California Student Aid Commission Follow-Up:

Although Changes to the Commission's Business Model Have Produced Positive Results, Proposed Federal Changes Could Affect Federal Family Education Loan Program Revenues

September 2007 Letter Report 2007-505

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September 18, 2007 2007-505

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

Dear Governor and Legislative Leaders:

This letter report presents the results of a follow-up review the Bureau of State Audits (bureau) conducted concerning the California Student Aid Commission (Student Aid) and EDFUND, the nonprofit, auxiliary organization established to provide operational and administrative services to Student Aid for its participation in the Federal Family Education Loan (FFEL) Program. Specifically, we followed up on Student Aid's efforts to implement selected recommendations from a report the bureau issued in April 2006 titled *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* (2005-120). During this follow-up review, we focused on four key findings related to managing the FFEL Program in a manner that benefits the State.

Our review found that Student Aid made constructive progress in implementing our recommendations related to managing the FFEL Program in a manner that benefits the State. For example, it has reassessed the financial impact on the FFEL Program caused by changes in federal law that took effect in federal fiscal year 2006. In response to those changes, EDFUND implemented a strategy to ensure that borrowers would not have to pay the 1 percent federal default fee assessed on student loans. Additionally, EDFUND successfully reduced its reliance on defaulted loan consolidations through a mix of changes in its collection methods. Finally, Student Aid was successful in collecting $28 million in voluntary flexible agreement (VFA) revenue from the federal government that we previously reported it might not be able to collect.

While Student Aid and EDFUND have made progress, continued improvement in certain areas is necessary for the State to better manage the FFEL Program. Specifically, the 15-member commission (commission) that governs Student Aid may not have had a solid understanding of the specifics of the changed default fee strategy because they did not receive the details until days before it was implemented. Also, the commission and Student Aid did not review the actual financial agreements that EDFUND entered into with third parties to implement the strategy until on or around August 27, 2007, nearly two months after they went into effect. Further, unless Student Aid is successful in negotiating a new agreement with the U.S. Department of Education (Education), the amount of future VFA revenue will likely be reduced. Also, Student Aid and EDFUND still need to formally approve a plan for business diversification to generate additional sources of revenue.

However, state legislation that became operative August 24, 2007, makes significant changes to the operations of EDFUND. Specifically, that legislation requires the Director of the Department of Finance (director) to approve all commission activity relating to the FFEL Program and authorizes the director to act as the agent of the State for the sale and transfer of the student loan guarantee portfolio and related assets and liabilities of the FFEL Program.

Finally, as of September 7, 2007, both houses of Congress have approved House of Representatives Bill 2669 (H.R. 2669). If signed into law by the president, this bill will significantly reduce certain revenues earned by FFEL Program guarantors throughout the student loan industry.

Background

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 FFEL Program, which are the two major programs available to California students. In fiscal year 2005–06[1] it awarded $760 million to more than 257,000 students under the Cal Grant program. Additionally, during federal fiscal year 2006, which covers the period of October 1, 2005, through September 30, 2006, Student Aid, through its auxiliary organization, guaranteed new loans totaling more than $6.8 billion under the FFEL Program. As of September 30, 2006, outstanding FFEL Program loans guaranteed by Student Aid totaled more than $26.9 billion. Student Aid is governed by a 15-member commission whose members generally serve four year terms. Although Student Aid is ultimately responsible for the proper administration of the FFEL Program, it has delegated the responsibility for the day-to-day operations to EDFUND. EDFUND, a nonprofit entity incorporated in 1997, serves as Student Aid's auxiliary organization, providing operational and administrative services to Student Aid for its participation in the FFEL Program. EDFUND is governed by its own board of directors (board), nominated and appointed by the commission.

However, Senate Bill 89 (SB 89), an urgency measure enacted as Chapter 182, Statutes of 2007, and signed by the governor on August 24, 2007, which took effect immediately, may affect the ownership of EDFUND. This bill authorizes the director of the Department of Finance (Finance) to act as an agent for the State in the sale and transfer of the student loan guarantee portfolio and certain related assets and liabilities of the FFEL Program held by EDFUND. Alternatively, this bill authorizes the director of Finance to enter into an arrangement other than the sale and transfer of EDFUND's assets if the director, in consultation with the state treasurer, determines that arrangement will meet the goals specified in SB 89. SB 89 also prohibits the commission from authorizing EDFUND to perform any new or additional services

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

unless they are deemed necessary or convenient by the director of Finance for the operation of the loan program or for maximizing the value of the state student loan guarantee program. Similarly, the director must approve any expenditure by EDFUND. Moreover, SB 89 provides that all actions, approvals, and directions of the commission affecting the state student loan guarantee program are effective only upon the approval of the director. Thus, the director now has significant authority over the commission and EDFUND. Finally, the bill requires the director to conduct the activities authorized by SB 89 no later than January 10, 2009.

In 2005 the Joint Legislative Audit Committee (audit committee) requested that the bureau review Student Aid's governance and oversight of EDFUND, including its 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.

In April 2006 we issued our report and concluded that the State's ability to sustain the FFEL Program was uncertain because of changes recently made to the federal laws governing the program. In addition, we concluded that ongoing tensions between Student Aid and EDFUND had hampered efforts to complete essential tasks and Student Aid may have lost the opportunity to receive $24 million for the FFEL Program. Finally, the area of business diversification also was hampered by the lack of cooperation between Student Aid and EDFUND and the fact that the two entities did not have a viable plan for business diversification.

Pursuant to the authority granted to the bureau, including the audit standards the bureau operates under, it has been a long-standing administrative practice to require each agency or department we have audited to report to the bureau on its progress in implementing our recommendations at three intervals—60 days, six months, and one year (California Government Code, Title 2, Section 8543, et seq. and Government Auditing Standards, paragraph 1.28). Under that same authority, it also has been a long-standing administrative practice of the bureau to conduct follow-up reviews of audits when resources are available and the bureau determines it is prudent to do so.

Although EDFUND Has Taken Measures to Remain Competitive, Challenges Remain

In our April 2006 report we found that the State's ability to sustain the FFEL Program was uncertain because of changes made to the federal laws governing the program. Specifically, we reported that Student Aid's ability to generate sufficient revenues to justify its continued status as a FFEL Program guarantor could be threatened by a change required under the Federal Higher Education Reconciliation Act of 2005 (Reconciliation Act). Among other things, the Reconciliation Act requires guaranty agencies to collect and deposit 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 to use their own nonfederal funds to cover the fee. We pointed out that Student Aid's future as a guaranty agency may rest on how other guaranty agencies choose to implement this change. Those with a national presence could gain a considerable portion of Student Aid's FFEL Program new loans by charging borrowers lower fees than Student Aid plans 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, a reduction in revenues could severely impair its ability to continue operations. As a result, we recommended that Student Aid continue to reassess the financial impact on the FFEL Program caused by changes in federal law.

In this follow-up review, we conclude that Student Aid has taken steps to address our recommendation. Specifically, it paid the federal default fee on behalf of borrowers for all loans it guaranteed from July through September 2006. As of September 30, 2006, Student Aid paid almost $11 million in federal default fee expenses for loans it guaranteed during the first three months the fee was in effect. According to EDFUND, Student Aid has continued to pay federal default fee expenses for loans guaranteed during those first three months because the fee is recognized and paid upon disbursement, not guarantee, of the loan amount.

According to the commission, it determined that it would not be able to pay the fee on behalf of all borrowers for loans guaranteed on or after October 1, 2006. The commission also stated that many of its lenders—organizations that provide the funds for the loans made to the FFEL Program, such as banks and other financial institutions—agreed to pay the fee for loans guaranteed from October 1, 2006, through June 30, 2007, thus allowing it to remain competitive in the marketplace.

EDFUND implemented a default fee strategy designed to share the cost of the federal default fee with lenders so that borrowers would not have to pay the fee.

Beginning July 1, 2007, EDFUND, Student Aid's auxiliary organization, implemented an annual default fee strategy enacting a policy discussed with and approved by the commission on September 7, 2006. The intent of this policy, titled *Students First: A Partnership for America's Future*, was for EDFUND and any interested lenders to form partnerships beginning with the 2007–08 academic year to pay the federal default fee on behalf of borrowers through nonfederal sources. This cost-sharing policy was designed to pay 100 percent of the federal default fee on behalf of students/borrowers and was open to any lender that agreed to participate as long as EDFUND's share of the costs did not exceed its approved budget. The policy also acknowledged that a cost-sharing arrangement between EDFUND and its lenders is a necessary component of the policy and that EDFUND would develop a default fee strategy to implement the policy. Although the commission approved the policy language in its September 2006 meeting, EDFUND officials and Student Aid staff acknowledge that the commission did not review the default fee strategy associated with the policy at that meeting. Rather, the commission deferred the development and implementation of the detailed provisions of the strategy to EDFUND staff, provided that it remain consistent with the total amount approved in the 2007 EDFUND budget.

EDFUND's default fee strategy is considered confidential and proprietary in nature; as such, we are precluded from discussing its specifics. According to EDFUND officials, it decided to subsequently modify the implementation details of a previously prepared default fee strategy due to changes within the industry and the need to remain cost competitive with other national guaranty agencies. For example, some of EDFUND's largest competitors in the student loan guaranty business announced they would waive the need for both borrowers and lenders to pay the federal default fee and, in turn, pay the entire fee themselves. As a result of this event and the continual evolution of the student loan marketplace, EDFUND revised its proposed default fee strategy in March 2007.

Although we are precluded from discussing specifics because of the confidential nature of EDFUND's default fee strategy, its successful implementation could result in financial benefits for the FFEL Program. In our prior audit report, we stated that because Student Aid's FFEL Program lost $8.3 million in federal fiscal year 2005, a reduction in revenues could severely impair its ability to continue operations. As shown in Table 1 on the following page, the FFEL Program recorded revenues of $3.5 million in excess of expenses for the federal fiscal year 2006, an improvement from the previous year's loss. Although the FFEL Program's revenues increased by $39 million (32 percent), the main reason for revenue growth was that Student Aid received $36.5 million in VFA revenues from Education in federal fiscal year 2006, $30.3 million more than it received in the previous year. About $28 million of this VFA revenue was earned in federal fiscal year 2005 and was an area in question at the time of our prior audit. Although these VFA funds contributed greatly to increased program revenues, EDFUND expects a significant decline in VFA revenues in the future.

Table 1
Federal Family Education Loan Program Operating Fund Revenues and Expenses

		FEDERAL FISCAL YEAR 2005	FEDERAL FISCAL YEAR 2006
Standard activity revenues	Net recoveries on loan defaults	$58,148,572	$59,379,705
	Account maintenance fees	24,695,401	26,952,724
	Loan processing and issuance fees	21,833,220	23,100,000
	Default aversion fee	5,840,918	10,466,708
	Lender premium fee	0	257,090
	Total standard revenues	**$110,518,111**	**$120,156,227**
Supplemental activity revenues	Interest income	2,791,992	1,989,051
	Restricted fund revenue	3,485,766	3,742,571
	Voluntary flexible agreement	6,174,255	36,499,663
	Other revenues	105,571	42,680
	Total supplemental revenues	**$12,557,584**	**$42,273,965**
Standard activity expenses*		**84,602,443**	**85,686,031**
Supplemental activity expenses	Restricted expenses	3,485,766	3,742,571
	Minimum reserve subsidy	42,185,841	58,103,170
	Federal default fee subsidy	0	10,796,734
	Other expenses	1,076,206	641,651
	Total supplemental expenses	**46,747,813**	**73,284,126**
Loan program revenues net of expenses		**$(8,274,561)**	**$3,460,035**

Source: Student Aid's Operating Fund Unaudited Revenues and Expenses Variance Report for the 12 months ending September 30, 2005 and 2006.

* Includes salaries and benefits, consulting and professional fees, collection agency costs, and various other operating expenses.

The revised federal default fee strategy also should help EDFUND meet the federally imposed minimum reserve requirement. Federal law requires Student Aid to maintain a minimum amount of funds in its Federal Student Loan Reserve Fund (Federal Fund) equal to 0.25 percent of its insured original principal amount of loans outstanding, called a minimum reserve requirement.[2] 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. However, Student Aid's Federal Fund balance at the end of federal fiscal years 2004 and 2005 was not sufficient to meet the minimum reserve requirement. Consequently, Student Aid had to transfer $9 million and $42.2 million for federal fiscal years 2004 and 2005, respectively, from its Operating Fund to the Federal Fund at year-end to meet

2 This requirement existed before the passage of the Reconciliation Act and remains unchanged.

the minimum reserve levels. Similarly, as shown in Table 1, at the end of federal fiscal year 2006, Student Aid incurred an expenditure of $58.1 million in its Operating Fund. As in previous years, this expenditure represents a transfer to the Federal Fund to cover the minimum reserve requirement.

However, because the commission elected to pay the federal default fee for loans Student Aid guaranteed from July 1 through September 30, 2006, and lenders are paying the fee for all loans guaranteed between October 1, 2006, and June 30, 2007, these fees will be deposited into the Federal Fund to help satisfy the minimum reserve requirement. Therefore, if it generates enough revenues from the federal default fee, the amount Student Aid will need to transfer, if any, from the Operating Fund could be reduced significantly. In fact, Student Aid believes the need for minimum reserve transfers will be eliminated. Due in large part to the potential reduction or elimination of Student Aid's need to make a minimum reserve transfer, it is forecasting loan program revenues substantially in excess of expenses for federal fiscal year 2007.

Student Aid is forecasting FFEL Program revenues substantially in excess of expenses for federal fiscal year 2007.

Although the financial impact of recently proposed federal changes, which are discussed later in the report, remain unknown for federal fiscal year 2008, the effectiveness of EDFUND's default fee strategy could result in continued revenues in excess of expenses for the FFEL Program, depending on the fiscal impact of the proposed federal changes. It also could help eliminate any competitive disadvantage EDFUND would have faced if it were forced to charge borrowers the 1 percent fee. Effective implementation of the strategy would involve successful partnering with many of its larger lenders to share the fee so that borrowers would not be required to pay it, thereby assisting EDFUND in retaining or expanding its current market share. Although success is largely contingent upon the fluidity of the student loan industry and various market forces—many of which are beyond its control—EDFUND has taken a proactive approach with its default fee strategy.

However, it appears the commission may not have had a solid understanding of the default fee strategy specifics until only days before the strategy was implemented. Although the commission heard briefings on the default fee strategy in January and March 2007, it did not actually review the specifics until it met in June 2007, just days before the new financial agreements to be formed under the strategy were to take effect. Finally, according to Student Aid, the commission was not provided with the actual financial agreements between EDFUND and third parties until August 27, 2007, almost two months after they went into effect. EDFUND's counsel has stated that third-party agreements were not provided until then because of legal concerns related to confidentiality.

The commission was presented with the information related to the strategy in its May 2007 meeting but it was not discussed due to time constraints. EDFUND believes a default fee strategy has been in place since September 2006, when the commission approved the policy and directed EDFUND to move forward with implementing a specific default fee strategy for fee-sharing agreements with its lenders beginning July 1, 2007. EDFUND also believes it appropriately entered into fee-sharing agreements with its lenders in accordance with the commission's approved default fee policy.

In the commission's June 21, 2007 meeting, nine days before the revised default fee strategy and its associated partnership agreements were set to take effect, EDFUND provided an extensive overview of the revised federal default fee strategy to the commission in closed session. The specific details of this closed session are confidential, so we cannot disclose them in this report. However, although EDFUND briefed the commission on the specifics of the federal default fee strategy, the commission was not provided copies of the actual financial agreements that EDFUND entered into with third parties until more than two months later because of EDFUND's assertion as to the confidential nature of those agreements.

We are concerned that the commission reviewed the details of the default fee strategy only nine days before the strategy and corresponding agreements were set to take effect. According to EDFUND's president, the commission would not typically review the details of how a strategy or function would be executed. The president also stated that the commission never asked about the specific details of how the default fee strategy would be implemented until the June 21, 2007 meeting, because those are the types of administrative details left to EDFUND's staff. However, the commissioners ultimately must answer to the Legislature, the Governor's Office, and the public regarding the fiscal and operational success or failure of the FFEL Program. These agreements with lenders potentially commit Student Aid to paying tens of millions of dollars to lenders despite the fact that the commission did not review the specific details of the strategy or the terms of the actual agreements with third parties before they were finalized. Because the commission lacked this understanding, it was at a disadvantage in attempting to evaluate the costs, benefits, risks, and legality of the strategy and the agreements. In addition, without reviewing such documents well in advance, the commission's internal control mechanisms and its ability to adequately manage and monitor the FFEL Program are weakened.

EDFUND Has Successfully Shifted Its Collection Strategy For Defaulted Loans

In our April 2006 report we questioned why EDFUND relied so heavily on using consolidations to collect on defaulted loans. Revenues from defaulted loan consolidations represented roughly 78 percent of Student Aid's gross collections from defaulted loans. As a result, we recommended that Student Aid monitor EDFUND's progress toward reducing its reliance on defaulted loan consolidations.

The Reconciliation Act, enacted in February 2006, caused significant changes to the FFEL Program. Beginning 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. In other words, guaranty agencies may only retain up to 10 percent of consolidation recoveries, compared with 18.5 percent previously. Further, effective October 1, 2009, the Reconciliation Act requires 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.

These changes have had a significant impact on EDFUND's collection strategy and contributed to a dramatic shift away from loan consolidations to other payment types, such as loan rehabilitations. As shown in Table 2, in federal fiscal year 2005 consolidations comprised $41.4 million, or 71 percent, of EDFUND's total net recoveries on loan defaults. One year later, for federal fiscal year 2006, consolidations dropped to $23.8 million, or 40 percent of total net recoveries. Most other payment types, including administrative wage garnishments, voluntary borrower payments, and loan rehabilitations, increased significantly.

Changes to federal law have significantly impacted EDFUND's collection strategy and contributed to a dramatic shift away from loan consolidations to other payment types.

Additional federal changes contained in the Reconciliation Act also contributed to a shift in EDFUND's collection strategy. Specifically, requirements related to loan rehabilitations have changed. Before July 1, 2006, a borrower who had fallen into default was required to make 12 consecutive monthly payments to qualify for loan rehabilitation. Beginning July 1, 2006, the Reconciliation Act reduced this requirement to nine payments in a 10-month period, allowing borrowers to qualify earlier. In addition, the grace period for a qualifying payment was increased from 15 to 20 days, making it easier to make payments that are considered timely.

As shown in Table 2, loan rehabilitations tripled from federal fiscal year 2005 to 2006. Moreover, the amount of a borrower's disposable pay that was subject to garnishment increased from 10 percent before July 1, 2006, to 15 percent thereafter.

Table 2
EDFUND's Shift in Collection Strategy
(Dollars in Thousands)

	Federal Fiscal Year 2005		Federal Fiscal Year 2006	
Administrative wage garnishments	$3,064	5.3%	$5,283	8.9%
Voluntary borrower payments	6,718	11.5	10,455	17.6
Consolidations	41,427	71.2	23,830	40.1
Loan rehabilitations	6,153	10.6	18,852	31.8
Franchise Tax Board tax and lottery offsets	792	1.4	959	1.6
Total net recoveries	**$58,154**	**100.0%**	**$59,379**	**100.0%**

Source: Student Aid and EDFUND's Supplemental Report on Net Collection Recoveries and Loan Default Expense.

Although changes to federal law have played a large role in EDFUND's shift in collection strategy on defaulted loans, EDFUND also has changed the way it handles consolidations to collect on defaulted loans. EDFUND has implemented a new rehabilitation automation project (project). The project automates many processes related to loan rehabilitations that had been performed manually. Examples include reviewing the borrower's payment history and eligibility requirements, sending rehabilitation agreements to qualified borrowers, and gathering information needed by the lender for processing. According to EDFUND, the new project has enabled it to rehabilitate more loans with the same staffing level. As a result, the project has helped contribute to the shift away from defaulted loan consolidations.

Additionally, EDFUND has restructured its commission scales for its loan collectors. We are precluded from revealing the specifics of this restructuring because it is confidential. However, it appears that the changes have helped EDFUND successfully shift its collection strategy away from consolidations and toward rehabilitations and other payment types.

Student Aid Has Received VFA Revenue Originally Called Into Question, Though Future Revenues Will Likely Be Lower

In our April 2006 report we concluded that the inability of Student Aid and EDFUND to agree on the role of each organization and the general lack of cooperation between the two hampered efforts to negotiate an important agreement with Education that may have resulted in a lost opportunity to receive at least $24 million in federal fiscal year 2005. The new VFA—an agreement with Education aimed at promoting activities that benefit the FFEL Program—had not been executed at the time of our prior report. Thus, Student Aid had not billed Education for its VFA payment. As a result, we recommended that Student Aid ensure that a new VFA with Education be completed.

In its one-year response to our audit report, Student Aid asserted that its original VFA, signed in 2001 with Education, remains in place and that it was successful in collecting $28 million for federal fiscal year 2005 in September 2006, which we confirmed. In addition, Student Aid provided Education with a revised VFA in October 2005 and made minor revisions in March 2006, neither of which were acted upon. Further, according to Student Aid, executives from Student Aid and EDFUND met with Education in October 2006 and determined that, based on this meeting and other communication, the original VFAs for the five guaranty agencies that have these agreements remain in place and that Education has not negotiated any new agreements. Student Aid believes that Education's involvement in developing the president's proposed budget for federal fiscal year 2008—which seeks to eliminate VFA revenue altogether—may have contributed to the stalled VFA negotiations. Finally, the provisions contained within the existing VFA combined with federal changes contained in the Reconciliation Act may have contributed to EDFUND receiving less VFA revenues in federal fiscal years 2006 and 2007.

Student Aid successfully collected $28 million in voluntary flexible agreement revenues for federal fiscal year 2005.

EDFUND received $28 million in VFA revenue for the 2005 federal fiscal year. However, it received only $8.5 million for federal fiscal year 2006. EDFUND originally budgeted VFA revenues of $31.4 million for federal fiscal year 2006 but earned revenue from only one of the three VFA components. The VFA outlines specific eligibility requirements for the three types of VFA revenue: early withdrawal fees, performance-based collections, and shared claim savings. EDFUND received the $8.5 million in early withdrawal fees for helping borrowers who withdraw from school to avoid loan defaults.

However, for federal fiscal year 2006, EDFUND missed out on VFA revenues related to performance-based collections and shared claim savings. For performance-based collections, EDFUND must ensure that its recovery rate for defaulted loans is greater than the baseline recovery rate established in federal fiscal year 2000. EDFUND missed this measure by just 0.30 percent, achieving a recovery rate of 14.79 percent compared with the 15.09 percent baseline rate. We cannot calculate the value of the potential revenue, but EDFUND did receive $13.8 million in performance-based collection revenue for the prior year. For shared claim savings, Education pays 50 percent of every reinsurance claim dollar below a 3 percent default trigger point. For federal fiscal year 2006, EDFUND missed reaching this trigger point by one one-hundredth of a percent, coming in at 3.01 percent. Again, because it just missed reaching the trigger point, we cannot calculate the amount of potential revenue that was not realized; however, EDFUND received $14.2 million in shared claim savings revenue for the prior year.

External factors appear to have contributed to EDFUND missing the performance measures, some of which are significant. Specifically, according to EDFUND officials, the existing VFA promotes and rewards a straight consolidation strategy, so EDFUND had collected a substantial percentage of its defaulted loans through consolidations. However, as discussed earlier, we recommended in our prior audit report that Student Aid monitor EDFUND's progress toward reducing its reliance on defaulted loan consolidations, based in large part on federal changes prescribed by the Reconciliation Act. We also discussed how EDFUND has implemented our recommendation by shifting its collection strategy for defaulted loans away from consolidations to other methods, such as loan rehabilitations. According to EDFUND, this strategy shift made it more difficult to achieve historical principal and interest collection levels on defaulted loans. Consolidations recognize 100 percent of principal and interest at the time of consolidation, whereas all other payment types are recognized over time, in some cases taking as long as nine years. Moreover, according to EDFUND, in federal fiscal year 2006, a reduction in the exceptional performer reimbursement rate from 100 percent to 99 percent caused lenders to file default claims much earlier than normal, creating about $14 million in claims that typically would have occurred during federal fiscal year 2006. EDFUND indicated that these factors contributed to it missing the shared claim savings trigger points and missing out on the subsequent revenue. Because provisions in the current VFA appear obsolete compared with the new environment and current business practices, Student Aid and EDFUND should continue their efforts to ensure that the critical task of negotiating a new agreement is completed. Otherwise, EDFUND is unlikely to qualify for certain future VFA revenues.

EDFUND and Student Aid Still Do Not Have a Business Diversification Plan

In our April 2006 report we noted that 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. Moreover, we recommended that Student Aid ensure that critical tasks, including the development of a diversification plan, are completed.

The commission and EDFUND board members agreed that insufficient cash reserves precluded any major initiatives to diversify its student loan activities in the near term.

Although it has been more than a year since publication of our report and associated recommendations, neither Student Aid nor EDFUND have formally approved a plan for business diversification to generate additional sources of revenues. In its one-year response to our report, Student Aid advised that the State has redirected approximately $300 million in operating funds to pay for non-loan FFEL Program general fund obligations, and that the commission and EDFUND board members agreed during a July 26, 2006, joint workshop that insufficient cash reserves precluded any major initiatives to diversify in the near term. In addition, current state law prohibits Student Aid from venturing into many aspects of the lending business. Pursuant to a section of the Education Code, it is precluded from loan origination or loan capitalization activities. Nevertheless, the commission and the EDFUND board agreed during that meeting that they would continue to be alert to potential opportunities to partner with other entities for diversification efforts. Subsequent to that meeting SB 89 took effect, and any diversification plan now requires the approval of Finance's director.

Finally, Student Aid noted that changes in the Higher Education Act have led EDFUND to adjust its business strategy with lenders interested in entering into partnerships to pay the default fee on loans guaranteed on or after July 1, 2007. Student Aid further anticipates that these partnership agreements will maintain market competitiveness and result in a commitment to keep the loans from exiting the commission's portfolio subsequent to paying the fee on behalf of the borrowers. Student Aid believes it is critical for such loans to remain in the portfolio over subsequent years for the commission to recoup the costs of this investment and to increase loan volume through these lenders. Moreover, in the joint Student Aid/EDFUND workshop held on July 26, 2006, the presentation noted that opportunities must be balanced against risks to the core guarantee business and that available capital should be used to invigorate core guarantee business because this focus can produce greater and more immediate revenue returns.

New Proposed Federal Changes Could Affect FFEL Program Revenues

As of September 7, 2007, both houses of Congress have approved H.R. 2669, which, if enacted, will reduce the guaranty agency collection retention rate on borrower payments from 23 percent to 16 percent beginning on October 1, 2007. H.R. 2669 also contains provisions that will reduce the account maintenance fee paid to FFEL Program guarantors from 0.10 percent to 0.06 percent of the original principal amount of outstanding loans issued by the guaranty agency. These changes, if signed into law, are likely to significantly impact the revenues earned by FFEL Program guarantors throughout the student loan industry. Representatives in the White House Press Office have indicated that the president intends to sign H.R. 2669 when it reaches his desk.

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 letter report.

Respectfully submitted,

Elaine M. Howle

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State Auditor

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