversify. Given that its plan was no longer viable because of restrictions included in the legislation, Student Aid was not any closer to diversifying its business.

### *A Business Diversification Plan Does Not Exist and Student Aid Could Not Retain Funds From the Legislature for This Purpose*

***To aid in Student Aid's efforts, the Legislature designated $70 million from the Operating Fund for business diversification.***

Student Aid and EDFUND continued to struggle with business diversification. EDFUND's federal fiscal year 2005 Loan Program Business Plan, dated March 3, 2005, stated that recent reductions in FFEL Program reimbursements and the pending loss of funds from the Operating Fund only make more urgent the need to diversify its sources of revenue. To aid in its efforts, the Legislature designated $70 million from the Operating Fund for business diversification. The Budget Act of 2005 stated that pursuant to legislation enacted during the regular legislative session for fiscal year 2003–04, Student Aid may develop a carefully crafted business diversification plan that would help it remain competitive. The Budget Act of 2005 also stated that Student Aid shall be further authorized to transfer up to $70 million of the unencumbered balance of the Operating Fund for purposes of business diversification.

According to the board chair, in a joint workshop held in July 2004, Student Aid's executive director and the former EDFUND president agreed that the executive director would prepare a business diversification plan within six to eight months with EDFUND's assistance. However, we could not confirm this or the options discussed because we could not obtain meeting minutes for the joint workshop.

Although Student Aid had given the authority to develop a business diversification plan to its executive director in July 2004, the executive director stated that Student Aid and the board met in closed session at a January 2005 workshop and delegated this authority to the former president of EDFUND. According to the former president of EDFUND, she met with two entities that expressed interest in a partnership. She further stated that each of the entities had different business models and, therefore, the opportunities were different. We could not determine from the available EDFUND board meeting minutes when or if it discussed these options. Therefore, we cannot determine why the options for partnership were not pursued further.

***The Budget Act of 2006 did not set aside any funds for business diversification activities because Student Aid and EDFUND did not have any immediate options for business diversification.***

On February 22, 2005, the speaker of the Assembly wrote a letter to the chair and vice chair of Student Aid asking for an update on efforts to assess preparedness for diversifying its loan services. He further stated that, given the need to use $146.5 million to support the Cal Grant program and the set-aside of $70 million for business diversification in the previous year, it was critical for the Legislature to understand how these and other proposals would affect the long-term solvency of the Operating Fund. Student Aid's executive director responded on March 7, 2005, stating that neither Student Aid nor EDFUND had completed its final review of the reports presented by two consultants and that Student Aid had not completed its independent review. Subsequently, according to the executive director of Student Aid, she informed Finance that Student Aid and EDFUND did not have an immediate option for entering into business diversification. The Budget Act of 2006 did not set aside any funds for business diversification activities but instead allocated $51 million of Operating Fund money for use within the Cal Grant program.

According to the president of EDFUND, the Legislature's decision to transfer $51 million of the $70 million in funds budgeted for business diversification, as well as other transfers of funds out of the Operating Fund, severely limited and continues to limit EDFUND's flexibility and the types of business diversification opportunities it is able to pursue. According to its accounting records, since federal fiscal year 2001, EDFUND has spent roughly $490,000 to identify business diversification options. However, as of March 2006, almost eight years later, Student Aid and EDFUND had yet to formally approve a suitable plan for business diversification to generate additional sources of non-FFEL Program revenue.

## Student Aid and EDFUND Have Been Unable to Agree on a New Operating Agreement for the FFEL Program That Delineates Their Respective Roles

*Student Aid may be inappropriately ceding some of its responsibilities to EDFUND based on the provisions included in a draft roles and responsibilities document.*

Student Aid and EDFUND do not agree on the appropriate role each should have in the administration of the FFEL Program. Despite attempting to craft a roles and responsibilities document (document) since at least May 2005, they have yet to finalize one. In November 2005, six months later, the commission reached a consensus on the document. However, according to the chair of the commission, Student Aid plans to wait until our report is issued before giving final approval. Disagreements among commissioners and board members have played a significant role in their inability to complete the task. Furthermore, based on our review of the ninth version of the two-page draft document, Student Aid may be inappropriately ceding some of its responsibilities to EDFUND.

In the September 17, 2005 draft document, Student Aid and EDFUND present their delineation of each entity's role and responsibility for administering the FFEL Program. However, we have concerns about some provisions the document contains. For example, it states that EDFUND has the primary role in operating all aspects of the FFEL Program. However, federal law requires the guaranty agency that chooses to delegate the performance of the FFEL Program function to another entity to ensure that the other entity complies with the program requirements and to monitor its activities. In addition, federal regulations require the state agency to maintain full responsibility for the operation of the FFEL Program when the program is administered by a nonprofit organization.

The draft document also indicates that those in charge of technology at Student Aid and EDFUND handle technological information development and coordination jointly. Yet state law requires Student Aid to maintain its responsibility for, among other things, information development and coordination. Finally, the document states that it is EDFUND's role to represent the State's FFEL Program with industry and trade associations and similar groups, including communication with Education concerning federal reporting, operational communication, development of the VFA , and program compliance. Although we acknowledge that EDFUND needs to play a role in these areas, Student Aid is ultimately responsible for the FFEL Program and needs to have a strong presence.

Furthermore, the draft document identifies the major oversight roles and responsibilities of Student Aid. However, the roles and responsibilities are vague and subject to interpretation. For example, the document states that Student Aid exercises its ultimate responsibility over the FFEL Program by annually approving the business plan, annual budget, and performance goals of EDFUND, and by *appropriate* monitoring and verification of EDFUND operations and support services. The document also states that Student Aid staff will work with EDFUND in *appropriate* ways. However, *appropriate* is not defined in either instance. The document also does not specify the level of review that Student Aid will perform when verifying and monitoring EDFUND's business plan, annual budget, and performance goals or policy, either before or after its approval.

The document concludes by stating that Student Aid expects and requires cooperation between its executive director and EDFUND's president, as well as their staff, to implement these roles and responsibilities. However, we also question the overall value of this document in resolving the long-standing tension and distrust that exists between Student Aid and EDFUND. For instance, the chair of Student Aid, who is also an EDFUND board member, and the executive director, stated that a major point of contention between the two entities is that there is no consensus on the appropriate level of oversight that Student Aid should exercise over EDFUND. They also stated that oversight means different things to different people. Consequently, there will continue to be animosity between the two entities unless Student Aid and EDFUND can reach an accord on the level of oversight performed by Student Aid.

This animosity is based largely on the fact that EDFUND officials believe Student Aid is attempting to micromanage EDFUND operations and, in the process, is interfering with its business activities. On the other hand, Student Aid believes it has the duty under state and federal laws to be informed of and have the opportunity to review the impact and justification of major decisions made by EDFUND, including budgeting; policy development; business strategies; communications with state, federal, and industry representatives; composition of loan portfolio; and increases or decreases in personnel and the effect of those decisions on EDFUND's major business activities. Thus, even if the entities were to reach agreement on specific and detailed language within the document, there is nothing to guarantee that they will implement their respective roles and responsibilities.

***If Student Aid and EDFUND are unable to resolve their fundamental differences and EDFUND cannot demonstrate that it can generate an operating surplus that is sufficient to sustain the FFEL Program and support Student Aid's other services and programs, it is our opinion that having an auxiliary organization may not benefit the State.***

Ultimately, if the two entities are unable to resolve their fundamental differences and EDFUND is unable to demonstrate that it can generate an operating surplus that is sufficient to sustain the FFEL Program and support Student Aid's other services and programs, it is our opinion that there is little basis to believe that having an auxiliary organization to assist in the administration of the FFEL Program will benefit the State. In the event this should occur, among the viable options, two should be considered. First, Student Aid may elect to contract with an existing guaranty agency to administer its FFEL Program. Alternatively, the Legislature may decide that it is no longer beneficial to the State to have a designated FFEL Program guaranty agency. Regardless of the option chosen, it would be necessary to dissolve EDFUND in accordance with the terms of its articles of incorporation.

## RECOMMENDATIONS

To determine if it remains beneficial for the State to participate in the FFEL Program as a guaranty agency, the Legislature should:

- Closely monitor Student Aid and EDFUND to ensure that they are able to remain competitive with other FFEL Program guaranty agencies.

- Closely monitor the Operating Fund to ensure that the FFEL Program is generating a sufficient operating surplus so that it can supplement funding for Student Aid's other services and programs. If it is unable to generate a sufficient operating surplus, the Legislature should require Student Aid to dissolve EDFUND and contract with another guaranty agency to administer the FFEL Program. The contract should include, among other things, a provision that allows Student Aid to receive a share of the revenues generated by the guaranty agency, which then could be used to supplement funding for Student Aid's other financial aid programs. In addition, the contract should include a provision for Student Aid to hire external auditors to ensure that the guaranty agency is complying with federal laws and regulations. Alternatively, the Legislature could reconsider the need for a state-designated guaranty agency.

- Closely monitor Student Aid's progress toward completing critical tasks, including the renegotiation of its VFA with Education and the development of a business diversification plan.

To manage the FFEL Program in a manner that benefits the State, Student Aid should:

- Continue to reassess the financial impact on the FFEL Program caused by changes in the federal Higher Education Act and the recent announcements made by some large guaranty agencies that they will pay the federal default fee for borrowers.
- Monitor EDFUND's progress toward reducing its reliance on defaulted loan consolidations.
- Ensure that critical tasks, including the renegotiation of its VFA with Education and the development of a diversification plan, are completed.
- Ensure that the roles and responsibilities it delineates for itself and EDFUND do not inappropriately cede its statutory responsibilities to EDFUND. ■

# CHAPTER 2

## *The California Student Aid Commission's Oversight of Its Auxiliary Organization Requires Significant Improvement*

### CHAPTER SUMMARY

The California Student Aid Commission (Student Aid) has taken no action to reduce EDFUND's cost of administering the Federal Family Education Loan (FFEL) Program or to ensure that Student Loan Operating Fund (Operating Fund) expenses incurred by EDFUND represent a prudent use of funds. In federal fiscal year 2005, Student Aid approved $185,700 in EDFUND executive bonuses despite the fact that the FFEL Program had an operating deficit of $8.3 million during that year.

Additionally, Student Aid does not ensure that EDFUND's policies for travel and business expenses are fiscally conservative. We also identified numerous instances when EDFUND used the Operating Fund for lodging and meals that exceeded its own policy. Moreover, EDFUND used poor judgment by incurring exorbitant costs for events such as picnics and holiday festivities for its employees and their families, as well as employee day conferences. All these practices have a negative impact on the already depleting Operating Fund.

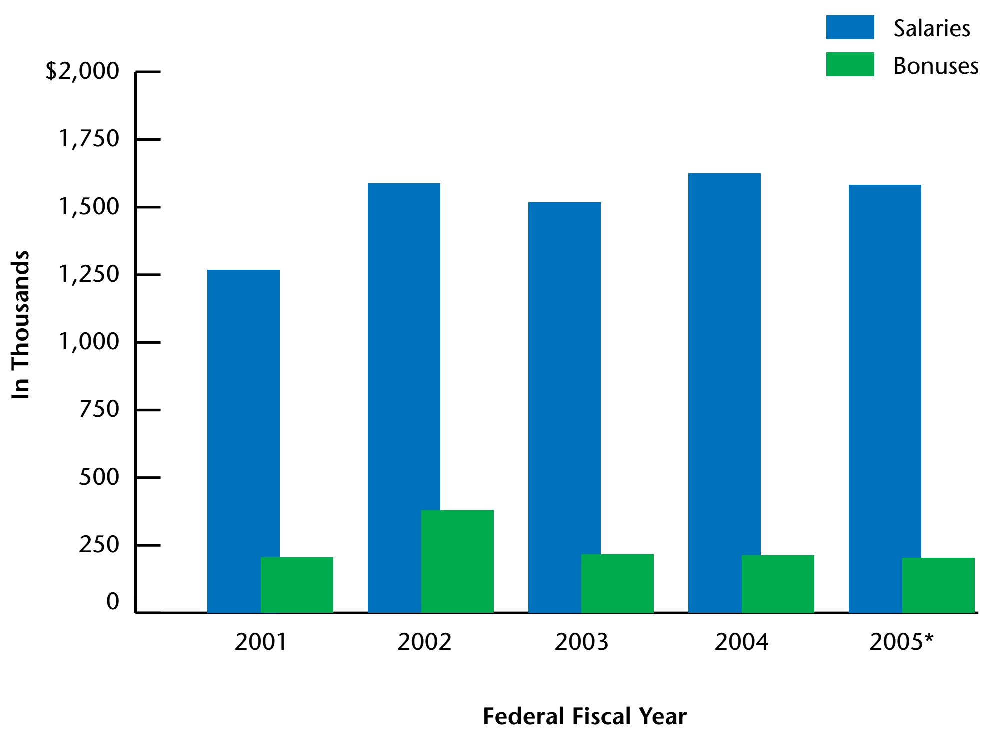
Student Aid's efforts to increase its oversight of EDFUND's process in handling the FFEL Program by, for example, participating more vigorously in developing EDFUND's budgets and business plans, have been unsuccessful for the most part. A major concern is that it has not resolved issues with EDFUND even after its staff points out specific problems. These ongoing issues are putting the future success of Student Aid's participation in the FFEL Program at risk.

## STUDENT AID'S PROCESS FOR ESTABLISHING EXECUTIVE SALARIES AND BONUSES FOR EDFUND REQUIRES IMPROVEMENT

EDFUND's current policy for setting salaries does not meet the requirements established in federal regulations for nonprofit organizations. For example, although EDFUND uses surveys to assist in establishing salaries for its executives, it does not limit data to survey sources related to the financial industry, which exposes it to the risk of greater scrutiny by the federal government and the public. Figure 8 shows the trend of executive salaries and bonuses during the last five federal fiscal years.

**FIGURE 8**

**Salaries and Bonuses Paid to EDFUND's Executives**




Source: EDFUND Human Resource Payroll System.

* Executive salaries and bonuses for federal fiscal year 2005 show a decrease due to the resignation of the president and general counsel in August 2005 and the resignation of the chief financial officer in July 2005.

Additionally, the executive bonus compensation policy Student Aid issued in August 2002 is flawed because it allows such bonuses even when EDFUND is operating the FFEL Program at a deficit. Finally, EDFUND's method for establishing bonuses for its nonexecutive staff allows them to receive bonuses without meeting many of its established goals.

### EDFUND's Policy Does Not Meet Federal Requirements for Executive Salary Determination; Nor Does It Comply With Its Own Policy

EDFUND created its current policy for setting executive salaries in response to federal regulations ensuring reasonable compensation for employees who exercise substantial control over nonprofit corporations. These regulations presume that payments under a compensation arrangement are not excessive if they meet certain requirements. However, EDFUND's policy does not meet the requirements; nor does it adhere to all elements of its policy.

EDFUND's policy for setting executive salaries is a four-step process. In the first step, its personnel committee collects comparable data as an evaluation point against which to set salaries. Comparable data would be the salaries paid in the labor market for the type of employees EDFUND would hire. The personnel committee may do this through surveys, public information, knowledge of members of the EDFUND board of directors (board), job offers from competitors, or any other means of identifying comparable compensation paid by similar organizations. The second step is to determine the initial executive salary rates. An executive committee reviews comparable data, organization and individual performance indicators, and the financial position and mission of EDFUND, and sets the salary of the president. The executive committee delegates to the president the authority to set the salary of the other executive management team members subject to his or her review of the same criteria for those individuals. In the third step, the board ratifies the decisions of the executive committee. Finally, the executive committee and board approve the compensation decisions that have been made and documented in the minutes.

This four-step process does not meet federal regulations requiring certain formalities in setting the compensation for disqualified employees of nonprofit corporations in order to avoid excess benefit to those who exercise substantial control over the corporation.[10] Under the regulations, payments under a compensation arrangement are presumed to be at fair

[10] Disqualified employee is defined, along with other technical terms, in the Appendix.

market value if the arrangement is approved in advance by an authorized body of EDFUND composed of individuals without a conflict of interest, the authorized body obtained and relied upon appropriate comparability data, and the body adequately documented its basis for determination. Adequate documentation consists of the terms, approval date, members of authorized body present, members who voted, comparability data and how it was obtained, and any actions taken with respect to consideration of the transaction by anyone who is a member of the body but who had a conflict of interest. EDFUND's policy does not meet all these requirements, which exposes it to the risk of increased scrutiny by the federal government and the general public. Specifically, EDFUND's policy does not address board members who have a conflict of interest.

***EDFUND's policy for setting executive salaries does not meet the federal requirements, which exposes it to the risk of increased scrutiny by the federal government and the general public.***

In addition, we question the manner in which EDFUND carried out its salary comparison. Its Personnel and Nominations Committee did commission a salary comparability study that was completed in October 2005. However, rather than limiting data to survey sources related to the financial industry, the study combined a variety of surveys, one of which used data from nonprofit organizations that included positions in the area of health and social welfare and three sources that did not specify the industries surveyed.

Further, since the inception of the policy in October 2002, the only board minutes we found discussing salary decisions were for the November 15, 2002, November 14, 2003, and January 13, 2006, board meetings. Moreover, our review of the January 13, 2006, closed-session board meeting minutes found that EDFUND failed to follow its policy for setting executive salaries. Additionally, EDFUND failed to follow Student Aid's policy for setting bonuses that we discuss beginning on page 39 and state law that requires EDFUND to conduct its business in accordance with the operating agreement.

Its policy requires the executive committee to keep detailed minutes describing the salary determination process, but EDFUND provided us with minutes only from its November 9, 2005, executive committee closed session; based on our review, no other salary-related executive committee minutes exist. Moreover, these minutes do not include the compensation decisions that were made, as the EDFUND policy requires.

EDFUND cannot demonstrate that it follows its executive salary determination policy because the board and executive committee have not kept sufficient minutes of their meetings.

### Student Aid's Policy Regarding EDFUND Executive Incentive Compensation Is Flawed

The operating agreement between Student Aid and EDFUND specifically states that EDFUND agrees to administer its executive performance payment plan in accordance with the Student Aid policy statement and guidelines memo (policy) titled *EDFUND Incentive Compensation Plans,* dated August 12, 2002. This policy states that "EDFUND's executive management team, consisting of the president and vice presidents, may receive incentive compensation payments (bonuses). A precondition for this compensation is that the FFEL Program has been managed to a year-end operating surplus or deficit at least as positive as the budget (as revised) for the year, excluding the revenues and expenses related to the VFA and any non-FFEL Program expenses directed by Student Aid."

If the precondition is met, the EDFUND board or its designated committee is responsible for proposing the amounts of the bonuses. The policy further states that the EDFUND board shall recommend the proposed bonus amount, if any, for the president and the total bonus amount for the executive management team. Student Aid's executive director reviews the proposed bonus amounts and submits her recommendation, which is based on her review of the board's assessment of EDFUND's overall performance and the president's individual performance, to the chair of the commission, who determines whether the proposed bonuses are appropriate and what, if any, they will be.

***EDFUND's policy for awarding executive bonuses is flawed because it allows bonuses when an operating deficit exists.***

This policy contains flaws because it allows bonuses when an operating deficit exists and excludes some FFEL Program revenues and expenses from the calculation of the Operating Fund surplus or deficit. In addition, the policy is completely discretionary and is silent on how EDFUND should determine the amount of the executive compensation pool.

### *Student Aid Allows EDFUND's Executive Management Team to Receive Substantial Bonuses Even With an Operating Deficit*

Student Aid and EDFUND have extended their operating agreement each year since October 2002 and have not renegotiated its terms. The precondition as stated in Student Aid's current policy allows for bonuses to be awarded even if there is an operating deficit at year-end. However, the October 1, 2000, and October 1, 2001, operating agreements stated clearly that in no event will payments of bonuses be made if the Operating Fund has not realized a positive surplus for the year just ended. Neither the Student Aid nor the EDFUND representatives who signed the federal fiscal years 2000, 2001, and 2002 agreements are still employed by either entity. Further, neither Student Aid's current executive director nor EDFUND's current president could provide the rationale for changing the precondition. Thus, we cannot determine the impetus for changing the precondition to allow the executive management team to receive bonuses even when their efforts result in either an Operating Fund or FFEL Program deficit. Regardless, the precondition as stated in the federal fiscal year 2002 operating agreement is inconsistent with Student Aid's goal (in the same operating agreement) for EDFUND to provide a reliable, sustainable, and increasing revenue stream to ensure the continuation of a strong competitive FFEL Program and to provide resources for the other priorities established by Student Aid. Additionally, Student Aid set a goal for EDFUND to provide the most efficient and effective service while controlling costs. If EDFUND managed the FFEL Program in a manner that resulted in a year-end operating deficit, then it clearly did not meet Student Aid's goals. Consequently, it would be imprudent of Student Aid to award bonuses to EDFUND's executive management team.

*If EDFUND managed the FFEL Program in a manner that resulted in a year-end operating deficit, then it clearly did not meet Student Aid's goals. Consequently, it would be imprudent of Student Aid to award bonuses to EDFUND's executive management team.*

The Student Aid executive director acknowledges that the current bonus plan is flawed. She was asked why she had not exercised a provision of the Student Aid policy that states if the EDFUND board or the executive director disagrees with the commission chair's decision, either may request a closed session review by the full commission. She stated that, during her first year as executive director, she agreed to approve the executive bonus amount with the understanding that EDFUND had agreed to put a new methodology and process in place for federal fiscal year 2004. For federal fiscal year 2004, due to several concerns regarding the EDFUND executive management team, the executive director asked the commission chair to delegate the responsibility for signing the approval of the discretionary executive bonus payment to the chief of the management services division. She further stated that, for federal fiscal year 2005, the commission chair made the final decision, as in previous years, regarding the executive bonus pool. However, given her consistent concerns, the executive director should have brought the issue to the full commission for vote.

### *The Policy Specifically Excludes Certain Loan Program Revenues and Expenses*

***If EDFUND had included all FFEL Program revenues and expenses in its calculation, it would have arrived at a deficit of $8.3 million rather than the $26 million surplus it reported.***

In calculating bonuses based on its performance for federal fiscal year 2005, EDFUND used preliminary data to determine whether there was a FFEL Program operating surplus or deficit. Using the methodology for the precondition prescribed by the current policy, EDFUND had an operating surplus of $26 million. However, the policy specifically excludes revenue and expenses related to the voluntary flexible agreement (VFA) and any non-FFEL Program expenses directed by Student Aid. As shown in Table 1 on the following page, had EDFUND included all FFEL Program revenues and expenses in the calculation and used actual year-end data in its calculation, it would have arrived at an operating deficit of $8.3 million.

EDFUND separates its FFEL Program fiscal activities into two categories, standard and supplemental. For example, it considers its expenses related to collection agency costs to be standard expenses, while expenses from its EdShare competitive grant program are supplemental to the FFEL Program. To calculate its standard FFEL Program operating surplus, EDFUND considers all VFA revenues and its minimum reserve subsidy expenses to be supplemental. However, both of these categories are related directly to EDFUND's operation of the FFEL Program and, therefore, should be considered standard activities.

According to the president of EDFUND, Student Aid recommended that it move the VFA revenues out of the calculation of operating surplus or deficit after Student Aid saw that the actual VFA payments significantly exceeded the forecasted amounts. He further stated that a former chief of Student Aid's FFEL Program oversight division believed that the large VFA payments skewed the performance metrics in EDFUND's favor. Finally, he stated that EDFUND does not include the minimum reserve subsidy expense in the calculation, considering it not a standard expense but a benefit to borrowers tied to the decision to waive the federal default fee.

## TABLE 1

### Student Aid's Federal Fiscal Year 2005 FFEL Program Operating Surplus (Deficit) Calculation

| | Calculation Based on Student Aid's Policy* | Calculation Including All Loan Program Revenues and Expenses† |
|---|---|---|
| **Operating Revenues** | | |
| Net recoveries on defaulted loans | $ 58,148,572 | $ 58,148,572 |
| Account maintenance fees | 24,745,396 | 24,695,401 |
| Loan processing and issuance fees | 22,200,000 | 21,833,220 |
| Default aversion fees | 5,840,918 | 5,840,918 |
| Voluntary flexible agreement | 0 | 6,174,255 |
| Other revenues | 105,571 | 6,383,329 |
| **Total revenue** | **111,040,457** | **123,075,695** |
| **Operating Expenses** | | |
| Salaries and benefits | 52,253,501 | 52,179,813 |
| Operating expenses‡ | 23,025,678 | 22,901,146 |
| External collection costs | 9,705,719 | 9,705,719 |
| EdShare§ | 0 | 865,327 |
| Minimum reserve subsidy | 0 | 42,185,841 |
| Other expenses | 0 | 3,512,410 |
| **Total expenses** | **84,984,898** | **131,350,256** |
| **Operating surplus (deficit)** | **$ 26,055,559** | **$ (8,274,561)** |

* Student Aid's unaudited preliminary federal fiscal year 2005 Revenues and Expenses Variance Report and Statement of Activities Report presented at the November 9, 2005, executive committee meeting.

† Student Aid's unaudited final federal fiscal year 2005 Revenues and Expenses Variance Report, dated December 12, 2005.

‡ Includes expenses related to computers, consulting and professional fees, Student Aid loan program expenses, facilities operations, and travel expenses.

§ EdShare is a competitive grant program for individual institutions, and consortia of colleges and universities that is aimed at generating new approaches to borrower education, debt management, and default prevention. EDFUND does not include the EdShare expenses in the calculation because it considers this expense to be a benefit to borrowers.

We discuss the Federal Student Loan Reserve Fund (Federal Fund) and the federal law that requires guaranty agencies to maintain a minimum amount of funds in the Federal Fund more fully in Chapter 1. The minimum reserve subsidy is the amount Student Aid must transfer into the Federal Fund to ensure that it meets this requirement, relating it directly to the FFEL Program. In addition, according to Education, the purpose of the VFA is to promote activities that will benefit the FFEL Program. Thus, the revenues and expenses associated with Student Aid's VFA

*Had EDFUND included all FFEL Program revenues and expenses in the calculation of the results of its operation, EDFUND's executive management team would not have been eligible for $185,700 in bonuses in federal fiscal year 2005.*

are related directly to the FFEL Program. Had EDFUND included these two categories in its standard operating activities in federal fiscal years 2003 and 2004, it still would have generated a FFEL Program operating surplus because its VFA revenues were considerably larger than its minimum reserve subsidy expenses. For example, in federal fiscal year 2004 EDFUND collected almost $58 million in VFA revenues and had only $9 million in minimum reserve subsidy expenses. However, EDFUND's federal fiscal year 2005 VFA revenues were only $6.2 million, while its minimum reserve subsidy expense was $42.2 million. Excluding these two items from the calculation masks Student Aid's and EDFUND's failure to negotiate a new VFA.

As previously stated, the precondition in the current policy states that the operating deficit must be at least as positive as the revised budget. For federal fiscal year 2005, EDFUND's revised budget does not reflect an operating deficit. However, had all FFEL Program revenues and expenses been included in the calculation, the Operating Fund would have had a deficit in federal fiscal year 2005 and, thus, EDFUND's executive management team would not have been eligible for bonuses totaling $185,700. Based on our review of Student Aid's revenue and expense variance reports for federal fiscal years 2000 through 2005 and including all FFEL Program revenues and expenses in the calculation of the precondition, federal fiscal year 2005 was the first year EDFUND did not realize a FFEL Program operating surplus. Until Student Aid changes its precondition to require EDFUND to include all FFEL Program revenues and expenses and forbids it from paying bonuses when an operating deficit exists, less money will continue to be available to support other priorities.

### *The Board's Determination of the Total Bonus Amount for the Vice Presidents Appears Inconsistent*

The current policy directs the board to recommend the proposed bonus amounts, if any, for the president and the total bonus amount for the vice presidents. However, the board does not appear to use consistent criteria from one year to the next when determining the total bonus amount.

In federal fiscal year 2005, it recommended a proposed total bonus pool amount of 20 percent of the cumulative salaries of the six vice presidents. It relied on the recommendation of EDFUND's executive committee, which relied on an analysis prepared by the current president. According to the president, he considered the following factors: (1) Student Aid's unaudited preliminary federal fiscal year 2005 variance report presented at the November 9, 2005, executive committee meeting; and (2) the federal fiscal year 2005 year-end assessments of the organizational metrics. Additionally, he stated that he considered that incentive compensation programs generally are designed to motivate employees to perform at higher-than-expected levels, to reward outstanding individual and team performance, and to encourage commitment to the organization and persistence. Moreover, he wanted to take into consideration the fact that, due to the loss of the EDFUND chief financial officer, two vice presidents assumed additional duties to ensure coverage of the chief financial officer and the business services functions.

The decisions regarding the total amount of the bonuses for the vice presidents for federal fiscal years 2003 through 2005 have been inconsistent. The EDFUND board previously calculated the total bonus pool amount for its vice presidents as a percentage of the cumulative salaries of all eligible vice presidents. Although the Operating Fund had significant surpluses in federal fiscal years 2003 and 2004, the board recommended total bonus pools for the vice presidents that were percentage reductions from the previous years. For federal fiscal year 2003, the Operating Fund had a surplus of $116 million. However, the board recommended a total executive bonus pool for vice presidents of $153,478, which represents barely 19 percent of the total salaries received by all the vice presidents that year. According to the board chair, the decision to reduce payments from the roughly $380,000 paid in federal fiscal year 2002 to the $153,478 paid in federal fiscal year 2003 reflected the generally more unsettled outlook for the student loan guaranty industry beginning with federal fiscal year 2003 because of the decrease in fees paid to guarantors and because of the uncertainty surrounding the impending reauthorization of the federal Higher Education Act.[11]

***In federal fiscal years 2003 and 2004, the Operating Fund had surpluses of $116 million and $63 million, respectively and executive bonuses represented 19 percent and 15 percent of total salaries. However, in federal fiscal year 2005, executive bonuses increased to 20 percent of total salaries despite an operating deficit of $8.3 million.***

The board echoed similar concerns in recommending the federal fiscal year 2004 total bonus pool. Although the Operating Fund had a surplus of $63 million, the board again recommended a reduction in the pool to 15 percent of the total salaries for the vice presidents. According to the board chair, it again considered the diminished state of the Operating Fund, the State's deficit, the relative rates of compensation for state employees, and other issues. He further stated that although the

[11] According to EDFUND's payroll data, the actual amount paid in federal fiscal year was $217,310.

board agreed that the performance of the company during that year was strong, it felt compelled to limit total bonus payments in spite of the obvious indicators of performance. However, in federal fiscal year 2005, despite having an Operating Fund deficit of $8.3 million, the percentage used to calculate the bonus pool for vice presidents increased from the 15 percent used the year before to 20 percent. Uncertainty still existed in the student loan guaranty industry surrounding the reinstitution of the federal default fee.

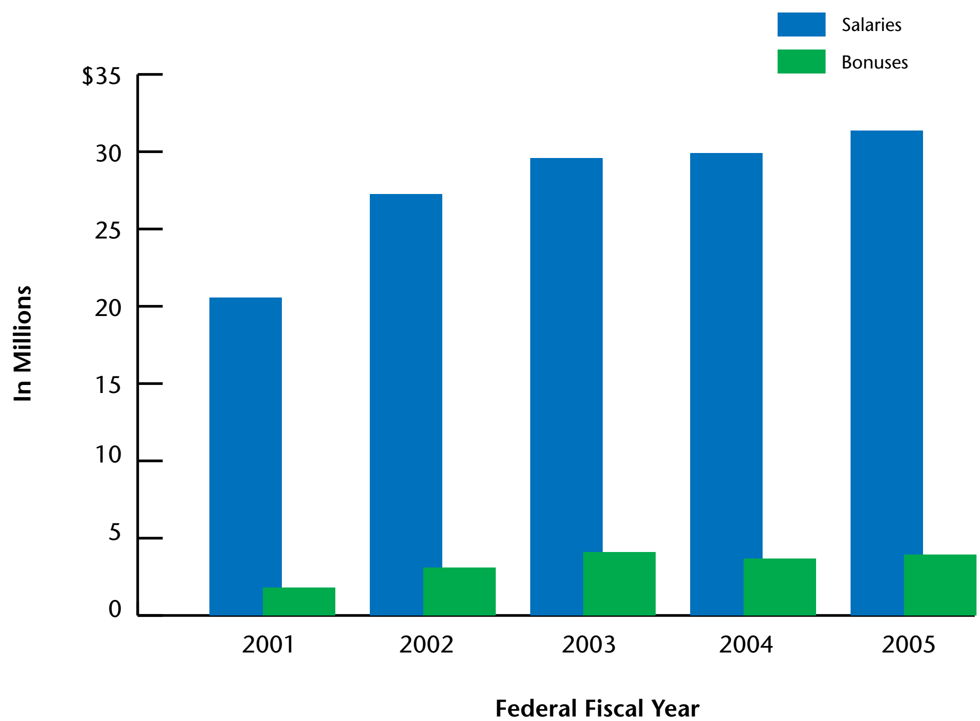
According to Student Aid's executive director, she provided a recommendation to the chair of the commission regarding the executive bonuses, but the chair had the ultimate authority to make the final decision. According to the chair of the commission, he discussed the executive bonus pool with the executive director before he made his decision, and she verbally agreed with him that the chair had the authority to make the final decision regarding the pool amount. Nevertheless, given Student Aid's and the board's previous practice of considering outside industry conditions, as well as internal performance, the FFEL Program operating deficit and future fiscal uncertainties, and the uncertainties surrounding the student loan guaranty industry, it is unclear why either would approve an increase in the percentage for the vice presidents' bonus pool.

## THE METHOD USED TO DETERMINE NONEXECUTIVE BONUSES ALSO NEEDS TO BE REEVALUATED

EDFUND has three bonus plans for nonexecutive employees, known as variable pay plans. Two of its three plans reward employees for both individual performance within and the overall performance of EDFUND as an organization, while the third plan is a straightforward award based on a percentage of monthly collections of defaulted loans (see Figure 9 on the following page). Although its executive director has raised several concerns regarding EDFUND's method of calculating organizational performance, Student Aid has done little to fully address the issues. Until Student Aid resolves these issues, EDFUND will continue to award bonuses that are not based on an accurate assessment of its organizational performance.

**FIGURE 9**

**Salaries and Bonuses Paid to EDFUND's Nonexecutive Employees**




Source: EDFUND Human Resources Payroll System.

### EDFUND Uses High-Level Organizational Metrics to Measure Its Performance and Award Incentive Compensation to Nonexecutive Employees

The operating agreement between Student Aid and EDFUND requires EDFUND to administer its three variable pay plans according to the Student Aid policy discussed previously. One plan, the EdShare Collect, is for internal collectors and internal collection supervisors. This plan awards incentives by establishing monthly net revenue targets and comparing those targets against the actual monthly net revenue collected to identify the appropriate predefined percentage to calculate the monthly bonuses. The other two variable pay plans, EdShare and the Incentive Pay Plan for Client Relations Managers, are each divided into two components—an organizational performance component and an individual performance component—and are paid yearly.

The individual component of the Incentive Pay Plan for Client Relations Managers measures the employee's individual performance as substantially related to the maintenance and growth of loan guaranty volume within specific targeted schools. Client relations managers can receive a bonus of up to 20 percent of their base pay, consisting of up to 3 percent for organizational performance and up to 17 percent for individual performance.

Depending on the position, an employee in the EdShare Plan may earn 4 percent to 12 percent of his or her base salary as the individual component. For assistant vice presidents and directors, the individual component is based on their accomplishment of individual objectives that are tied directly to department objectives. For all other EdShare Plan participants, the individual component is based on the numeric value of their performance appraisals. Organizational performance goals are determined through a process outlined in the 2002 Student Aid policy.

### Student Aid Has Not Fully Addressed Concerns Raised by an Assessment of EDFUND's Accomplishment of Performance Goals

Student Aid's policy states that at the end of the federal fiscal year, its executive director will assess the percentage of accomplishment EDFUND has achieved toward the performance goals set by Student Aid. The executive director will report her findings to the chair of the commission, who will concur or modify that recommendation on behalf of Student Aid.

EDFUND's accomplishment of these performance goals affects the bonuses received by its nonexecutive staff. For example, under the EdShare Plan, EDFUND's performance constitutes a maximum of 9 percent of the 15 percent potential maximum payout for its assistant vice presidents and directors. However, for other staff, EDFUND's performance represents as low as 3 percent of the up to 15 percent potential maximum payout. The remaining percentages are based on the individual performance of staff. EDFUND uses several high-level organizational metrics (organizational metrics) to measure its performance of the goals set by Student Aid. Table 2 on the following page describes the 12 organizational metrics for federal fiscal year 2006.

## TABLE 2

### EDFUND High-Level Organizational Metrics for Federal Fiscal Year 2006

| Metric | Metric Description |
|---|---|
| Loan program operating surplus margin | This measures the loan program overall surplus margin on all product line operations.* |
| Revenue growth | This measures the change in ongoing operational revenue streams from the prior year. |
| Cost per net dollar collected | This measures the total cost (and margin) per dollar recovered from defaulted borrowers. |
| Cost per loan guarantee processed | This measures the total cost per loan guaranteed. |
| Loan guarantee volume (excluding consolidations) | This measures the dollar volume of new guaranteed loans. |
| National market share | This measures EDFUND's percentage of the total national market. |
| Customer feedback score | This is an average score of the surveys used in determining the overall satisfaction reported by EDFUND's school, lender, and borrower partners with its services. |
| Adjusted aggregate default rate | This is used to gauge the percentage of loans that are in default status relative to loans that are in repayment, deferment, and forbearance, adjusted for external environmental factors beyond the control of the guarantor. |
| Support activity efficiency | This measures support operation efficiency by comparing the ratio of general company support area expenses to total revenues. |
| Turnover rate | Measures the turnover rate in a given period. |
| Employee productivity | This measures the loan program revenue per employee. In general, when revenue per employee is rising, productivity is increasing. |
| Recovery rate | This measures the effectiveness of EDFUND's collection recovery efforts based on the outstanding default portfolio. |

Source: EDFUND's federal fiscal year 2006 Loan Program Business Plan.

* Does not include all loan program revenues and expenses as discussed on page 41.

Each of the organizational metrics can be measured with a numeric value. As part of its approval of EDFUND's annual business plan, Student Aid currently approves the organizational metrics and each metric's goal, as well as a weighting for each metric. The weighting can be interpreted as the importance of each metric relative to the others.

EDFUND reported that its federal fiscal year 2004 accomplishment of organizational performance goals was 93.7 percent. In a memo to the chair of the commission, Student Aid's executive director expressed several concerns about the performance assessment information EDFUND staff generated under its new methodology. She pointed out that the metrics were weighted without Student Aid's approval. Although EDFUND's approved federal fiscal year 2004 business plan contained the organizational metrics and the numerical goals, it did not include any weighting of the goals. However, the information provided to the executive director by EDFUND for her review included assigned weights of the goals. Additionally, she stated that EDFUND had given scores that were above the assigned weights for most metrics, which could create a company performance assessment score beyond 100 percent. Table 3 illustrates how a hypothetical organization may use EDFUND's methodology to calculate its overall performance in meeting its goals.

**TABLE 3**

**Example of Company Performance Calculation**

| Performance Metric | Actual | Goal | Variance to Goal | 100 Percent Plus Assigned Variance | Weight | Metric Score (Weight x 100 Percent + Variance) |
|---|---|---|---|---|---|---|
| Metric 1 | 20% | 20% | 0% | 100% | 50% | 50% |
| Metric 2 | 150 | 100 | 50 | 150 | 30 | 45 |
| Metric 3 | 80 | 100 | (20) | 80 | 20 | 16 |
| **Total company performance assessment score** | | | | | | **111%** |

Source: Bureau of State Audits' calculation based on EDFUND's methodology.

The executive director recommended to the former chair of Student Aid that the assigned weights should be reviewed and approved by Student Aid because they are policy decisions, and that the weighting of goals should be eliminated for federal fiscal year 2004. Further, she recommended that Student Aid approve any changes to the methodology used to calculate the organizational performance assessment score, including how weighting is to be used in the calculation and whether to recognize scores above 100 percent. Finally, she recommended that, for federal fiscal year 2005, Student Aid should revisit the policy for EDFUND incentive compensation plans in the operating agreement to establish a procedure for approving any changes in the methodology used to calculate and score performance.

The former chair of the commission concluded that the weights EDFUND used were inappropriate because neither its board nor Student Aid explicitly agreed to them. He further stated that, although he is strongly in favor of using weighted formulas to aid the assessment process, he recommended removing the weights from the formula, which lowered EDFUND's accomplishment of performance goals from 93.7 percent to 89.7 percent. He added that it is imperative that the methodologies, including those related to weighting, are mutually agreed upon far in advance of the next evaluation period. Because EDFUND uses the accomplishment of its performance goals to determine the potential maximum payout for its nonexecutive staff, it is reasonable to conclude that the reduction in the performance percentage score would have resulted in savings for federal fiscal year 2004.

Student Aid approved organizational metrics, goals, and weights for federal fiscal year 2005 through its approval of the EDFUND business plan on March 10, 2005. Although Student Aid approved the weights, according to its executive director, Student Aid and EDFUND staff did not resolve the questions related to the methodology and the use of the weights to calculate the organizational performance assessment score. Specifically, Student Aid did not approve the policy decision to recognize scores above the assigned rates. The executive director further stated that to facilitate the approval and to move forward for the federal fiscal year 2005 business plan, Student Aid and EDFUND staff agreed to the weights with the understanding that another meeting was required to discuss the methodology and to address her previously stated concerns regarding the percentages that were scored above their respective weights.

Student Aid and EDFUND did not agree on the calculation methodology for the federal fiscal year 2004 EDFUND performance assessment, so the issue of metric scores assigned higher than the weights persisted. EDFUND used the same calculation methodology for federal fiscal year 2005 that it used the previous year, which resulted in an overall organizational performance assessment score of 100.6 percent, even though it failed to meet almost half of its goals. In the executive director's recommendation regarding EDFUND's assessment of the 2005 performance goals, she again pointed out the lack of agreement in advance regarding whether to recognize metric scores above 100 percent of the assigned percentage weight.

However, the EDFUND president argued for maintaining the 100.6 percent performance score and for allowing points to be included in the calculation for goals not met. According to the president, the importance of measuring performance is just as significant when assessing goals not fully achieved, and rather than being regarded as a failure, substantial progress to full goal achievement needs to be recognized, especially when the actual performance levels represent a substantial improvement over those of prior years. Nonetheless, the chair of the commission concluded that he concurred with the executive director that Student Aid did not authorize the use of a metric score above the assigned percentage weight, and therefore approved a performance score of 96 percent. The chair further directed the executive director and the EDFUND president to work through the calculation methodology issues and present an agreed-upon recommendation to Student Aid by January 6, 2006.

The executive director and president have agreed that these four issues must be addressed: whether and how to recognize goals not achieved, whether and how to recognize a percentage of accomplishment above the assigned weights, whether to set a standard for acceptable variance to a goal, and how midyear budget changes may affect a goal. However, as of March 2006, little progress had been made to resolve these issues. Until these outstanding issues are resolved, EDFUND will still receive points for that metric toward the total performance score even if it fails to meet a goal or to improve on the prior year's performance level.

## MORE FUNDS WOULD HAVE BEEN AVAILABLE IF STUDENT AID HAD REQUIRED EDFUND TO FOLLOW MORE FISCALLY CONSERVATIVE POLICIES

***EDFUND spent almost $700,000 from the Operating Fund for 14 events we reviewed, including holiday receptions and employee conferences. These events often included lodging and meals at upscale hotels and resorts for high-level staff and expensive guest speakers and entertainment.***

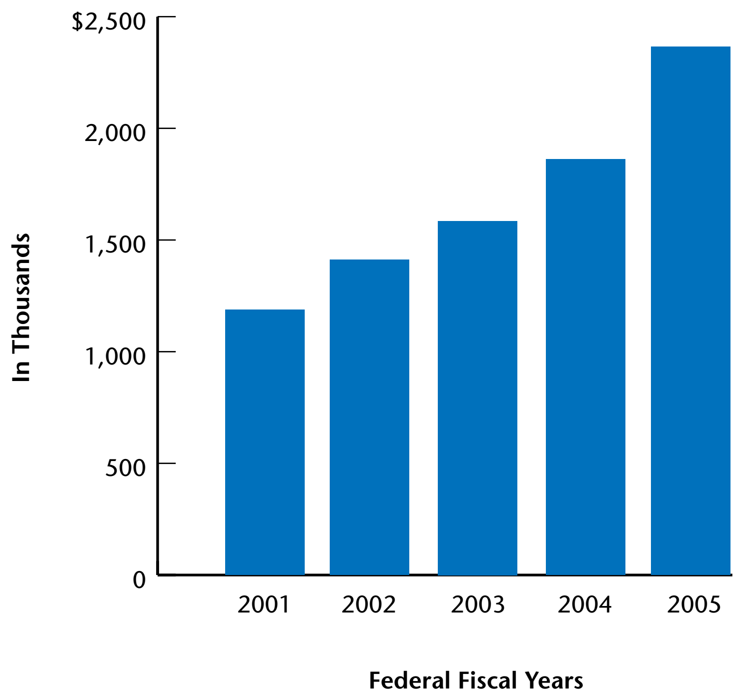
Student Aid has not ensured that EDFUND policies are fiscally conservative. Further, EDFUND does not always comply with its business and travel expense policies. We also found a few instances in which Student Aid did not comply with the State's travel policy. In addition, EDFUND spent almost $700,000 over five federal fiscal years from the Operating Fund for the 14 events, such as holiday receptions, employee conferences, and EDFUND/Student Aid workshop and meetings, that we reviewed. These events often included lodging and meals at upscale hotels and resorts for high-level staff, and expensive guest speakers and entertainment. We question how spending large sums of money on these type of events supports the State's mission of assisting students in achieving their educational goals.

### Student Aid Did Not Ensure That EDFUND's Travel Policy Was Fiscally Conservative; in Some Instances, EDFUND and Student Aid Did Not Comply With Their Travel Policies

Student Aid did not ensure that funds available to benefit students were maximized by requiring EDFUND to adopt a travel policy that is as fiscally conservative as that of the State. Further, in some instances, EDFUND did not comply with its travel policy. Figure 10 shows that EDFUND's travel expenses have been increasing steadily.

**FIGURE 10**

**EDFUND Travel Expense Trend**




Source: Student Aid's Unaudited Revenues and Expenses Variance Reports for the 12 months ending September 30, 2001, through 2005.

### *Student Aid Did Not Ensure That EDFUND's Travel Policy Is Consistent With State Policy, Resulting in Higher Expenses Than Necessary*

The operating agreement between Student Aid and EDFUND specifies that Student Aid's executive director must approve EDFUND's travel policy. Federal regulations prohibit guaranty agencies from using Operating Fund money to reimburse travel expenses that are not in accordance with a written policy approved by the secretary of the U.S. Department of Education (Education) or a state policy. EDFUND created its travel policy in 1999 and Student Aid sent it to the federal secretary of Education for approval. The State has established a policy that provides guidelines on traveling for official state business and for obtaining reimbursements. It is more conservative than the EDFUND policy in most cases. Student Aid should have chosen to restrict EDFUND to the state policy rather than sending the EDFUND policy to Education for approval. EDFUND could have saved thousands of dollars in travel costs if Student Aid had required it to adhere to state policy.

Under EDFUND's policy, expenses for lodging that occurs at least 50 miles from the employee's normal place of business are reimbursable up to the greater of the state or federal allowance and employees must submit a receipt with their travel expense report. Although the State's policy has a set rate of $110 per night for lodging for state-sponsored conventions, conferences, or business meetings, EDFUND's policy contains no such provision. Our review of five invoices found that EDFUND routinely paid rates that were higher than $110. For example, EDFUND paid for its employees and Student Aid's employees lodging at conferences and workshops it held in Berkeley at the rate of $185 per night, in Del Mar at the rate of $199 per night, and in Monterey at an estimated rate of $194 per night. Total costs exceeding state policy rates for lodging at conferences, meetings, and workshops for the five invoices were $15,000.

***Our review of five invoices found that EDFUND routinely paid rates that were higher than $110 per night. Total costs exceeding state policy rates for lodging at conferences, meetings, and workshops for the five invoices were $15,000.***

EDFUND has two methods for reimbursing its employees for meal expenses: the per diem method and the receipt method. State policy allows employees to claim actual expenses up to $34 for each full 24-hour period of travel, with a specific breakdown of up to $6 for breakfast, $10 for lunch, and $18 for dinner. Additionally, it requires employees to have receipts substantiating the amount claimed. Under its per diem method, EDFUND allows travelers to claim $40 of meal and incidental expenses for each complete day spent traveling on EDFUND business, and there is no breakdown per meal. Further, EDFUND's policy states that employees using this method will not have to substantiate expenses with receipts or other documentation.

Under its receipt method, EDFUND allows travelers to receive reimbursement for actual meal costs sustained while traveling on official EDFUND business. Although each individual meal must be substantiated with a receipt or other proof of payment, EDFUND's receipt method does not contain a maximum amount for breakfast, lunch, and dinner, or a lesser allowance when meals are provided by another source. Its only requirement is that the meal costs not exceed $52 per each complete business day being reimbursed. We found 14 instances, totaling roughly $1,600, in our review of 26 travel and expense claims in which EDFUND reimbursed employees for meals that exceeded the state policy.

In one instance, we found that EDFUND reimbursed an employee who paid for a dinner for 20 employees at a cost of $79 per person, which exceed the state policy's dinner rate of $18.

EDFUND's policy regarding partial travel days also differs from state policy, which allows breakfast for a trip that begins at or before 6 a.m. and ends at or after 9 a.m. and dinner for a trip that begins at or before 4 p.m. and ends at or after 7 p.m. EDFUND's policy instead allows employees to receive reimbursements for meals in the amount of $20 to $34, without receipts, depending on the total number of hours they travel. For example, EDFUND reimbursed an employee a full $40 for meals on the first day of a trip beginning at 7:30 a.m. and $30 for meals on the last day of the trip, when travel ended at 8:30 a.m. In this case, the employee received $30 more than would have been allowed under state policy.

**EDFUND's Partial Travel Day Policy**

- 12 hours or more–$40 (including incidentals)
- 6-12 hours–$30 (no incidentals)
- 3-6 hours–$20 (no incidentals)
- Less than 3 hours–no reimbursement

Source: EDFUND Policy Memo.

Further, EDFUND's policy related to incidental costs differs from state policy, which allows up to $6 to cover actual expenses such as personal phone calls, laundry and dry cleaning, newspapers and magazines, tips, etc. In addition to the $6, EDFUND reimburses its employees for other incidental costs, including up to $7 per day for personal phone calls and any laundry expenses for trips exceeding five days. Thus, EDFUND employees can receive, at a minimum, $13 per day for incidental costs.

Finally, EDFUND's policy includes provisions for its employees to receive reimbursement for noncommercial lodging and meals, which is a further difference from state policy. Specifically, the State does not have a provision for reimbursement of noncommercial lodging or meals in its short-term travel policy.

EDFUND's travel policy is dated November 22, 1999. In a discussion with the executive director, she admitted that she had not reviewed the policy during her tenure with Student Aid. As shown in Figure 10 on page 52, EDFUND's travel expenses have been increasing steadily. Although this may be due, in part, to EDFUND's continued expansion into other states, Student Aid could have better controlled or reduced a portion of these costs had it renewed EDFUND's policy to ensure that it conformed to state policy.

### *EDFUND and Student Aid Did Not Always Comply With Their Respective Travel Policies*

We found several instances in which both EDFUND and Student Aid did not comply with their respective travel policies. In some instances, EDFUND violated its travel policy related to meal reimbursements and unused airline tickets. In addition, Student Aid improperly justified lodging at costs greater than the state rate.

EDFUND's policy requires that meals provided by another source will not be allowed when an employee uses the per diem method of claiming reimbursement. However, we found several instances in which the traveling employee was reimbursed for meals that were provided by another source. In the most egregious case, an employee was reimbursed for several days' worth of meals when traveling to a conference, despite the fact that the conference provided almost all meals, and meals were provided on the flight as well.

EDFUND's policy regarding the cancellation of airline tickets states that unused or partly used and nonrefundable airline tickets should be returned to the travel agency for possible future use. However, for two of the 26 travel and expense claims we reviewed, an employee canceled two trips with a nonrefundable flight and failed to follow EDFUND's policy. EDFUND's failure to ensure that its employees comply with its policy prevented it from possibly reusing these tickets for future travel, thereby reducing such costs to the Operating Fund.

***We found three instances where commissioners stayed at upscale hotels in Sacramento at rates of $258 and $292 per night.***

We also discovered three instances in which Student Aid justified unreasonable hotel expenses. One travel expense claim for a commissioner lists two separate visits to Sacramento during which he stayed at an upscale hotel with rates of $258 and $292 per night. A travel expense claim from a second commissioner shows that she stayed at the same hotel for one of these occasions for two nights at the rate of $258. The total excess cost for these two commissioners was $730. State law allows Student Aid to reimburse commissioners for their actual and necessary traveling expenses. According to our legal counsel, the attorney general opined that the purpose of requiring express statutory authority for the payment of official expenses is to protect the public from unnecessary or excessive claims from public officials. We believe daily hotel charges of $258 and $292 are excessive.

## EDFUND's Imprudent Spending Practices

Our review of 14 events sponsored by EDFUND identified many instances that we believe represent an unreasonable use of Operating Fund money. For example, EDFUND spent almost $11,000 in Operating Fund money to pay for its 2005 holiday dessert reception for 600 employees. These costs are distributed in almost equal proportions to food, decorations, and services provided by the event facilitators. In addition, EDFUND conducts an employee day conference each year. These conferences are attended by most of its employees and generally focus on issues that are pertinent to events currently affecting EDFUND. Although we believe such events are important to build camaraderie, update employees on business activities, and conduct training for staff, we question the reasonableness of some of the costs associated with them.

***For its 2005 employee day conference, EDFUND spent $25,000 for three guest speakers and $5,200 for promotional gifts.***

For the five employee day conferences held in calendar years 2001 through 2005, there were roughly $478,000 in expenses, many of which we question. For instance, at its 2005 employee day, EDFUND spent more than $25,000 for three guest speakers, and approximately $5,200 in promotional gifts. Similarly, at the 2002 EDFUND employee day conference, the majority of the total cost of more than $126,000 was the approximately $55,600 EDFUND spent for an event facilitator. In total for the five employee day conferences, EDFUND spent almost $165,000 for guest speakers alone.

As shown in Table 4, EDFUND also regularly holds meetings and workshops for board members and executive staff, typically at upscale hotels and resorts in expensive locations. For instance, in May 2003, EDFUND held a board quarterly meeting and workshop at an upscale resort in Del Mar. Participants included members of the board, an attorney from a private law firm, EDFUND staff, and two staff from Student Aid, including the executive director. Lodging costs alone for the three-day, two-night event totaled more than $8,300. EDFUND also paid for six banquet charges for a total of roughly $8,700. Considering that most of the attendees were headquartered in the Sacramento area, EDFUND could have held the event in its boardroom, which easily can accommodate 21 people.

## TABLE 4

### Expenses Associated With Selected EDFUND Events 2001 Through 2005

**Employee Day Conferences**

| Event | Location | Number of Employees | Food | Promotional Gifts | Banners, Signs, Printing | Guest Speakers | Other* | Total Costs |
|---|---|---|---|---|---|---|---|---|
| 2001 Employee Day Conference | Sacramento area | 650 | $ 27,303.61 | $ 7,011.42 | $ 3,474.67 | $ 7,836.75 | $ 25,388.89 | $ 71,015.34 |
| 2002 Employee Day Conference | Sacramento area | 700 | 27,103.42 | 6,287.94 | 4,681.88 | 55,625.73 | 32,420.97 | 126,119.94 |
| 2003 Employee Day Conference | Sacramento area | 600 | 20,534.20 | 5,378.38 | 2,322.44 | 41,358.05 | 15,958.54 | 85,551.61 |
| 2004 Employee Day Conference | Sacramento area | 565 | 19,842.75 | 3,767.75 | 483.69 | 34,282.16 | 38,391.73 | 96,768.08 |
| 2005 Employee Day Conference | Sacramento area | 580 | 30,583.59 | 5,177.81 | 383.01 | 25,740.47 | 36,486.89 | 98,371.77 |
| **Totals** | | | **$125,367.57** | **$27,623.30** | **$11,345.69** | **$164,843.16** | **$148,647.02** | **$477,826.74** |

**Celebratory Events**

| Event | Location | Decor | Food | Promotional Gifts | Banners, Signs, Printing | Entertainment | Other* | Total Costs |
|---|---|---|---|---|---|---|---|---|
| 2001 Holiday Celebration | Sacramento area | $ 1,533.75 | $15,396.15 | $2,743.83 | $1,004.25 | $1,750.00 | $ 6,397.60 | $ 28,825.58 |
| 2002 Holiday Celebration | Sacramento area | 5,115.94 | 17,042.52 | | 1,488.64 | 1,505.00 | 1,036.53 | 26,188.63 |
| 2003 Holiday Celebration | Sacramento area | 3,156.95 | 15,022.35 | 296.31 | 599.63 | 750.00 | 3,748.24 | 23,573.48 |
| 2005 Holiday Dessert Reception | Sacramento area | 3,095.00 | 4,200.00 | | | | 3,429.00 | 10,724.00 |
| 2005 Company Picnic | Sacramento area | 1,818.00 | 12,532.89 | | 855.70 | 5,591.37 | 14,941.97 | 35,739.93 |
| **Totals** | | **$14,719.64** | **$64,193.91** | **$3,040.14** | **$3,948.22** | **$9,596.37** | **$29,553.34** | **$125,051.62** |

**Workshops and Meetings**

| Event | Location | Number of Nights | Number of Guests | Food | Lodging | Other* | Total Costs |
|---|---|---|---|---|---|---|---|
| Board Quarterly Meeting and Annual Workshop | L'Auberge Del Mar Resort and Spa, Del Mar | 2 | 21 | $ 8,662.13 | $ 8,358.00 | $ 889.28 | $17,909.41 |
| 2002 Student Aid/EDFUND Annual Workshop | Laguna Cliffs Marriott Resort and Spa, Dana Point | 1 | 36 | 6,273.31 | 3,960.00 | 1,717.96 | 11,951.27 |
| 2003 Annual Joint Workshop | Claremont Resort and Spa, Berkeley | 2 | 36 | 13,822.23 | 13,320.00 | 2,822.15 | 29,964.38 |
| 2003 Student Aid/ EDFUND Joint Meeting | Monterey Plaza Hotel, Monterey | 2 | 36 | 15,254.55 | 13,585.52 | 1,635.45 | 30,475.52 |
| **Totals** | | | | **$44,012.22** | **$39,223.52** | **$7,064.84** | **$90,300.58** |
| **Grand Total** | | | | | | | **$693,178.94** |

Source: Bureau of State Audits' compilation based on EDFUND's accounting records.

* Other costs may include fees, taxes, charges for audio-visual equipment, wages for employees planning events, insurance costs, etc.

Likewise, in February 2003, EDFUND and Student Aid held a workshop for 36 employees at an upscale resort in Berkeley. Total costs for meals provided by the resort were more than $13,800 and hotel charges were $13,300 for the 19 EDFUND and 17 Student Aid employees who stayed at the hotel for two nights. Again, we question whether holding an event at an upscale resort was a prudent business decision considering that most of the attendees were headquartered in or around the Sacramento area. According to Student Aid's executive director, she did raise concerns about holding meetings in locations with costs that exceed state and federal rates to EDFUND's former president and the former chair of the commission.

***For its 2003 holiday celebration, EDFUND spent approximately $15,000 for a buffet for 900 people. This included 232 guests or family members.***

We also found several instances when EDFUND hosted and paid for an event and allowed family members to attend without paying their own way. For its 2003 holiday celebration, EDFUND spent approximately $15,000 for a buffet for 900 people. According to EDFUND's director of administration, 162 employees and 232 guests or family members checked in at the registration table, and there were possibly 75 or more employees or guests who did not check in. Thus, it appears that at least $4,600 was spent on guests and family. In 2005, EDFUND held a company picnic, at which it provided food and entertainment to 103 employees and 199 guests and children at its own cost of $35,700. We believe that, as an auxiliary to a state agency, EDFUND's spending of state funds for the benefit of nonemployees is not a prudent use of its funds. We question whether such spending is consistent with the mission of EDFUND.

## EDFUND DID NOT ALWAYS COMPLY WITH ITS CONTRACTING POLICIES

We also found that EDFUND's contracting policies are vague, leading to lack of guidance in contracting procedures, frequent issues of noncompliance, and questionable practices. For 15 of 16 contracts tested, we found violations ranging from lack of documentation to inadequate sole-source justification.

### EDFUND Contracting Policies Are Vague and Lead to Frequent Noncompliance

EDFUND's policy requires its staff to procure goods and services using one of three methods—competitive bid, sole- and single-source procurement, and an urgency provision for sole-source contracts that are greater than $100,000. In addition, the policy states that all procurements greater than $10,000 require at least three bids unless documentation exists indicating three viable vendors decline to bid or are not available. Staff also must provide a justification memorandum or bid/cost analyses approved by an assistant vice president or someone in a higher position. According to the policy, there is no exception to the bid and cost analysis requirement.

However, our review of 16 contracts found that EDFUND did not ensure that staff obtained the three bid and cost analyses requirement for 11 contracts exceeding $10,000. As a result, EDFUND cannot ensure that it received the best value for the goods or services. EDFUND's assistant general counsel pointed out that most of the contracts are sole-source contracts subject to another provision in EDFUND's policy that is silent on the need for staff to submit bids or analyses. She also acknowledged that these provisions of EDFUND's policy are misleading and contradictory.

Furthermore, although EDFUND's policy requires staff to submit a justification memorandum with procurements under its competitive bid and single- and sole-source methods, it provides no guidance on what the memo or analysis should include. For example, when the procurement is restricted to one supplier, state procedures require departments and agencies to consider the issues shown in the text box before approving the contract. None of the sole-source contracts we reviewed contained adequate justification. For example, justification for one sole-source contract was that the firm's insight into current market conditions and ability to advise EDFUND of the feasibility of increasing business volume in another state was unmatched among contract sources at its disposal. However, EDFUND did not provide any market research to support this statement. In another instance, the justification for the contract stated merely that changing firms would not be cost-effective or an effective use of time, without an analysis to support this statement. EDFUND's assistant general counsel acknowledges that its policy requires revision and stated that it is working toward doing so.

The policy also contains approval levels for sole-source contracts. For example, if the purchase price exceeds $50,000 the president must approve

**Key Considerations for State Noncompetitive Bid Contracts**

1. The need to restrict the acquisition to this good/service/supplier.
2. The background of the events leading to the acquisition.
3. The uniqueness of the acquisition (why was the good/service/supplier chosen?).
4. The consequences of not purchasing the good/service or contracting with the proposed supplier.
5. The market research conducted to substantiate no competition, including evaluation of other items considered.
6. The method used to determine that the price offered is fair and reasonable.
7. The cost savings realized or costs avoided by acquiring the goods/services from this supplier.

Source: Department of General Services, Procurement Division.

the requisition, and contracts that exceed $100,000 require prior approval from the board. Yet the president did not approve the requisition for five contracts. In addition, our review of the files for four contracts that were bid competitively found that they did not contain the necessary back-up documentation such as a request for proposal, bid/cost analysis, or a justification memo that EDFUND requires staff to use under its competitive bid process.

The operating agreement between Student Aid and EDFUND does not specifically require purchases of goods and services incurred by EDFUND to be reimbursed pursuant to a procurement and contracts policy approved by the executive director of Student Aid. Without such a provision, the State cannot ensure that EDFUND's purchases result in costs that are appropriate and reasonable.

## STUDENT AID NEEDS TO IMPROVE ITS OVERSIGHT OF EDFUND

Student Aid has not provided sufficient oversight over EDFUND to ensure the future success of Student Aid's participation in the FFEL Program. Specifically, Student Aid circumvented state law by delegating its authority related to the approval of EDFUND's budget without amending the operating agreement. Student Aid also dismissed several policy and fiscal concerns raised by its staff responsible for analyzing these issues. Moreover, Student Aid does not always independently verify reports that it receives from EDFUND. Rather, it relies on EDFUND staff to ensure their accuracy. Finally, Student Aid has not completed several key tasks identified within its mandated performance review of EDFUND, despite its staffs' recommendations to pursue them actively. For example, neither Student Aid nor EDFUND has performed an adequate assessment of the financial risks associated with EDFUND's student loan guaranty portfolio, a critical piece of information that Student Aid should have considered before approving EDFUND's annual budgets and business plans.

### Student Aid Circumvented State Law by Erroneously Relinquishing a Key Oversight Responsibility to the EDFUND Board

In November 2003, Student Aid delegated the authority of approving EDFUND's detailed budget for the operation of the FFEL Program to the EDFUND board. Our review of the

*Student Aid delegated the authority of approving EDFUND's FFEL Program budget to the EDFUND board. This action is inconsistent with both state law and the operating agreement.*

minutes for this meeting did not find any discussion by the commissioners or Student Aid staff regarding the legal ramifications of this decision. However, this action is inconsistent with both state law and the operating agreement between the two entities. The operating agreement between EDFUND and Student Aid states that EDFUND is responsible for submitting a summary business plan and annual operating budget, as approved by the EDFUND board, to Student Aid for review and approval. The business plan is to include a description of business objectives EDFUND plans to pursue, its information technology strategies, description of proposed new products or services, and descriptions of proposed material changes in EDFUND's operations. The budget is to include all projected revenues and expenses that will be incurred in operations connected with the business plan. Once approved by Student Aid, EDFUND must conduct its business operations only in conformity with the business plan and budget approved by Student Aid. In order to facilitate the annual budget and business plan negotiation process between EDFUND and Student Aid, EDFUND is required to submit a draft of these documents to Student Aid's executive director and contract manager pursuant to a mutually agreed upon schedule for submission to and review by Student Aid.

State law requires that the operations of EDFUND be conducted in conformity with an operating agreement approved by Student Aid. State law in effect at the time Student Aid made its delegation also required that prior to approval, Student Aid must provide the proposed operating agreement to the Department of Finance for its review and comment. However, Student Aid circumvented these provisions of state law when it delegated the approval authority of EDFUND's detailed operating budget to the EDFUND board without amending the operating agreement. Specifically, in its November 21, 2003 meeting, the commission approved a motion made by a joint committee that included, among other things, the delegation of the approval of EDFUND's detailed budget for the FFEL Program to the EDFUND board. According to the chair of Student Aid, the motion was intended to prescribe the process for developing a capital utilization plan. Further, he stated that Student Aid staff have conducted detailed reviews of EDFUND's budget proposals for federal fiscal years 2005 and 2006. Nevertheless, Student Aid continues to violate state law until it rescinds its delegation of the approval authority of EDFUND's detailed operating budget to the EDFUND board.

### Student Aid Approved EDFUND's Federal Fiscal Years 2005 and 2006 Business Plans and Budget Despite Several Unaddressed Concerns

Before EDFUND board and Student Aid approval of EDFUND's fiscal years 2005 and 2006 business plans that incorporated its budget proposal, the Student Aid staff responsible for reviewing these documents communicated several key concerns to the board that were left unaddressed. In addition, when Student Aid brings issues to the commission's attention, there is no evidence to demonstrate that it always addresses them.

***The EDFUND board approved the federal fiscal year 2005 budget despite a recommendation from Student Aid's staff that the budget not be approved because of several unresolved concerns.***

Before the September 17, 2004, EDFUND Finance and Budget Committee (finance committee) meeting, Student Aid's executive director sent a memo to all board members that outlined several issues for the committee to consider when discussing EDFUND's fiscal year 2005 budget. Among these issues, the executive director expressed concern that there was no recognition of the reserve established in the Budget Act of 2005 for Student Aid to fulfill its obligations under the FFEL Program. The executive director also expressed concern that EDFUND staff was not recommending any reduction in FFEL Program activity and that the final budget indicated an operating deficit. Despite these concerns, the finance committee approved a motion to recommend the budget to the board for approval. In fact, one committee member stated that he felt strongly about proceeding forward with consideration of the proposed budget even though a deficit was projected. The board approved the budget at its September 30, 2004, meeting as recommended by the finance committee. Because Student Aid was focusing its attention on conducting a mandated performance review of EDFUND, it did not approve EDFUND's federal fiscal year 2005 business plan until March 2005, six months into EDFUND's fiscal year. Moreover, it appears that Student Aid approved the business plan despite a recommendation from Student Aid's staff in November 2004 against approving it.

Student Aid's Federal Policy and Programs Division (oversight division) is responsible for ensuring that Student Aid's responsibilities as the State's guaranty agency under the FFEL Program are carried out according to state and federal laws, regulations, and the agreement with Education. The oversight division's responsibilities include reviewing EDFUND's business plan and budget for Student Aid. In October 2005, the oversight division received a copy of EDFUND's federal fiscal year 2006 business plan and budget proposal for its review.

Upon completion of the oversight division's review, the acting chief of the division (acting chief) provided to all Student Aid commissioners and EDFUND's interim president a copy of her analysis, and asked that all commissioners review the information in preparation for the upcoming Fiscal Policy and Long-Range Planning Committee (fiscal committee) meeting where the business plan and budget were to be discussed. The oversight division's analysis outlined several concerns related to EDFUND's business proposal, including concerns with its marketing strategy. The analysis also pointed out major increases in four categories of EDFUND's proposed expenses from its prior fiscal year budget. The oversight division staff also stated their belief that it was critical that Student Aid perform a detailed review of EDFUND's baseline budget and proposed increases to determine how these data related to EDFUND's marketing strategy.

During a closed-session meeting on November 10, 2005, the board approved EDFUND's federal fiscal year 2006 business plan and budget. However, this decision was made without resolving the oversight division staff concerns. The board chair, who is also a Student Aid commissioner, requested that the oversight division provide high-level questions based on its analysis of EDFUND's federal fiscal year 2006 business plan and budget. EDFUND provided high-level responses to these questions on November 12, 2005, two days before the Student Aid fiscal committee meeting in which EDFUND's federal fiscal year 2006 business plan and budget were discussed. On November 16, 2005, Student Aid's executive director sent a memo to the commissioners discussing, among other things, that one commissioner noted during the fiscal committee meeting that Student Aid staff provided important points that should be considered. Despite the concerns raised by the oversight division staff, during Student Aid's November 17, 2005 meeting, the fiscal committee made a motion that Student Aid approve EDFUND's business plan and budget as presented. Student Aid approved the plan and budget, despite the fact that several of the oversight division's concerns were left unaddressed. According to the chair of Student Aid, staff have not always delivered the information needed in a timely or complete manner. Nevertheless, Student Aid further diminishes its oversight responsibility when it does not address issues raised by its staff.

## Student Aid's Monitoring of EDFUND Is Inadequate

***Student Aid's oversight division relies on EDFUND staff to ensure the accuracy of reports EDFUND is required to submit.***

Student Aid has not monitored the performance of EDFUND adequately to ensure the future success of the State's FFEL Program. For example, Student Aid does not independently verify several of the reports that EDFUND is required to provide, and relies on EDFUND staff for ensuring the accuracy of the data. Furthermore, Student Aid has not taken action on three key tasks identified in its June 2005 performance review of EDFUND. It also has not assessed the organizational risks associated with the State's student loan guaranty portfolio. Without addressing key tasks such as this, Student Aid lacks information that could be used to make critical FFEL Program policy decisions.

### *Student Aid Does Not Independently Verify the Reports Submitted by EDFUND*

Student Aid's oversight division does not independently verify several of the reports that EDFUND is required to submit to Student Aid. In many cases, the oversight division relies on EDFUND staff to ensure the accuracy of these reports. These data include information that Student Aid is required to submit to Education. Furthermore, Student Aid and EDFUND use the data to make strategic decisions affecting the direction of the FFEL Program. By not independently verifying the accuracy of EDFUND's reports, Student Aid cannot ensure that the data it receives are complete and accurate.

During our review of Student Aid's oversight division, we found that it relies heavily on the EDFUND staff to ensure the accuracy of several required reports. Along with the annual business plan and budget, discussed earlier in this chapter, EDFUND is required by the operating agreement to provide Student Aid with several annual, quarterly, monthly, and special reports. These reports consist of financial and FFEL Program-related information that is critical for Student Aid to perform adequate fiscal and administrative oversight of EDFUND. For example, the oversight division relies on EDFUND staff to verify the accuracy of several FFEL Program statistics, including listings of participating schools by dollar volume and market share data by region. Student Aid uses these data to gauge EDFUND's performance and to identify trends in collections, defaults, and loan volume.

According to the acting chief, the oversight division performs a high-level reasonableness test with regard to these reports by comparing the data to previous reports. She also stated that the oversight staff could use various government Web sites to verify data. However, she further stated that the oversight division's limited staffing levels and workload do not allow for a detailed review of the reports to ensure their accuracy. Consequently, the oversight division is unable to detect erroneous or inaccurate information.

**Student Aid and EDFUND should perform the following tasks:**

- Reexamine the basic assumptions of the current business model.
- Reevaluate technology and services.
- Reassess marketing strategies.
- Undertake a thorough organizational risk assessment in relation to the existing portfolio and future growth strategies.
- Renegotiate its voluntary flexible agreement with the U.S. Department of Education.
- Maximize the efficiency and effectiveness of its collection recoveries on student loans that default.
- Continue to explore business diversification options.

Source: *California Student Aid Commission Performance Review of EDFUND*, dated June 2005.

### *Student Aid Has Not Acted Upon Key Tasks Identified in Its Performance Review of EDFUND*

Neither Student Aid nor EDFUND has completed key tasks designed to address potential organizational risks associated with the State's participation in the FFEL Program. According to state law, Student Aid must conduct regular performance evaluations of EDFUND's operations in furtherance of its fiscal and fiduciary responsibilities. Student Aid hired two consultants to assist it in conducting the performance review, at a total cost of $138,000. It completed its mandated performance review of EDFUND in June 2005. However, Student Aid and EDFUND have completed only one of the seven tasks they need to do for the State's FFEL Program to remain competitive with other guaranty agencies.

Student Aid and EDFUND appear to have made significant progress toward one task, which deals with the reevaluation of technology and services. Specifically, Student Aid and EDFUND have completed and are implementing some significant technology projects that Student Aid believes will provide economies of scale; reduction in resource use; and greater service to students, schools, and staff. For tasks related to the renegotiation of the VFA with Education, maximizing the efficiency and effectiveness of collection recoveries, and continuing to explore business diversification options, Student Aid and EDFUND have made some progress as we discuss more fully in Chapter 1. For two of the remaining three tasks related to reexamining the basic assumptions of EDFUND's business model and reassessing marketing strategies, there has been no progress made despite recommendations from Student Aid's oversight division to incorporate these issues within EDFUND's federal fiscal year 2006 business plan. For the remaining task, undertaking a thorough organizational risk assessment in relation to the existing portfolio and future growth strategies, EDFUND officials claim that this is done on an ongoing basis. However, they could not provide us with any evidence of this activity. During a review of EDFUND's federal fiscal year 2006 business plan, Student Aid's staff recommended that the plan should describe in more detail certain aspects of the current portfolio. However, Student Aid did not act upon the recommendations presented by staff, and instead approved EDFUND's federal fiscal year 2006 business plan without addressing these critical issues.

According to the chair of Student Aid, Student Aid approved EDFUND's federal fiscal year 2006 business plan in November 2005 because there was a high sense of urgency for EDFUND to have an approved business plan before more than two months of the federal fiscal year had passed. He also stated that Student Aid was preoccupied with addressing the mandated performance reviews, EDFUND's executive management team turnover, the aggressive actions taken by EDFUND competitors, and the increasing workload resulting from commission vacancies. Even though we understand the importance of the commissioners' other priorities, Student Aid could have approved the plan under the condition that concerns raised by Student Aid staff would be addressed in the near future.

## SOME FUNCTIONS OF BOTH ORGANIZATIONS SHOULD BE RESTRUCTURED TO ENSURE INDEPENDENCE

The independence of certain activities at Student Aid and EDFUND is in question because one individual serves in multiple roles. Specifically, the chief of Student Aid's internal audits is also the vice president of EDFUND's audit services. The same individual also serves as the interim vice president of EDFUND's legal services. Student Aid has a statutory responsibility to oversee the activities of EDFUND. Consequently, a potential organizational and personal impairment exists because one person holds three positions.

Furthermore, we question Student Aid's decision to allow its commissioners to serve as EDFUND board members. For instance, among other duties, EDFUND board members are required to approve its budget and business plan as well as certain expenditures. However, commissioners also are required to approve EDFUND's budget and business plan. Therefore, we question whether a commissioner who is also a board member can objectively perform his or her duty of reviewing the budget and business plan when he or she had a role in approving these documents as a board member.

### The Independence of the Internal Audit Functions at Student Aid and EDFUND May Be Compromised

Potential organizational and personal independence impairments exist at Student Aid and EDFUND because the same person serves as Student Aid's chief of internal audits and as EDFUND's vice president of audit services. Additionally, a further organizational impairment existed at EDFUND because its vice president of audit services was also the interim vice president of its legal services.

***EDFUND's vice president of audit services may have organizational and personal independence impairments because she also serves as Student Aid's chief of internal audits.***

State law requires all state agencies that have their own internal auditors or that conduct internal audits or internal audit activities to comply with the Standards for the Professional Practice of Internal Auditing, published by the Institute of Internal Auditors (IIA). In addition, the Government Auditing Standards issued by the Comptroller General of the United States apply to audits of government entities, programs, activities, and functions, and of government assistance administered by nonprofit entities.

Both the IIA standards and government auditing standards address organizational impairments. For example, government auditing standards state that, in order for a government internal audit unit to be free from organizational impairments to independence, the unit must meet all of the following criteria: be accountable to the head or deputy head of the government entity, report audit results to the head or deputy head of the government entity, and be located organizationally outside the staff or line management function of the unit under audit. Although Student Aid's organization chart indicates that the chief internal auditor reports to its executive director, the duty statement for the position states that the chief is a member of Student Aid's senior management team. The senior management team is responsible for the day-to-day operations of Student Aid. Our concern is that an internal auditor should be independent of the senior management team that makes the day-to-day business decisions. Because the chief internal auditor must monitor the disposition of the results of the internal audits she conducts and ensure that management has implemented the recommendations or accepts the risk of not implementing the recommendations, the chief's position as a member of Student Aid's senior management team creates the appearance of an organizational impairment. The chief internal auditor also reports to the chairs of Student Aid's and EDFUND's audit committees. Typically, the audit unit's independence is enhanced when it also reports regularly to the entity's independent audit committee. However, the appearance of organizational impairment still exists because the chief internal auditor does not appear to have met the three criteria.

Additionally, the chief internal auditor may have a personal impairment to her independence. Student Aid has the statutory responsibility to oversee EDFUND. The internal audit services charter for Student Aid and EDFUND, which defines the purpose and responsibility of the internal audit activity, states that the scope of internal audit services encompasses the examination and evaluation of the adequacy and effectiveness of Student Aid's system of internal control and the quality of performance in carrying out assigned responsibilities. The charter further states that the internal audit activities include the review of EDFUND.

Student Aid's chief internal auditor is an employee of EDFUND and receives her salary and bonus payments from EDFUND. As an employee of EDFUND, the chief internal auditor receives considerably more in compensation than she would as an employee of Student Aid. Thus, we question her ability to remain impartial and unbiased when choosing potential audit areas or developing audit findings related to Student Aid's oversight of EDFUND. For example, in Student Aid's draft internal audit plan and risk assessment for fiscal year 2004–05, one potential audit area was Student Aid's monitoring of EDFUND's compliance with the provisions of the operating agreement. There was an annotation that the internal audit unit would review the methodology used by Student Aid's Federal Policy and Program Division in performing oversight functions. The chief internal auditor assigned a risk rating of medium to this potential audit area and, as a result of insufficient audit resources, no audits have been performed in this area. We believe the chief internal auditor should have assigned a risk rating of high because the operating agreement is the sole means of dictating EDFUND's operations. Further, as discussed previously in the chapter, we found several weaknesses related to the operating agreement that affect Student Aid's oversight of EDFUND.

Student Aid's chief internal auditor disagrees with our assessment that an organizational or personal impairment exists. Moreover, Student Aid views the chief internal auditor's role as an employee of EDFUND who has accepted responsibilities at Student Aid that are similar to those she has at EDFUND. Nevertheless, according to the standards, internal auditors must avoid even the appearance of partiality.

Further, because Student Aid did not comply with certain standards, it missed an opportunity to identify these potential impairments itself. Specifically, both the IIA standards and government auditing standards require audit organizations to undergo an external assessment conducted by a qualified independent reviewer or review team from outside the organization. The IIA standards require this assessment every five years while the government auditing standards require it every three years. However, its chief internal auditor stated that an external assessment of Student Aid's internal audits unit had not been conducted in several years. If Student Aid had complied with these standards, it would have been able to identify and address the issues we raise sooner.

Student Aid's chief internal auditor also has possible organizational impairments in her position as EDFUND's vice president of audit services. In this position, she is responsible for directing the internal audit functions of EDFUND and directing the program review and compliance function for the FFEL Program. Again, the duty statement for the position states that the vice president is a member of EDFUND's executive management team. Similar to Student Aid's senior management team, EDFUND's executive management team is responsible for its day-to-day operations.

EDFUND's vice president of audit services was acting as EDFUND's interim vice president of legal services, which further impaired her independence. Government auditing standards cite as an example of a personal impairment individuals of an internal audit organization who are also responsible for managing an entity or making decisions as senior management that could affect operations of the entity or program being audited. When asked about her responsibilities as the interim vice president of legal services, the vice president of audit services stated that EDFUND placed her in this position because there were no other vice presidents available to perform the duties due to their workloads. Further, EDFUND's vice president of audit services explained that she did not handle any legal matters. Instead, she was responsible for reviewing and signing the legal invoices and time sheets, disseminating information from the executive management team to legal staff, and helping the assistant general counsel manage the relationship with the temporary external general counsel. Authorizing, executing, or consummating transactions, such as approving invoices, hinders the chief internal auditor's ability to objectively and independently evaluate the internal controls related to those transactions. As such, simultaneous occupation of both positions is potentially an organizational and personal impairment of independence. After we brought this issue to EDFUND's attention, it assigned the legal duties to staff other than the chief internal auditor.

### The Composition of the EDFUND Board Could Impair Student Aid's Decision Making

State law requires Student Aid to oversee the development and operations of EDFUND and to nominate and appoint EDFUND's board. Further, state law requires Student Aid to maintain its responsibility for financial aid program administration and policy leadership program evaluation. Therefore, whether in fact or in appearance, a commissioner may have a perceived conflict with overseeing the operations of an organization for which he or she is also a board member. Additionally, the Student Aid executive director, as a voting member, may have a similar perceived conflict.

State law also requires one member of the board to be an employee of EDFUND and one member to be a student enrolled in a California public or private postsecondary educational institution. Student Aid determines the remaining composition of the board. Since the creation of EDFUND, Student Aid commissioners have been serving as EDFUND board members. In its May 23, 2005 meeting, Student Aid removed six EDFUND board members due to concerns about the governance of the FFEL Program. According to the chair of Student Aid, the decision allowed the commissioners to make a more responsible decision regarding the program's future governance.

Among other things, EDFUND board members must approve all of EDFUND's expenses and fund authorizations. The operating agreement between Student Aid and EDFUND requires Student Aid to review and approve EDFUND's business plan and annual operating budget. Moreover, any material expenditure or material change in operations or corporate policies outside of the plan and budget must have Student Aid's prior approval. Thus, we question whether a commissioner who is also an EDFUND board member can objectively perform his or her duty of reviewing EDFUND's business plan and operating budget when he or she has played a role in authorizing and approving the expenses.

Allowing commissioners to serve as board members also can create a barrier to Student Aid's oversight responsibilities. For instance, in November 2004, a commissioner who was also the vice chair of the EDFUND board sent an e-mail to Student Aid's executive director and another commissioner complaining about the scope of a performance review of EDFUND that Student Aid had hired consultants to perform. The vice chair questioned why an "annual" performance review included a scope that was going back five years. As a commissioner appointed by the governor to act in the best interests of Student Aid, the commissioner should embrace the intentions of Student Aid staff to conduct a comprehensive review of EDFUND operations. Moreover, state law does not limit reviews conducted by Student Aid to a one-year period. Rather, it requires Student Aid to conduct regular performance evaluations of EDFUND's operations in furtherance of its fiscal and fiduciary responsibilities for approved programs. Additionally, the vice chair stated that she, along with other board members, were well aware that the executive director and Student Aid oversight personnel do not trust the EDFUND board or its staff. The commissioner's perspectives illustrate the problems with appointing commissioners to serve as board members and ultimately could hamper Student Aid's ability to oversee the operations of EDFUND effectively.

Similarly, allowing the executive director to be a voting board member can create a barrier to Student Aid's oversight responsibility. According to the operating agreement between Student Aid and EDFUND, Student Aid's executive director is responsible for reviewing EDFUND's business plan and annual operating budget and approving EDFUND employee bonus plans and travel policy. Thus, we also question whether the executive director, in her role as a voting board member, can perform her duties objectively. The chair of Student Aid agrees that it would be best if commissioners do not serve as board members and that the executive director serve only as a nonvoting board member.

## THE EDFUND BOARD HAS VIOLATED STATE LAW GOVERNING CLOSED-SESSION MEETINGS

The EDFUND board has not fully complied with certain provisions in state law related to closed-session meetings. For example, the board did not consistently keep a confidential minutes book of the topics discussed and decisions made in these sessions, as state law requires. Consequently, we were unable to determine the extent to which the board has complied with its recent statutory authority for closed sessions and the closed-session meeting provisions of the Bagley-Keene Open Meeting Act of 2004 (Bagley-Keene Act).

On August 11, 2004, the governor approved Senate Bill 1108, which amended state law to give the board the authority to hold a closed-session meeting to consider a matter of a proprietary nature, the discussion of which would disclose a trade secret or proprietary business information that could potentially cause economic harm to EDFUND or cause it to violate an agreement with a third party to maintain the information in confidence if that agreement were made in good faith and for reasonable business purposes. State laws define trade secrets as information, including a formula, pattern, compilation, program, device, method, technique, or process that derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use. The trade secret also must be the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

In addition, the Bagley-Keene Act contains provisions that govern closed sessions. For example, the board must disclose in an open meeting the general nature of the items to be discussed in a closed session before holding it. In three instances, the minutes do not indicate that the board or one of its committees went into a closed session, although the related meeting agendas indicate that a closed session was to occur.

***The EDFUND board did not keep a minute book for 12 of 21 closed-session meetings, as required by the Bagley-Keene Act.***

The Bagley-Keene Act also requires the board to designate a clerk, other officer, or an employee who shall attend each closed session and keep and enter in a minutes book a record of the topics discussed and decisions made at the meeting. The minutes book is to be kept confidential but, if needed, it must be made available to members of the board or, if a violation of the Bagley-Keene Act is alleged to have occurred in closed session, to a court of general jurisdiction. However, the board did not keep a minutes book for 12 of the 21 closed-session meetings occurring between April 19, 2004, and December 13, 2005. According to the board official responsible for keeping board meeting records, she was advised by EDFUND's former general counsel that it was not necessary to take notes on items where no action was taken during the session. The board official also stated that if the session only included discussion of specific subject(s) and no decisions were made on the item, that board's notes would simply reflect that it had met in closed session on the specified matter and that no action was taken. She further explained that if decisions were rendered in a closed session, minutes would reflect those determinations. However, the former general counsel's advice not to take notes unless an action was taken contradicts the Bagley-Keene Act.

When we asked EDFUND's assistant general counsel about the board's current record-keeping practices, she stated that the board recently was made aware that a closed-session minutes book should be maintained. The assistant general counsel asserted that the board now uses a confidential minutes book that will be maintained by the board secretary or general counsel.

***Our review of documents kept by EDFUND for open meetings held between August 19, 2004, and December 13, 2005, found that in one instance the board clearly violated its closed-session authority when it voted to retain outside counsel to advise it on this legislative audit, which clearly does not qualify as business proprietary information or a trade secret.***

Because it did not consistently keep minutes that reflect its discussions during closed sessions, the board is unable to prove that its discussions were limited to the consideration of items of a business proprietary nature or related to trade secrets. Our review of documents kept by EDFUND for open meetings held between August 19, 2004, and December 13, 2005, found that in one instance the board clearly violated its closed-session authority. The documentation indicates that the board voted to retain outside counsel to advise it on this legislative audit, which clearly does not qualify as business proprietary information or a trade secret. Because the board failed to comply with the record-keeping provisions of the Bagley-Keene Act, we are unable to ascertain the extent to which it has taken other actions that violate its closed-session authority.

Finally, neither Student Aid nor EDFUND has established policies and procedures for conducting closed sessions. According to the February 18, 2005 board minutes, the former EDFUND president stated she felt the board should establish some policies with broad guidance on topics deemed appropriate for closed session that staff could follow. However, according to a board official, there has been no further discussion regarding this issue. Student Aid confirmed that it has not provided any guidance to the board on this matter.

## A FORMER EMPLOYEE OF EDFUND MAY HAVE VIOLATED THE POLITICAL REFORM ACT OF 1974 BY ATTEMPTING TO INFLUENCE A COMMISSION CONTRACT

The Political Reform Act of 1974 (act) is the central conflict-of-interest law governing the conduct of public officials in California. The legislative intent expressed in the act states that public officials, whether elected or appointed, should perform their duties in an impartial manner, free from bias caused by their own financial interest or the financial interests of persons who have supported them. The act prohibits a public official from making, participating in making, or in any way attempting to use his or her official position to influence a governmental decision in which he knows or has reason to know he or she has a financial interest. A violation of the act may subject an individual to administrative remedies and civil penalties. The Fair Political Practices Commission, which administers and enforces this law, has developed an eight-step process, as shown in the text box, for determining whether an individual has violated the law.

**The Fair Political Practices Commission's Eight-Step Process**

1. Is the individual a public official?
2. Is the public official making, participating in making, or influencing a governmental decision?
3. Does the public official have one of the six qualifying types of economic interests?
4. Is the economic interest directly or indirectly involved in the governmental decision?
5. Will the governmental decision have a material financial effect on the public official's economic interest?
6. Is it reasonably foreseeable that the economic interest will be materially affected?
7. Is the potential effect of the governmental decision on the public official's economic interest distinguishable from its effect on the general public?
8. Despite a disqualifying conflict of interest, is the public official's participation legally required?

Source: Conflicts of Interest, California Attorney General's Office.

During our audit, we obtained information that indicated that a former senior manager for EDFUND might have violated the act by attempting to use her position at EDFUND to influence the Student Aid staff person who engaged in contract negotiations with a corporation in which the former senior manager held stock. During 2005, Student Aid's former chief of its oversight division was responsible for negotiating a prospective lender agreement. During these negotiations, the former senior manager for EDFUND had a series of e-mail communications with the former oversight division chief. In these e-mails, EDFUND's former senior manager indicated that she was in direct contact with counsel for the lender related to the contract negotiation, and she advised the former oversight division chief that she thought it was inappropriate and unnecessary to attempt to bargain for certain contract terms that would require the lender to indemnify Student Aid.

According to the financial disclosures made by the former senior manager to EDFUND, she held stock in the lender during these negotiations.[12]

The former oversight division chief ultimately did not follow the recommendations of EDFUND's former senior manager and negotiated a contract that contained those terms related to indemnification. Nonetheless, the various communications made by EDFUND's former senior manager may have constituted an attempt to improperly influence the formation of this contract given that the amount of her stock ownership at the time may have served as a disqualifying interest under the act.

Although in the final analysis any determination regarding a violation of the act would need to be made by the Fair Political Practices Commission and ultimately by a reviewing court, we believe that the factual circumstances merit referral to the Fair Political Practices Commission. Accordingly, we have referred this matter to the Fair Political Practices Commission.

## RECOMMENDATIONS

To ensure that it maximizes the amount of funds available to fulfill its mission and administer the FFEL Program effectively, Student Aid should:

- Ensure that EDFUND complies fully with federal regulations and its policy governing salary setting for its executives, including modifying its policy to address board members who have a conflict of interest and ensuring that its consultants compile comparable compensation data solely from similar financial-related organizations.

- Ensure that EDFUND determines bonuses for its president in accordance with Student Aid's policy.

- Modify its policy statement and guidelines memorandum titled *EDFUND Incentive Compensation Plans* to ensure that EDFUND's executive management team does not receive a bonus if the FFEL Program or Operating Fund realizes a deficit.

[12] The Form 700 that this individual had filed under the Political Reform Act of 1974 disclosing her financial interests indicated that she owned stock with a fair market value of more than $100,001 and less than $1,000,000. The actual fair market value while these negotiations were ongoing may have been different.

- Ensure that EDFUND includes all FFEL Program revenues and expenses in its calculation of the program's operating surplus or deficit.

- Ensure that it and EDFUND's board establish guidelines to use when approving the total bonus pool amount for EDFUND's executive management team.

- Direct its executive director and EDFUND's president to resolve outstanding issues related to the methodology used to measure EDFUND's performance, which affects the bonuses for its nonexecutive employees.

- Amend its operating agreement to require EDFUND to establish a travel policy that is consistent with the State's policy.

- Closely monitor EDFUND expenses paid out of the Operating Fund for conferences, workshops, all-staff events, travel, and the like. Discontinue using Operating Fund money to pay for expenses related to nonemployees attending its company functions.

- Ensure that reimbursements to commissioners for their expenses are not excessive.

- Ensure that EDFUND follows through on its efforts to revise its contracting policies.

- Amend its operating agreement to require purchases of goods and services incurred by EDFUND to be reimbursed pursuant to procurement and contracting policies approved by the executive director of Student Aid.

- Rescind its delegation of the approval authority of EDFUND's detailed operating budget to the EDFUND board.

- Follow through on issues raised by its staff regarding EDFUND's operations.

- Require staff to independently verify the accuracy of the reports submitted by EDFUND.

- Complete key tasks outlined in the June 2005 mandated performance review of EDFUND.

- Replace its current chief of internal audits with an individual who is free from the appearance of organizational and personal impairments to independence.

- Ensure that it complies with IIA and government auditing standards that require an external assessment of its internal audits unit.

- Consider removing Student Aid commissioners from the EDFUND board.

- Consider changing the Student Aid executive director's role on the EDFUND board from a voting member to a nonvoting member.

- Ensure that EDFUND complies with the Bagley-Keene Act record-keeping requirements by maintaining a confidential minutes book of the business discussed during its closed sessions. In addition, Student Aid and EDFUND should establish policies and procedures to help ensure that closed sessions are conducted within the board's authority as required by state law. These policies and procedures should provide the board and staff with clear guidelines in defining trade secrets and business proprietary information that can be discussed during closed sessions so that no further violations of state law occur.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

Date: April 20, 2006

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# APPENDIX

## *Glossary of Terms*

**Account Maintenance Fees**—The U.S. Department of Education (Education) pays a guaranty agency an account maintenance fee based on the original principal amount of outstanding Federal Family Education Loan (FFEL) Program loans insured by the agency. Since federal fiscal year 2000, the fee has been 0.10 percent of the original principal amount of outstanding loans.

**Consolidated loan**—A consolidated loan simplifies repayments because there is only one monthly payment, and the monthly payments are typically lower because the repayment period for consolidated loans is longer. However, the total interest paid over the life of the loan is usually greater. Federal law allows EDFUND to deposit 18.5 percent of consolidated loan repayments into the Student Loan Operating Fund (Operating Fund), with the remaining 81.5 percent to be deposited into the Federal Student Loan Reserve Fund (Federal Fund).

**Default Aversion Assistance**—These are activities performed by a guaranty agency that are designed to prevent a default by a borrower who is at least 60 days delinquent and that are related directly to providing collection assistance to the lender.

**Default Aversion Fees**—Education pays a guaranty agency a fee if it performs default aversion activities on a delinquent loan in response to a lender's request for default aversion assistance on that loan. The lender's request for assistance must be submitted to the guaranty agency no earlier than the 60th day and no later than the 120th day of the borrower's delinquency. The fee may not be paid more than once on any loan.

**Disqualified Employee**—An employee who is in a position to exercise substantial influence over the affairs of the organization.

**Loan Processing and Issuance Fees**—Education pays a guaranty agency loan processing and issuance fee quarterly based on the principal amount of FFEL Program loans originated during a fiscal year that are insured by the agency. Since October 1, 2003, the fee has been 0.40 percent.

**Net Recoveries on Defaulted Loans—**Collections revenue that federal regulations allow guaranty agencies to transfer into their Operating Funds from their Federal Funds. For example, federal regulations allow guaranty agencies to transfer 23 percent of the defaulted loan collections they receive directly from borrowers. The remaining 77 percent must be remitted to the federal government.

**Reinsurance Agreement—**A guaranty agency must have a reinsurance agreement to receive reimbursement from Education for its losses on default claims filed by lenders. Education may enter into a reinsurance agreement with the guaranty agency that reimburses the guaranty agency for the following:

- 95 percent of the guaranty agency's losses on default claim payments to lenders on loans for which the first disbursement is made on or after October 1, 1998.

- 98 percent of the guaranty agency's losses on default claim payments to lenders on loans for which the first disbursement is made on or after October 1, 1993, and before October 1, 1998.

- 100 percent of the guaranty agency's losses on default claim payments to lenders for the following:

    - Loans for which the first disbursement is made before October 1, 1993.

    - Loans made under an approved lender-of-last-resort program.

    - Loans transferred under a plan approved by Education from an insolvent guaranty agency or a guaranty agency that withdraws its participation in the FFEL Program.

*Agency Comments provided as text only.*

# CALIFORNIA STUDENT AID COMMISSION

April 10, 2006

Ms. Elaine Howle*
State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

Dear Ms. Howle:

The California Student Aid Commission welcomes the opportunity to respond to the findings and recommendations in your report.

The Commission supports this process and has worked closely with the Bureau of State Audits (BSA). The Commission appreciates the fact that BSA has revealed issues that did not arise from prior outside audits or from management of the Student Aid Commission or EDFUND. Some of the Report's findings will serve as a basis for making improvements in the Student Aid Commission and EDFUND's performance and accountability.

Further, while the Commission agrees with a number of findings in the Report, some areas of disagreement are covered in the attached response.

This response does not encompass all of the actions that we expect to be adopted by the Student Aid Commission once the Commission's full membership has the opportunity to meet and evaluate the Report's findings and recommendations. The action required under many of the recommendations is a policy decision that appropriately requires formal action of the Commission itself, and not merely the action of the Special Committee assigned to review the Report or the Commission's executive management. Future actions can and will be considered when the Commission convenes its meetings. Additionally, the majority of the appointed members of the Student Aid Commission, as distinguished from the Commission's executive management, did not participate in this review.

Sincerely,

James Sandoval
Chair, California Student Aid Commission

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* California State Auditor's comments begin on page 95.

# Overview

The Student Aid Commission (the Commission) is a guarantor in the federal student loan program and also administers other student financial aid programs for the state of California. EDFUND is a nonprofit public benefit corporation and an auxiliary organization the Commission founded in 1997 to operate the Commission's services under the Federal Family Education Loan (FFEL) Program.

In this response to the report of the Bureau of State Audits (hereafter referred to as "the Report") the Student Aid Commission largely agrees that both organizations must work to accomplish changes that will ensure continued high performance, effective definition of responsibilities, and public accountability for both organizations.

We are concerned that the findings in chapter one of the Report exclude any information about the positive achievements of the Student Aid Commission and EDFUND. In the past eight years, the Student Aid Commission and EDFUND:

1. Tripled annual loan volume while increasing EDFUND's spending by only seven percent, or the equivalent of less than one percent each year
2. Advanced and modernized a previously unstable technology system
3. Saved borrowers more than $300 million in fees
4. Reduced the default rate from 14.4 percent to 6.4 percent
5. Resolved outstanding audit issues with the U.S. Department of Education
6. Measured and achieved superior customer service ratings
7. Collected more than $3 billion in unpaid defaulted loans

When the state authorized the Student Aid Commission to create an auxiliary organization, a large number of administrative and operational matters were left to the Commission's discretion. As EDFUND has matured, these discretionary decisions of the Commission have been a source of continual negotiation between the two organizations in an effort to preserve accountability, ensure congruence with the mission and responsibilities of the Student Aid Commission, and foster the development of EDFUND as a performance-based nonprofit corporation that must compete for loans against loan program guarantors in other states.

In response to an earlier draft report, we have advised BSA staff members verbally that various sections of the report include confidential or proprietary information. We believe these matters have been addressed in the final report, and appreciate the responsiveness of the BSA.

## Fiscal Issues

Ensuring the competitiveness and fiscal viability of the student loan guaranty program is of paramount importance to the Student Aid Commission and EDFUND. This goal is made more challenging by recent changes in the federal Higher Education Act, but both organizations faced similar changes that became effective in 2003 and adapted to them, growing both loan volume and revenue.

We regret the Report's assertion that "Student Aid's ability to generate sufficient revenues to justify its continued status as a guaranty agency may be in jeopardy because of a change required under the Federal Higher Education Reconciliation Act." The Report's conclusion that the Student Aid Commission should remain a guarantor only if it generates sufficient surplus revenue from the loan program to support state programs and operations is presumptuous. The Commission is committed to working with the state to determine the appropriate uses of Student Loan Operating Fund revenues.

The Higher Education Reconciliation Act of 2005 ("HERA") will require adaptation of proven collection and marketing strategies. EDFUND can and will remain competitive if it is allowed to continue to adapt its strategies in the marketplace and to make core financial investments in student loan operations.

We also benefited from a performance-based Voluntary Flexible Agreement (VFA) with the U.S. Department of Education ("Department") that must be revised at the request of and on a schedule determined by the Department in order to ensure consistency with the Department's goals for all VFA's.

***Finding*** – The federal Higher Education Reconciliation Act of 2005 could make it difficult for the FFEL Program to generate an operating surplus.

***Response*** – The HERA affected some sources of revenue for student loan guaranty agencies beginning with the 2006-07 fiscal year and imposed a new federal default fee. EDFUND anticipates that, even under the HERA, core loan program revenues (without adding income from the Voluntary Flexible Agreement) will increase in fiscal year 2006-07 and the Student Loan Operating Fund will end the year with a small surplus, even after the loan fund pays $22.6 million for Student Aid Commission administrative and program expenses. In the past two years, substantial portions of the operating fund were used "on a one-time basis" to cover non-loan program and Cal Grant funding during the state's budget emergency.

EDFUND also projects, based on current volume levels and market intelligence, that despite the imposition of the new federal default fee, it will substantively maintain current loan volume levels through the 2006-07 fiscal year. This will provide a solid base for related revenue sources. In addition, and contrary to the opinion stated in the Report, collections revenue is expected to continue to increase despite the changes affecting student loan collections.

We anticipate finalizing the new Voluntary Flexible Agreement soon and renewing our 2005-06 and 2006-07 performance-based payments under that VFA. Payments received as a result of these negotiations would be in addition to the revenue increases noted above. It is important to note, however, that we have always viewed revenue from the VFA as supplemental to core revenues and have managed loan program operating expenses so that we do not depend on VFA revenue to realize positive year-end results. This is in recognition of the Department discretionary power to enter into a VFA with a guarantor and the fact that it can be terminated with 90 day's notice.

Contrary to the Report's assertion that EDFUND cannot determine what, if any, impact its strategy related to the imposition of the federal default fee will have on remaining competitive, EDFUND is forecasting that it will substantively maintain current loan volumes through the 2006-07 fiscal year. The analysis in the Report includes information EDFUND has already examined in developing its forecast. The fee for EDFUND's borrowers will not be imposed until October 1, 2006. Only a few of the nation's guarantors have announced their decisions and only two large national lenders have stated that they will pay the fee, one of which covers loans guaranteed by the Student Aid Commission through EDFUND. However, given the potential impact on the market of anticipated federal default fee decisions, the Student Aid Commission intends to monitor EDFUND's forecasts and market assumptions closely.

Additionally, the HERA strengthened the requirements for the federal government to pay guarantors the Account Maintenance Fee and established the annual amounts for the U.S. Department of Education fund that pays that fee. In prior years, the Department did not have sufficient funding to pay the entire amount of the fee to guarantors.

***Finding*** – Other federal changes caused EDFUND to shift its strategy for collecting on defaulted student loans.

***Response*** –The HERA primarily changed the revenue formula for income earned from defaulted student loan collections to encourage the use of the loan rehabilitation program as a collection technique and to reduce the use of the loan consolidation program as a collection technique. These changes take full effect in 2009. The HERA also made changes to the loan rehabilitation program to make it easier for defaulted borrowers to satisfy the rehabilitation requirements.

Under the HERA, all guarantors earn lower retention rates for loans that are collected using defaulted loan consolidation. Prior to the changes in the Act, the U.S. Department of Education did not formally alter its guarantor policies or regulations to either encourage or discourage guarantors from using loan consolidation as a collection technique.

EDFUND has already adapted its collection strategies to conform to the HERA even though the Act's new collection provisions take effect on October 1, 2006 and then later in 2009. EDFUND is projecting an overall increase in future net collection revenues, not a decline as indicated in the Report. Also contrary to statements in the Report, EDFUND has been gradually shifting to more diversified collection revenue sources from consolidation revenue since the 2004-05 fiscal year, and immediately and aggressively stepped up the collections strategy shift following the enactment of the HERA. EDFUND reports that since it made the changes, recent monthly collections using methods other than loan consolidation were at levels not previously attained. EDFUND reports a nine percent decrease in Direct Loan consolidations and a 43 percent increase in non-consolidation collections over the past five months by comparison to the same period last year.

Also notable is the fact that a guarantor receives higher retention (net payments to the guarantor) for these types of collection, offsetting the lower income from defaulted loan consolidations. While this was the case prior to the enactment of HERA, important changes in HERA made loan rehabilitation for borrowers more attractive.

Moreover, the proposed VFA under negotiation with the U.S. Department of Education provides additional performance-based incentives for EDFUND to increase its portfolio of non-consolidation loan collections. Additionally, we anticipate that the VFA finalization will include pending payments for EDFUND's collection performance during the first part of the current fiscal year.

EDFUND's current strategy is to move default collections toward borrower payment and loan rehabilitations, and the Student Aid Commission will monitor the actual collection revenues and the financial impact upon the Student Loan Operating Fund.

***Finding*** – Student Aid may have lost the opportunity to receive millions in federal revenue because it failed to promptly renegotiate its Voluntary Flexible Agreement.

***Response*** – The negotiations with the U.S. Department of Education are not final. Under the agreement with the Department, these negotiations will encompass the new agreement, and address payments to be provided to the Student Aid Commission during the intervening period of time. Since the Student Aid Commission was never assured of receiving $24 million for the fiscal year 2004-05, and negotiations for payments during the 2004-05 fiscal year have not been completed, it is incorrect to say that we may have lost this amount. ●

While we would have preferred a timelier re-negotiation of the Voluntary Flexible Agreement with the U.S. Department of Education, we believe the Report's assertion that it could have been completed in eight to 10 months is unwarranted. The negotiation of the Student Aid Commission's first successful VFA started in August 1999 and was completed 18 months later in March 2001, approximately the same period of time as has been required to re-negotiate the Student Aid Commission's current VFA. ●

The Department has existing VFA agreements with four guarantors (including the Student Aid Commission). We have been informed by the Department that other existing voluntary flexible agreements are under re-negotiation, but none of the re-negotiations have been concluded. The Department's VFA Web site also reports that four proposals for new VFA's were received in 2004 – at about the same time as the re-negotiation of the Commission's VFA commenced – but none of them have been posted for public comment, the step the Department takes once a negotiation has been completed. Moreover, we believe that the negotiations surrounding the CSAC/EDFUND VFA are more complex because it is the VFA with the greatest number of proposed changes to the text and provisions of the original agreement.

The ability to successfully conclude negotiations is to a large degree determined by the U.S. Department of Education which has the discretion to (1) continue with the current agreement; (2) enter into a new agreement at a time of their choosing; or (3) terminate the existing agreement with 90 days notice. Nevertheless, we acknowledge that some of the timing has been a function of EDFUND and the Student Aid Commission resolving who should have primary responsibility for preparing and negotiating the VFA amendments.

***Finding*** – Efforts to increase revenue through business diversification have not been successful.

***Response*** – The BSA validly points out that efforts to expand the Student Aid Commission and EDFUND's student loan revenue through business diversification have not been successful, in spite of much planning and several concrete proposals. It is true that attempts to diversify the loan business have not produced the desired financial and program aspirations of the Student Aid Commission and EDFUND. Additionally, we are aware that quicker action may have prevented the funds that the Legislature allowed the Commission to set aside from being used for other state purposes.

EDFUND started actively exploring opportunities for business diversification in fall 2001 and it contracted with a business strategy, research, and development firm to provide expert consulting for that analysis. Following subsequent discussions with state officials, the Student Aid Commission determined that legislation would be needed to authorize a business diversification project to be approved and funded by the Commission.

The 2004 legislation gave the Student Aid Commission and EDFUND the important authority to pursue our business diversification plans. However, this legislation included restrictions that precluded types of business diversification proposals that were being evaluated by the Student Aid Commission and EDFUND.

Despite these constraints, the Student Aid Commission and EDFUND engaged an ad hoc committee of Commission and Board members to oversee and pursue business diversification opportunities in 2004. That diversification committee thoroughly examined a full range of business opportunities, hired an expert business strategy consulting firm, and assessed potentially viable business partnership opportunities.

The Student Aid Commission intends to work with EDFUND to accomplish its business diversification objectives while taking into consideration the current financial position of the Student Loan Operating Fund and the limitations placed in the 2004 state law.

## Summary

The Student Aid Commission and EDFUND must remain fully competitive with other FFEL Program guaranty agencies.

***Providing Financial Support for State Aid Programs*** – The Operating Fund balance should be sufficient to ensure that EDFUND meets the regular expenses of the program and can also contribute current and future investments in its operating infrastructure, particularly advancements, upgrades, and replacements in technology. Support for the Student Aid Commission and state of California programs, such as Cal Grants is an additional positive outcome of EDFUND's financial success.

***Voluntary Flexible Agreement*** – The re-negotiation of the VFA is a top priority for the Student Aid Commission and EDFUND. As noted above, it's difficult to assert exactly how many months the re-negotiation should have required because no explicit standard for the VFA timeline exists, and to our knowledge no other VFA re-negotiation has been concluded.

***Business Diversification*** – We have not acted on a business diversification plan and since February 2003 a new plan has not been devised. In the context of a smaller fund balance, we must continue to review available opportunities, applying thorough analysis and evaluation, and if feasible, provide a plan for consideration consistent with the state law.

***Reassessing the Fiscal Impact on the FFEL Program*** –The Student Aid Commission and EDFUND management must complete a joint assessment of the current outstanding student loan portfolio, particularly in light of any recent changes in federal law.

***Monitoring Reduction of Defaulted Loan Consolidations*** – The Student Aid Commission and EDFUND can inform the Legislature of progress under the terms of the Higher Education Reconciliation Act toward reducing defaulted loan consolidations and increasing alternative collection mechanisms.

## Oversight Issues

The Commission takes seriously its dual responsibilities: first to maintain its responsibility for and oversight of EDFUND, and second, to ensure EDFUND's financial viability and ability to function with the highest degree of effectiveness for students, educational institutions, lenders, the federal government, and the general public.

The Student Aid Commission determines the composition of and appoints members to the EDFUND Board of Directors, except that at least one member must be a student and one an employee of EDFUND. The Commission exercises responsibility over the loan program by direct annual approval of EDFUND's business plan, annual budget, and performance goals. Additionally, the Commission monitors and verifies EDFUND operations and support services throughout the year, as defined by the operating agreement between the two organizations.

The Education Code provisions leave the degree and manner of oversight largely to the discretion of the Student Aid Commission. Oversight is a source of continual negotiation between the two organizations in an effort to preserve accountability, ensure congruence with the mission and responsibilities of the Student Aid Commission, and foster the development of EDFUND as a performance-based nonprofit corporation in a competitive student loan program environment.

***Finding*** – Student Aid and EDFUND have been unable to agree on a new operating agreement for the FFEL program that delineates their respective roles.

***Response*** – The Legislature provided the Student Aid Commission with the authority to enter into a multi-year operating agreement with EDFUND. The Student Aid Commission decided to renew the existing single-year operating agreement until it makes a final determination about the appropriate roles and responsibilities of both organizations. The Commission believes the two issues – the operating agreement and the roles and responsibilities upon which it must be crafted – are inextricably intertwined.

BSA rightly points out that there has been tension between the Student Aid Commission and EDFUND. In its January 2006 report, the Legislative Analyst's Office pointed out the same dilemma, analyzed its history, and offered the Legislature five possible alternatives to resolve the predicament.

California Education Code 69522 makes the broad role of the Student Aid Commission clear. The Commission has "responsibility for financial aid program administration,

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policy leadership, program evaluation, and information development and coordination." What is not prescribed in the law is the meaning and extent of oversight and the meaning and extent of management of "operational and support services" which are indicated in the law as part of EDFUND's administration and delivery of Commission programs and services.

Give and take between the Student Aid Commission and EDFUND over the degree of EDFUND's responsibilities is not a new problem, but has been present virtually since EDFUND was created nine years ago. The Commission now realizes that the roles and responsibilities of the EDFUND Board and the Commission's critical role in oversight and fiscal and fiduciary responsibility for its auxiliary cannot depend on shifting positions of Commission members or management staff when there are changes in the appointment of those members or staff. As a result, the Commission in 2005 began developing the roles and responsibilities document referenced in the Report. The Commission delayed final action on the document in accordance with recommendations it received to delay action until this Report was completed.

The current roles and responsibilities document, reviewed by BSA auditors, is not a final one. It is a statement of general principles, which – as BSA notes – must be made more specific to be suitable for inclusion in the Operating Agreement, or for developing new provisions of the Operating Agreement.

Beginning with a more detailed clarification of the respective roles and responsibilities of the Commission and EDFUND, the Student Aid Commission will work to develop policies and definitions to ensure that its own oversight mandate and EDFUND's operational role are managed effectively under both with state and federal law.

***Finding*** – Student Aid has yet to fully address concerns raised by its executive director's assessment of EDFUND's accomplishment of performance goals.

***Response*** – The Student Aid Commission's executive director and the EDFUND president are working to review the methodology for measuring year-end performance under the performance goals and metrics agreed to by the Student Aid Commission and EDFUND. Meetings to discuss the measurement standards are already scheduled for April 2006 and the Commission will await the results of those meetings before developing its actions related to the assessment of EDFUND's performance goals

***Finding*** – By erroneously relinquishing key oversight responsibility to the EDFUND Board of Directors, Student Aid circumvented state law.

***Response*** – In our review of the finding, we found that EDFUND provided detailed business plan and budget documents to the Commission staff for both 2004-05 and 2005-06, and the staff analyzed those documents. In a prior November 2003 action, the Student Aid Commission adopted a process for development of a Capital Utilization Plan that was construed as having delegated detailed budget approval authority to EDFUND. To the extent that the Commission's action has been interpreted as delegating the approval of the budget to EDFUND, such delegation was not the Commission's intent. Consequently, the chair will schedule action for the Commission to clarify its intent.

The finding with respect to approval of the detailed EDFUND budget appears to originate from an action at a Student Aid Commission in which the Commission approved a proposed process for financial planning related to the Capital Utilization Plan. The Student Aid Commission and EDFUND developed the Capital Utilization Plan to help guide the preparation of proposed budget documents in each organization and inform the Commission's future adoption of budgets, or expenditures, from the Student Loan Operating Fund. When the Student Aid Commission adopts the annual budget for the expenditure of Student Loan Operating Funds, it also adopts a budget for EDFUND's expenses. The entire EDFUND budget is a component of the Student Aid Commission's budget for expenditure of Student Loan Operating Expenses.

***Finding*** – EDFUND's federal fiscal year 2005 and 2006 business plans and budget were approved by Student Aid despite several unaddressed concerns.

***Response*** –The chair of the Student Aid Commission intends to direct the Commission's Fiscal Policy Committee to establish a process and appropriate dates for the evaluation of Commission staff recommendations on the EDFUND business plan and budget to ensure the timely submission and consideration of these recommendations.

The concerns were not addressed at the time of Student Aid Commission approval of FY 2006 budget because the approval of the business plan and budget by the EDFUND Board and the Commission was delayed. The EDFUND Board normally approves the business plan and budget for the following federal fiscal year at its August meeting, preceded by an EDFUND Finance and Budget Committee meeting, which makes a recommendation to the EDFUND Board. The materials then go to the Student Aid Commission for discussion and approval at their September meeting. As a result of changes in the EDFUND Board and its executive management during 2005, the budget and business plan documents were delayed. The EDFUND Board concluded that overall changes requested by CSAC staff were so comprehensive on all aspects of the business plan that there would have been no possibility of rewriting the business plan before the EDFUND Board meeting, or even before the Commission meetings - even if EDFUND management had agreed with all the changes. Members of the Student Aid Commission similarly concluded that many issues identified by staff were addressed and that others simply required additional information to be provided, and did not stand in the way of approval. Overall, the Commission decided not to delay approval because the Commission's adoption was already significantly late.

***Finding*** – Student Aid does not independently verify the reports submitted by EDFUND.

***Response*** – The Student Aid Commission concurs with the Report's recommendation and will establish appropriate verification and reporting processes, including examining whether the operating agreement needs to address such processes.

The current staffing level in the oversight division and workload may not have allowed for a detailed review of the reports to ensure their accuracy. In light of the finding posed in this audit, the Commission is committed to revising and clarifying its roles and responsibilities, including the expectations of the oversight division.

***Finding*** – Student Aid has not acted upon key tasks identified in its performance review of EDFUND.

***Response*** – The chair of the Student Aid Commission intends to request the members of the Commission to convene a committee to oversee the timely development of a new operating agreement. The operating agreement is the means by which the vast majority of the Commission's actions with respect to the performance review recommendations are to be adopted. To inform that process, the Commission will review the key tasks outlined in the June 2005 performance review and direct its staff and EDFUND to develop action plans in accordance with its conclusions.

The Student Aid Commission previously acted to accept the performance report issued by Commission staff on June 28, 2005. The Student Aid Commission also reaffirmed that EDFUND was operating in accordance with the Commission's expectations mitigating the urgency for adoption of significant actions related to EDFUND.

The performance review recommendations were received by the Student Aid Commission at a time when changes in the EDFUND Board of Directors, the departure of executive management, and pending changes in federal legislation created a near-term destabilized environment. The Student Aid Commission determined that it was more critically necessary to maintain a stable operating environment than to enter into major structural changes that might imbalance the performance of EDFUND and the Commission.

### Summary

The Student Aid Commission has multiple methods of ensuring oversight of EDFUND as its auxiliary organization. The Student Aid Commission also has an Education Code responsibility to maintain EDFUND's fiscal viability – and by inference the FFEL guaranty program – as well as to foster EDFUND's ability to prosper in the competitive student loan marketplace. The Student Aid Commission is the recipient of divergent views on the method of oversight, and the appropriate responsibilities of the two organizations, from its own management, the EDFUND Board of Directors, public stakeholders, legislators, gubernatorial agencies, and now this BSA Report.

The Student Aid Commission has expressed its intention to develop an appropriate document governing roles and responsibilities, adopt a new operating agreement, and will examine other issues that may arise from the BSA performance review. Moreover, EDFUND is operating under new executive management that must have the opportunity to contribute to this decision-making process effectively in order to thoughtfully and diligently administer the outcome.

## Nonprofit Issues

When the Student Aid Commission created EDFUND in 1997, the EDFUND Board of Directors set out to create a performance-based organization that would compete nationally in the student loan program by attracting and retaining the highest quality workforce.

The Student Aid Commission agrees that EDFUND's policies, and potentially its own policies, need to be evaluated, and if appropriate, revised to ensure the cost-effective use of funds, build transparency and accountability, and update the guidelines on events, workshops, and employee recognition programs. EDFUND has already begun revising policies. The Commission will consider whether its own action needs to be taken to provide further guidance to EDFUND.

***Finding*** – EDFUND's policy does not meet federal requirements for executive salary determination nor does it comply with the policy.

***Response*** – The Student Aid Commission and EDFUND Board of Directors agree that the compensation system should meet the standards of tax-code compliance for tax-exempt organizations, and the EDFUND Board asserts that it has followed a deliberate process, including using expert outside contractors, to ensure that compensation does meet those standards.

Consistent with the findings in this Report, the Commission will request the EDFUND Board of Directors to evaluate the compensation comparison methodology and to employ expert counsel to advise it on whether the comparison methodology it adopts satisfies federal requirements for tax-exempt organizations.

EDFUND contracted with the internationally-recognized firm of Hewitt Associates to conduct salary comparison surveys. Hewitt used a mix of financial and nonprofit organizations to obtain the data for the comparisons. The Report asserts that the comparative data should be obtained solely from financial organizations. EDFUND management is concerned that using financial organizations solely rather than financial and nonprofit organizations would result in higher rather than lower salary comparisons for executive compensation. Since EDFUND's own comparison methodology appears to be lower than the one recommended by the Report, then EDFUND's executive compensation levels would substantially meet the presumption of reasonableness in accordance with the federal requirements. Given BSA's divergence of opinion on the matter, it's appropriate for EDFUND to retain legal counsel to provide advice on the compensation methodology.

The EDFUND Board has not been consistent in documenting Executive Committee closed session meeting minutes. We agree that EDFUND should comply with its policy requirement that the executive committee of the Board maintain detailed minutes describing the salary determination process, including the avoidance of a conflict of interest by any board member, as required in its Bylaws and corporate policy.

***Finding*** – Student Aid's policy regarding the EDFUND executive incentive compensation is flawed.

***Finding*** –The board's determination of the total bonus amount for vice presidents appears inconsistent.

***Finding*** – EDFUND uses high-level organizational metrics to measure its performance and award incentive compensation to non-executive employees.

***Response*** – The Report raises three separate incentive compensation issues that must be re-evaluated and resolved by the Student Aid Commission. The Commission will benefit from the annual performance goal and incentive compensation discussions that are already scheduled between the executive director and president of EDFUND. The chair of the Student Aid Commission will schedule meetings for the Commission to examine its policy for the approval of incentive compensation and make corresponding changes in the Operating Agreement.

***Finding*** – Imprudent spending practices

***Response*** – The Student Aid Commission concurs that EDFUND has spent more on meetings and employee events than might have been considered fiscally conservative. The Commission will request the EDFUND Board of Directors to propose for the

Commission's consideration a policy that governs the expenses and scope of the employee conferences, employee recognition events, and the appropriate costs of annual Board of Director workshops.

***Finding*** – Student Aid did not ensure that EDFUND's travel policy was fiscally conservative; Further, EDFUND and Student Aid did not comply with their travel policies in some instances.

***Response*** – The findings and recommendations in the Report with respect to EDFUND's travel policies will be reviewed and deliberated by the Commission. In that review, the Commission intends to consider EDFUND's status as a nonprofit corporation and its competitive role in the marketplace. Additionally, the chair of the Commission and the chair of the EDFUND Board will direct management in each organization to establish processes to ensure compliance with the travel policy exceptions noted in the Report.

***Finding*** – EDFUND contracting policies are vague and lead to frequent non-compliance.

***Response*** – The Student Aid Commission agrees that some contracts included insufficient documentation, including the bid information, cost-benefit analysis, and sole-source justifications. Additionally, responsible contracting staff should have maintained all of the documents that were created or received as part of issuing EDFUND contracts. EDFUND is in the process of improving its contracting policy to require documentation to be maintained by contract officers, to improve the quality of information provided for sole source justifications and cost-benefit analysis, and to ensure that work is not initiated or approved in advance of obtaining signed contract documents. The chair will request a report to be submitted to the Commission with respect to actions taken by EDFUND.

## Summary

The Student Aid Commission and EDFUND Board of Directors have a responsibility to ensure that compensation is consistent with guidelines and standards for tax-exempt nonprofit organizations.

***Validating Comparison Organizations*** –EDFUND contracted with the internationally-recognized firm of Hewitt Associates to conduct salary comparison surveys using nonprofit and financial organizations. EDFUND will retain legal counsel to advise it on the appropriate compensation survey requirements.

***Validating Incentive Compensation Payment Standards*** – The Student Aid Commission must re-examine its policy for the approval of incentive compensation and make corresponding changes in the Operating Agreement.

# Accountability Issues

The Student Aid Commission and EDFUND requested the state to provide both organizations with the authority to discuss proprietary business matters in closed sessions. EDFUND should have abided by the state law's requirement that confidential closed meeting minutes be maintained.

The Student Aid Commission has added Commission members progressively to the EDFUND Board of Directors since it removed all Commission members from the Board in 1997 and later rescinded that action in 1999. While the action was taken to achieve congruence between the actions of the Board of Directors of EDFUND and the mission and policies of the Student Aid Commission, the Commission plans to also examine the appropriate composition of the Board, including having its members or the executive director serve as EDFUND Board directors.

In 2004, the Student Aid Commission merged its internal audit position to improve audit-related performance between the two organizations, but also recognizes that it needs to examine the independence of the internal auditor to ensure that the function achieves its compliance and accountability objectives.

***Finding*** – The EDFUND Board has violated state law governing closed session meetings.

***Response*** – We agree that the EDFUND Board should have been maintaining a confidential minute book of the matters discussed in its closed sessions. The EDFUND Board started complying with that requirement with its 2006 meetings.

***Finding*** – The independence of the internal audit functions at Student Aid and EDFUND may be compromised.

***Response*** – Effective in 2004, the Student Aid Commission and EDFUND adopted a series of actions that were designed to ensure congruence between the two organizations in responding to external and internal audits and audit findings. One of these actions was a decision to create a single internal auditor position that would have a direct reporting line to the joint audit committee of the Board and the Commission.

The internal auditor was temporarily placed in charge of the Legal Division's invoices and employee timesheets while the search for a replacement vice president of legal services is underway. Because of BSA's concern that this might create a potential impairment of the internal auditor's independence, EDFUND discontinued that practice.

The Report also finds that the internal auditor should not have an executive management role in either the Student Aid Commission or EDFUND. While the internal auditor's participation as an executive management team member could enhance executives' awareness of essential compliance issues, we will evaluate whether it would be more appropriate for this role to be advisory and non-voting. The Student Aid Commission must also examine whether it requires its own separate internal auditor.

***Finding*** – The composition of the EDFUND Board of Directors could also impair Student Aid's decision making.

***Response*** – Current bylaws specify that four of the 13 members of the EDFUND Board are to be Commissioners of the California Student Aid Commission, appointed by the Commission as are other members of the EDFUND Board. Under Education Code 69525, the Student Aid Commission has the authority to appoint members of the EDFUND Board of Directors, including determining the size and composition of the Board, except that the statute requires that one member of the Board be an employee of EDFUND and one member be a student enrolled in a California postsecondary institution.  There have been Commissioners on the EDFUND Board of Directors continuously except during a period between1998 and 1999, and the Commission later added its executive director as a board member.

The most important means the Student Aid Commission has for holding its auxiliary organization accountable and ensuring congruence with its mission is the appointment of the EDFUND Board of Directors.  In the context of the findings in this Report that Student Aid Commission members or the executive director serving as EDFUND Board of Directors may impact their independent decision-making roles, the Commission will evaluate the appropriate composition of the EDFUND Board.

## Summary

The Student Aid Commission and EDFUND have sought to comply with open meeting law requirements.  However, we recognize that additional guidelines and record-keeping are essential steps toward maintaining proper documentation and making compliance transparent to the public.

***Bagley-Keene Open Meeting Law Recording Requirements*** – Effective with its 2006 meetings, the EDFUND Board has maintained a confidential minute book of the business discussed during its closed sessions, and it will continue to do so as a matter of policy.  General Counsel is also developing written guidelines to govern the matters that may be appropriately considered in closed session.

***Composition of the Board of Directors*** –Consistent with the Commission's future review of this Report, and adoption of roles and responsibilities for each organization, it will re-evaluate the appropriate composition of the EDFUND Board of Directors, including having Commission members and the executive director serve as members of the Board.

***Independence of the Internal Auditor*** – While the Student Aid Commission acted to develop a joint organizational audit responsibility to enhance organizational compliance, there could be instances where the independence of the auditor is affected.  The chair of the Student Aid Commission will direct the joint audit committee to evaluate the findings and recommendations in the Report and propose appropriate action for the Commission and EDFUND.

# COMMENTS

## *California State Auditor's Comments on the Response From the California Student Aid Commission*

To provide clarity and perspective, we are commenting on the California Student Aid Commission's (Student Aid) response to our audit report. The numbers below correspond to the numbers we have placed in the margin of Student Aid's response.

Student Aid errs in characterizing our conclusion as presumptuous. State law allowed Student Aid to establish an auxiliary organization for the purpose of providing operational and administrative services for its participation in the Federal Family Education Loan (FFEL) Program. Additionally, according to state law, the implementation and effectuation of EDFUND shall be carried out to enhance the administration and delivery of Student Aid's *programs and services*. Furthermore, according to EDFUND's articles of incorporation, it was organized to promote and assist the *programs* of Student Aid. Finally, the operating agreement signed by the two entities states that Student Aid enters into the agreement for the purpose of enhancing its administration and delivery of Student Aid's *programs and services*. Therefore, we are simply pointing out that if EDFUND, Student Aid's auxiliary organization, is not able to generate sufficient revenues to accomplish the purposes for which it was created, the Legislature should reevaluate the need for a state designated guaranty agency and the current relationship between the two entities.

Student Aid has placed the Bureau of State Audits (bureau) in a difficult position. Specifically, as stated on page 18, EDFUND's legal counsel asserts that the specific details of the two analyses performed by EDFUND staff are confidential and proprietary. Yet, Student Aid has taken the liberty of using one of these analyses to assert that the Student Loan Operating Fund (Operating Fund) will end the year with a small surplus and that EDFUND projects it will substantively maintain current loan volume through the 2006–07 fiscal year. Nevertheless, although we are precluded from discussing the specific details of these analyses, the bureau stands by its conclusion on page 18 that, because of the recent announcements of other guaranty agencies, the State's

FFEL Program revenues could be reduced to the point where EDFUND's role as an auxiliary organization assisting Student Aid in administering the program is no longer warranted. Finally, Student Aid incorrectly implies that our report concludes that total collection revenue will decline because of changes in the federal laws. Rather, as stated on page 16, we conclude that other revisions to the FFEL Program *could* reduce revenues Student Aid earns from administering the program.

Student Aid's statement is problematic. As previously stated, we are precluded from discussing EDFUND's analyses. On page 19, EDFUND states that it has many tactics to minimize the impact of any changes in its competitive position. These tactics include strategies it and other guarantors in the industry use to maintain effective relations with and competitive services for schools, and to work with lenders to strike new relationships that include payment of the default fee. However, because these tactics are similar to those it usually employs and are still being implemented, we find it difficult to believe that EDFUND can accurately assess what, if any, impact they will have at this time. Thus, we stand by our statement that EDFUND cannot determine what, if any, impact these tactics will have on its ability to remain competitive in the student loan guarantee market.

Student Aid is misrepresenting certain facts related to EDFUND's collection strategies and collection revenues. Specifically, as we discuss on page 21, EDFUND correctly states that its January and February 2006 collections reflect an increase in its nonconsolidation activity. However, EDFUND fails to mention that its consolidation collections for February 2006 were roughly 37 percent more than its January 2006 consolidation collections and 8 percent more than the average monthly consolidation collections for the first quarter of federal fiscal year 2006. This trend does not indicate that EDFUND is aggressively reducing its use of consolidations to collect on defaulted loans.

Furthermore, Student Aid incorrectly asserts that our report states that EDFUND is projecting a decline in overall future net collection revenues. Our report makes no such claim. Rather, on page 16, we state that other revisions to the FFEL Program *could* reduce the revenues Student Aid earns from administering the program. More specifically, on page 19, we state that because it has relied so heavily in the past on using consolidations to collect on defaulted loans, these changes will almost certainly result in a decrease to the portion of net recoveries on loan defaults that result from this collection method. Finally, on page 21, we state that if EDFUND does not reduce its use of consolidations to collect on defaulted loans, it will realize reductions in revenues because of the collection charges that must be remitted to the U.S. Department of Education (Education), which will result in a corresponding decrease in the Operating Fund.

● Student Aid is correct that it was never *assured* of receiving the $24 million from its voluntary flexible agreement (VFA) with Education in federal fiscal year 2005, no more than it is *assured* of receiving any of its budgeted revenues. However, given Student Aid's actual VFA revenues over the previous years, along with its discussions with representatives from Education, Student Aid and EDFUND believed they could earn VFA revenues of $30 million. Consequently, as stated on page 25, in federal fiscal year 2005, EDFUND budgeted $30 million in VFA revenue. However, Figure 6 on page 23 shows that Student Aid received only $6 million. The remaining $24 million represents that amount Student Aid and EDFUND have yet to receive due to their failure to complete VFA renegotiations with Education. Specifically, as stated on page 25, according to Education's state agency liaison director, he informed Student Aid and EDFUND in June 2004 that they would not receive any VFA funding beyond federal fiscal year 2004 until the agreement was renegotiated to obtain cost neutrality.

● Student Aid is incorrect. As stated on page 22 of the report, this timeline was provided by a representative from Education. Additionally, logic dictates that it would take longer for an entity that has no prior experience to develop its first VFA. Therefore, comparing the length of time it took Student Aid to negotiate its first VFA in March 2001 with renegotiating the current VFA is baseless. Finally, Student Aid was aware, or should have been aware, that the federal government had concerns with its previous VFA. Specifically, as stated on page 23 of our report, in a January 2002 report, the U.S. General Accountability Office (GAO) identified concerns with California's VFA. The GAO thus recommended that Education renegotiate the VFA as soon as practicable. However, rather than being proactive and beginning internal discussions on developing a new VFA, Student Aid waited until it was formally notified by Education in June 2004, 30 months later, to begin developing a new VFA.

- Student Aid is understating the purpose of EDFUND. As previously stated, EDFUND was created to provide operational and support services essential for the administration of the FFEL Program *and* to enhance the administration and delivery of Student Aid's *programs and services*. Thus, Student Aid's statement that support for Student Aid and California programs, such as Cal Grants, is an additional positive outcome of EDFUND's financial success is inconsistent with state law, EDFUND's articles of incorporation, and their operating agreement.

- Student Aid is correct that state law leaves the degree and manner of oversight largely to its discretion. However, as noted on page 31 of our report, federal law requires the guaranty agency that chooses to delegate the performance of the FFEL Program function to another entity to ensure that the other entity complies with the program requirements and to monitor its activities. In addition, federal regulations require the state agency to maintain full responsibility for the operation of the FFEL Program when the program is administered by a nonprofit organization. Therefore, federal law and regulations make it clear that Student Aid is responsible for ensuring FFEL Program compliance, and therefore, it should not be negotiating oversight issues with EDFUND.

- Student Aid is missing our point. Specifically, as mentioned on page 66 of our report, we acknowledge Student Aid's assertion that certain events delayed the preparation of the budget and business plan document. However, Student Aid could have approved EDFUND's budget and business plan under the condition that concerns raised by Student Aid staff would be addressed in the near future. Furthermore, Student Aid states that the commission members concluded that many issues identified by staff and others simply required additional information to be provided. Yet, when we asked the chair of Student Aid if documentation of the commissioners' evaluations of the concerns raised by staff existed, he stated that such documentation does not exist. Thus, we cannot substantiate that the commissioners' evaluations thoroughly addressed all of the concerns raised by staff.

- Student Aid's assertion that comparing EDFUND's executive compensation with other financial organizations would result in higher rather than lower salaries is without foundation. Specifically, Student Aid provided no evidence to support its statement that the use of comparative data from financial organizations solely would result in higher rather than lower salary comparisons for executive compensation. Moreover, as stated on pages 37 and 38, federal regulations prescribe a compensation determination process to create a presumption of reasonableness, which includes obtaining appropriate comparability data. The federal regulations provide five examples of appropriate or inappropriate comparability data. None of these examples contemplate industries outside of the organization being considered. Finally, in compiling the comparable data, we would expect Student Aid to consider factors such as the number of clients served, annual revenues, and geographic location instead of simply using compensation data from financial institutions that are substantially larger, more complex, and more diversified than itself.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press