

California Student Aid Commission

*Annual Report to the Legislature on
EDFUND*

*Federal Fiscal Year
October 1, 2005 – September 30, 2006*

Report Date: April 1, 2007



April 1, 2007

Dear Members of the Legislature:

The California Student Aid Commission (Commission) has been serving students and families for more than fifty years by providing financial aid services to support California's students in reaching their educational goals. The Commission is the primary agency responsible for the administration of state-aid programs, key among them the Cal Grant Program. The Commission is also the designated state guaranty agency responsible for the Federal Family Education Loan (FFEL) Program which it administers through its auxiliary organization, EdFUND. The Commission maintains responsibility for financial aid program administration, policy leadership, program evaluation and information development and coordination.

EdFUND was created in 1997, to provide operational and administrative services for the Commission's participation in the FFEL Program in support of the Commission's mission. Specifically, EdFUND is responsible for ensuring that federally insured loans are issued to students attending eligible post-secondary educational institutions and that loans are taken out through an approved FFEL Program lender; maintenance of borrower account information; securing borrower repayments on delinquent and defaulted loans; and payment of claims to lenders when a borrower defaults.

Changes in the student loan industry in 2005-06 brought new challenges for the Commission and EdFUND. In spite of these challenges, EdFUND, in 2006, processed more than \$10.1 billion in student loans (including Consolidation loans) and manages a portfolio of outstanding loans valued currently at \$27 billion.

EdFUND has been successful not only in business terms – loan volume growth, revenues, and customer ratings – but also in public service terms. Students in California and throughout the nation have benefited from the services provided by EdFUND through its administration of the FFEL Program. These services focus on ensuring that borrowers have a successful educational experience followed by a successful student loan repayment experience.

The Commission and EdFUND will continue to face new challenges in the future as additional changes to the FFEL Program have been proposed by Congress. The report provides specific information about EdFUND's activities in 2005-06 while also addressing the issues facing both the Commission and EdFUND as we look to the future.

Please feel free to contact my office at (916) 526-8271, with any questions or comments you may have regarding this report.

Sincerely,

A handwritten signature in blue ink that reads "Diana Fuentes-Michel".

Diana Fuentes-Michel
Executive Director
California Student Aid Commission



Mission

Making education beyond high school financially accessible to all Californians.

www.csac.ca.gov



Mission

EDFUND is dedicated to maximizing benefits to borrowers by being the premier service provider in the student loan industry.

www.edfund.org

EDFUND is an auxiliary agent of the Commission and therefore, the Commission is required to provide an annual report to the Legislature on EDFUND, which complies with Section 69529.5 of Article 2.5, Chapter 2, Part 42 of the California Education Code which requires:

- §69529.5 (a) The commission shall report the following information to the Legislature on April 1 of each year, with respect to the operation of the auxiliary organization:
- (1) A description of the services provided by the auxiliary organization.
 - (2) The auxiliary organization's annual budget, funded activities, and personnel, including the sources of revenue available to fund its operations.
 - (3) Descriptions of changes made in the delivery of loans to California students and enhancements to programs and activities administered by the commission. The descriptions shall reflect all changes, both positive and negative.
 - (4) The level of compensation of managers and executives of the auxiliary organization.
- (b) Commencing on April 1, 2005 and on April 1 of each year, ending on April 1, 2010, the commission shall specifically describe the actions taken, and report the costs incurred and the revenues realized, by the auxiliary organization in disbursement services, loan servicing and repayment, secondary markets and private lender activities that the auxiliary organization undertakes pursuant to subdivision (a) of Section 69522.

Section 69529.5 of Article 2.5, Chapter 2, Part 42 of the California Education Code, as amended, pertaining to the creation of an auxiliary organization of the California Student Aid Commission.

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EXECUTIVE SUMMARY

The California State Legislature granted the California Student Aid Commission (Commission) the authority to create a nonprofit auxiliary to the Commission for the purpose of providing services related to the California Student Aid Commission's participation in the Family Federal Education Loan (FFEL) Program under the terms of an annual Operating Agreement. The Commission retains responsibility for financial aid policy leadership and FFEL Program oversight.

EDFUND provides services related to activities consistent with the Commission's mission and policy goals, including administration of the FFEL Program and general administrative support to the Commission. As part of the Commission's oversight responsibilities, the Commission conducts regular performance reviews of EDFUND as delineated in the Operating Agreement. In addition, EDFUND is subject to annual federal and state audits in accordance with federal loan program requirements. EDFUND is also required to have an independent audit of their financial statements.

Through EDFUND, the Commission has provided enhanced services and options to students in California and across the United States. This report provides information on the background of the Commission and the creation of EDFUND, as well as information on the services provided by EDFUND nationally, changes in the delivery of loans, program enhancements, the operational budget, and the level of compensation for managers and executives of EDFUND.

The past year has required the Commission and EDFUND to work more collaboratively to overcome many obstacles and resolve key issues in the administration of the FFEL Program. Both the Commission and EDFUND will continue to work together to ensure common goals are reached that will benefit students of the FFEL Program throughout California and nationwide.

Services Provided

The Commission and EDFUND have experienced uninterrupted growth in annual loan guarantee volume. While higher education borrowing nationally has grown to become by far the largest source of financial aid, the Commission's loan volume has grown at a faster pace than the overall national program. Ten years ago, the Commission's loan program activities were limited to the in-state or California market. In 2005-06, the Commission was the nation's second largest guarantor, booking an organization-record \$10.1 billion in loans while maintaining a current \$27 billion loan portfolio. Service functions which are central to EDFUND's competitiveness and success include personal customer service; loan management solutions for schools and lenders; information technology support; and outreach and communications.

In federal fiscal year 2005-06, 73.4 percent of out-of-state loan guarantee volume was for borrowers at for-profit or proprietary institutions, resulting in a higher than industry average loan default rate and associated claims payments. During 2005-06, the Commission/EDFUND paid \$519 million in claims on defaulted loans guaranteed by the Commission, an increase of \$49 million or 10.4 percent over the \$470 million in claims paid in 2004-05, reflecting both the overall growth of the loan portfolio as well as its

composition. While both the Commission's cohort default rate and the FFEL Program's cohort default rate have declined over the years of EDFUND's existence, the Commission's particular school mix for loans makes it likely that the Commission's default rate will continue in the future to be above the national average.

The Commission's guarantee services activities generated positive net revenues during 2005-06 of approximately \$3.3 million. However, other Commission activities funded by its administration of the FFEL Program resulted in a net deficit of \$21.4 million for 2005-06. This includes expenses of \$24.5 million related to the administration of the Cal Grant Program, outreach programs and the California Student Opportunity and Access Program (Cal-SOAP). The net deficit was covered by funds previously accrued in the Commission's Student Loan Operating Fund. The 2006-07 loan program business plan and operating budget anticipates a substantial net operating surplus. The revenue will be sufficient to cover both loan and operating expenses.

Changes in Loan Delivery

In a year filled with considerable pressure and changes, EDFUND achieved positive results. The Higher Education Reconciliation Act of 2005 significantly affected guaranty agencies, lenders and borrowers. Guaranty agencies were required to deposit a 1 percent Federal Default Fee into their Federal Fund beginning July 1, 2006 and meet specific changes in collection efforts. The Commission paid the Federal Default Fee (by making the required deposit from its Student Loan Operating Fund) through September 30, 2006. Many lenders agreed to cover the fee through June 2007.

New federal legislation also required changes in loan collections. EDFUND's movement away from relying on new consolidation loans on defaulted loans and toward borrower payments and loan rehabilitation as collections tools has been aggressive and successful.

EDFUND Program Enhancements include: strategic partnerships in connection with the Federal Default Fee, advancements in information security, enhanced delivery of student loan debt summaries, improvements in both published and online materials to assist students, and a forum on student borrowing to help students to a strong financial future.

Annual Budget

In FFY 2005-06, revenues collected by EDFUND totaled \$162 million against total expenses of almost \$183 million, with only \$86 million of these expenses from standard loan program activity. The remaining expenses were predominantly due to a minimum reserve subsidy of \$58 million to the Federal Fund and current grant administrative and outreach program support of nearly \$27 million. These expenses resulted in an operating deficit of \$21.4 million which was supported by surplus generated in prior years.

For FFY 2006-07, total revenues of \$138 million are budgeted against total expenses of \$138 million resulting in a balanced budget. Of the total budgeted expenses, \$92 million supports standard loan program activity, with the remaining supporting grant administrative and outreach program costs.

Of the 615 people employed at EDFUND as of September 30, 2006, 565 (92 percent) were EDFUND direct hires and 50 (8 percent) were state civil service employees of the Commission assigned to work for EDFUND.

Level of Compensations for Managers and Executives

Members of the EDFUND Board of Directors do not receive a salary. Board members are compensated for their time with a \$100 stipend for each day when the Board, or a Committee of the EDFUND Board, meets. They are reimbursed for actual and necessary travel expenses.

Executive management salaries are set by the EDFUND Board of Directors based on market surveys and individual qualifications; all other salaries are set by the EDFUND Human Resources Division based on market surveys and in consultation with hiring managers. EDFUND's executive management may receive incentive compensation at the discretion of the Commission upon recommendation from the EDFUND Board. The Commission is reviewing the issue of compensation for EDFUND executives and management.

BACKGROUND

The California Student Aid Commission (Commission) is the state's principle provider of intersegmental statewide grant aid to postsecondary student. Founded in 1955 as the California State Scholarship Commission, the 15-member Commission's primary programmatic responsibilities include operation of the Cal Grant Program, which will distribute close to \$900 million to California's college students during the 2007-2008 academic year. The Commission also administers several targeted grant scholarship and loan forgiveness programs and the FFEL Program through the activities of its nonprofit student loan services auxiliary, EDFUND.

Federal Stafford loans are the largest source of federal student aid and are for eligible undergraduate, graduate, and professional students. There are two types of Stafford loans: subsidized, for which the government pays the interest while students are in school and during grace and deferment periods; and unsubsidized, for which students pay all the interest on the loans. Students may receive both types of loans at the same time.

Under the FFEL Program, qualified students can receive Stafford and/or Graduate/Professional PLUS loans, and their parents can receive PLUS loans (loans for parents) for the college costs of their dependent student. The FFEL Program also provides Consolidation loans which allow students to combine existing loans to make repayment more manageable. These loans are backed by the federal government and guaranteed by guaranty agencies, like the California Student Aid Commission. The FFEL Program is administered in California by EDFUND.

There are currently 35 FFEL Program guaranty agencies in the United States. The Commission, through EDFUND (a nonprofit public benefit 501(c) (3) corporation), is the nation's second largest provider of student loan guarantee services under the FFEL Program. EDFUND offers students a wide range of financial aid and debt management

information, while supporting schools with advanced loan processing solutions and default prevention techniques. EDFUND is headquartered in Rancho Cordova, California with regional offices located throughout the nation.

Development of the EDFUND Model

Since 1978, the Commission has worked with three different loan program administration models. From 1978 to 1993, the Commission's loan program activities were outsourced to an external contractor. In 1985, following a comprehensive review of both grant and loan program operations, the Commission decided that it could operate the guaranty program most effectively by removing outside contractors and managing both operations and technology directly within the state system.

This decision was a result of an assessment that external contracting did not always guarantee superior service and its administrative costs were higher than desired by the Commission. Additionally, the Commission wanted to expand services to schools, make system operations more efficient, and save costs by merging the grant and loan administrative systems onto the same technology platform.

Following years of planning and system programming, the grant system became operational in 1991 and the loan system became operational in early 1993. From 1993 to 1996, the Commission administered all of the primary student loan program activities, except for mainframe support of the central database that was provided by the state's data center. The Commission continued to outsource some data programming through Electronic Data Systems (EDS), and also contracted with external collection agencies.

Since 1997, the Commission has administered the loan program through an auxiliary organization, EDFUND. The Commission originally pursued the creation of EDFUND as a result of competitive pressures that threatened to force the Commission out of the FFEL Program. Prior to the creation of EDFUND, the Commission found the administration of the loan program difficult under state-agency constraints specifically due to inflexible data processing and technology system limitations and unresolved federal and state regulatory compliance issues. During this time, relations between guarantors and the U.S. Department of Education (USED) were tense because of USED's desire to implement the new Direct Loan Program requirements.

Competitors who sensed that the Commission was in a vulnerable position because of its technology and service deficiencies entered the California market aggressively beginning in 1993. At the same time, about 30 percent of schools, including some of the largest public universities, changed to the new federal Direct Loan Program, which began its operations nationwide in 1994-95. In California, the share of Commission-guaranteed loans dropped from near 90 percent prior to 1993 to close to 50 percent by 1995.

As a result of the drop in loan volume, the USED and state Legislators became concerned about the loans under the Commission's guarantee. To address these issues and enable the Commission's loan guaranty program to be competitive, the California Legislature authorized the Commission's loan guaranty services to be administered by a nonprofit auxiliary corporation rather than within the state government structure. The Legislature also granted the Commission custody and control over the spending of loan program-generated funds needed for that purpose.

EDFUND was founded in 1997 (AB 3133, Chapter 961, Statutes of 1996) as a nonprofit subsidiary corporation of the Commission. The Board of Directors created a performance-based organization that operated competitively against both nonprofit and state agency guarantors. As its benchmarks for performance, the Board considered standards for both nonprofit organizations and private financial organizations.

EDFUND operates as the Commission's guaranty agency services provider under the FFEL Program and has made the Commission's guaranty program more competitive nationwide by successfully enhancing customer service, building reliable technology systems, and correcting previously unresolved federal and state audit issues.

The Commission and EDFUND have Saved California Money

Since July 2003, the Commission's entire administrative budget has been funded by loan program revenue generated through EDFUND, representing direct annual State General Fund savings. Over the past several years, direct savings included:

- \$12 - \$13 million annually for the Commission's administrative budget;
- \$8.5 million annually for the California Student Opportunity and Access Program (Cal-SOAP); and,
- \$197.5 million total for the Cal Grant Program in 2004-05 and 2005-06.

The Commission has also approved funding for several outreach and college preparation programs and an annual Public Awareness Campaign to build student awareness of the opportunities afforded to them through the Cal Grant program and various other state and federal financial aid programs.

EDFUND has also provided administrative services to the Commission such as mailings, printing, and technology support, which saves the Commission staff time and money. The following are examples of some of the successful synergy projects between the Commission and EDFUND:

- Technology Synergy Projects: EDFUND and the Commission successfully transferred the Commission's Data Center from the TEALE Data Center to EDFUND, saving the state money while promoting data reliability, confidentiality and improved security. EDFUND's technology development staff also worked cooperatively with the Commission's Research staff to develop an online survey application/tool to implement the Student Expenses and Resource Survey. The development of the online survey will greatly reduce Commission staff time in administration and data collection, as well as reduce costs associated with a paper-administered survey.
- Joint Research Project: Commission and EDFUND research staff annually identify a joint research project. This project is determined in relation to similar program goals. The work includes identifying project parameters, developing a methodology, generating data collection, formulating data analysis and lastly, developing the research draft. An example of the 2004 Joint Research project, Determined to Succeed report may be found on EDFUND's homepage at:

http://www.edfund.org/edfund/edcentral.cfm?edfpage=/edfund/news_library/research_reports.html.

- Outreach Campaign: In August 2006, the Commission Governmental and Public Affairs staff worked together with EDFUND's Communications Department to develop a request for proposal for the contract bid to develop and manage the Commission's Public Awareness and Outreach Campaign. Additionally, the Commission and EDFUND staff worked cooperatively to evaluate the proposals and choose the contractor.
- Integrated Voice Response (IVR) system: The Commission and EDFUND worked together to implement the IVR system as a further enhanced customer service improvement. The IVR allows for better communication between the Commission and students, schools, financial aid advisors and the general public. Since the IVR system has been in place, fewer calls have been dropped, response time to callers has been reduced and overall customer service has improved.
- Space Planning Project: In a significant cost-savings move, EDFUND, working with the Commission, signed a lease with the Mather Development Group (McCuen Properties) to occupy new twin, two-story office buildings to be located in the Mather Commerce Center. The new site will provide approximately 170,000 square feet of office space and house approximately 800 employees, including subleasing space to the Commission for its operations. EDFUND is finalizing its space planning and expects construction to begin soon. The projected move-in is set for mid-2008.

The Future

The California Legislature placed relatively few constraints on the management of the federal loan guaranty program and EDFUND. Instead, the Legislature granted broad powers to the Commission and the EDFUND Board, and, with each successive set of amendments to the law, expanded the authority granted to the two organizations. For example, in 1999 legislation clarified the authority to guarantee loans nationally and enter into a five year operating agreement.

Consistent with the current statutory requirements, the Legislature gave the Commission flexibility to manage EDFUND and the loan program. The Commission has the responsibility of addressing and resolving any of the issues that impact the successful performance of EDFUND or the administration of the federal loan guarantee program.

Because of changes in federal policies, guaranty agencies must aggressively streamline processes, enhance business efficiencies and expand their revenue base or risk becoming financially unstable. In the 40-year history of the federally guaranteed student loan programs, change and growth have both been constant. This means that the Commission and EDFUND must remain flexible by adjusting current operations and marketing focus to adapt to a rapidly changing environment. With this responsiveness, opportunities for future growth are good.

The Commissioners have been contemplating changes to the current roles and responsibilities of the Commission and of EDFUND as the Commission's loan auxiliary organization. In August 2005, the Bureau of State Audits began its work on an audit to examine the workings of EDFUND as an auxiliary to the Commission and of the Commission's leadership with respect to the roles and responsibilities of each organization.

The Commissioners held off on finalizing a roles and responsibilities document as well as a new operating agreement with EDFUND pending the outcome and recommendations of the audit. The audit report was released in April 2006. After several lengthy discussions, the Commissioners voted to develop a request for proposal and solicited bids for a firm to assist the Commissioners with a report and recommendations for the final roles and responsibilities document. The consultants will present a preliminary report to the Commissioners at their meeting which is scheduled for February 22 - 23, 2007. The Commissioners are expected to approve a final roles and responsibilities document in the spring 2007.

SERVICES PROVIDED BY EDFUND

EDFUND provides the following guarantee agency services in keeping with competitive business services:

- Guarantee services: The guarantee is an agreement that the federal government, through the Commission and EDFUND, will pay the lender 97 percent of the outstanding loan amount if the student defaults on the loan. Default occurs after the borrower fails to make payments for nine consecutive months, a period during which the borrower is typically contacted multiple times by the lender and guaranty agency and offered a variety of options for returning his or her loan to good standing.
- Default aversion assistance: Lenders must request default aversion assistance from the guaranty agency or guarantee services provider if a loan is declared delinquent when no payments or attempts to restructure payments have been made for 60 days past the payment due date. As a part of this process, EDFUND engages in an active default aversion program designed to increase borrower awareness of the variety of repayment options available, as well as the potential consequences of defaulting on a student loan.
- Payment of insurance claims: After a loan reaches a default status, the lender submits a claim to the guaranty agency. The guaranty agency then purchases the defaulted loan from the lender at rates determined by federal statute. The guaranty agency is in turn reimbursed by the federal government a percentage of the payment made by the guaranty agency to the lender. For all loans guaranteed after October 1, 1998 which later default, the guaranty agencies receive 95 percent reimbursement from the USED.
- Collections: When a guaranty agency pays an insurance claim to the lender, it then attempts to collect reimbursement from the borrower. Funds a guaranty agency recovers from defaulted borrowers through the collections process are returned to the federal government, minus a percentage retained by the guaranty

agency. In the event the guaranty agency exhausts all opportunities to collect on a loan, the loan may ultimately be transferred back to the federal government through a process known as mandatory assignment. EDFUND continues to focus on establishing debt recovery strategies that successfully balance the need to maximize revenue recovery with its obligation to match each borrower with the most appropriate repayment program.

- Loan Portfolio Management: EDFUND administers an existing loan guarantee portfolio valued at approximately \$27 billion. EDFUND tracks each loan's status on a routine basis and submits periodic reports to USED. EDFUND also consolidates status updates from FFEL Program lenders and reports them to the federal government through the National Student Loan Data System.
- Program Oversight: EDFUND's Program Review and Compliance Unit is responsible for reviewing its school and lender partners' compliance with federal regulations governing participation in the FFEL Program. Priority for reviews by EDFUND staff is given to educational institutions based on their cohort default rates, and to lenders based on their lending volume.

The following functions administered by EDFUND are central to the competitiveness and success of EDFUND:

- Customer Service: EDFUND provides customer service to the schools and students it serves via a network of regional client relations managers located throughout California and the nation. EDFUND's Client Services team of more than 70 client relations managers and support staff consists chiefly of seasoned former school financial aid administrators and lender representatives who work directly with school clients to ensure quality service delivery and strong customer satisfaction. Regional staff also work with high schools, educating staff and students about financial aid programs and participating in financial aid workshops. This level of local, personal and comprehensive customer service was unprecedented when implemented by EDFUND and remains one of its hallmarks in the student loan arena.
- Loan Management Support for Schools and Lenders: EDFUND provides extensive information and technical support for its school and lender customers seeking to track and manage large volumes of student loans
- General Information Technology Support: The administration of federal student loans is an information-intensive process involving multiple parties and agencies at almost every juncture. Establishing and maintaining a smooth, reliable and timely flow of information and data transactions among students, schools, lenders, federal authorities and a guaranty agency requires extensive and continuously available technical support. EDFUND consistently provides these to all its partners in the financial aid process through its loan management system and several auxiliary Web-enabled functions and services. In 2001, EDFUND invested \$5 million in the installation of a new data center, allowing the organization to terminate a major data processing contract and bring major mainframe support functions in-house, thereby producing substantial long-term cost savings.

- Communications and Outreach: EDFUND strives constantly to keep students, parents, schools, lenders and policy-makers well informed about financial aid opportunities, programs, policies and developments. Communication and outreach efforts include the production and coordination of a wide range of informational workbooks, research reports, videos, special alerts, newsletters and other targeted outreach material, as well as ongoing school and lender workgroups, site visits, open houses, EDFUND tours, briefings and conference and trade show participation. EDFUND also offers a variety of Web-based tools for students and schools, including EDFUND.net (a loan processing system for schools), EDWISE (an online financial planning guide for students), EDTE\$T (an online loan counseling tool for students and schools), a library of informational streaming video presentations and an online student newsletter.

Summary of Key Measurements

Loan Guarantee Volume

The Commission and EDFUND have experienced uninterrupted growth in annual loan guarantee volume. During the ten years of EDFUND operations, the Commission's annual loan guarantee volume has grown from \$2.2 billion in 1996-97 to \$10.1 billion in 2005-06, a more than fourfold increase. While higher education borrowing nationally has grown to become by the far the largest source of financial aid, the Commission's volume has grown at a faster pace than the overall national program. The number of loans in other states grew 5.7 percent to 961,088. At California schools, the 550,189 new loans were 0.5 percent more than last year.

National Guarantor

Ten years ago, the Commission's loan program was largely restricted to the in-state or California market. In 2005-06, the Commission was the nation's second largest guarantor. Looking at 2005-06 loan guarantees, 57.8 percent of the Commission's loan guarantee volume was at out-of-California institutions. It should also be noted that 73.4 percent of this out-of-state loan guarantee volume was for borrowers at for-profit institutions. This relatively high proportion of proprietary school loan guarantees might be described as a mixed blessing. The large volume of proprietary school loans produces Loan Processing Issuance Fee (LPIF) and Account Maintenance Fee (AMF) revenue for the Commission/EDFUND. It also results in the Commission/ EDFUND having higher-than industry average loan default rates and associated claims payments. The defaulted loan claims in turn provide the collection revenues opportunities discussed below.

Defaulted Loans

During 2005-06, on behalf of the Commission, EDFUND paid \$519 million in claims on defaulted loans guaranteed by the Commission. This was an increase of \$49 million or 10.4 percent over the \$470 million in claims paid in 2004-05. This increase in claims payments was driven by two primary factors. First, the growing annual guarantee volume's natural byproduct is an increase in future defaulted loans and resulting claim payments. Secondly, the Commission's loan guarantee volume, particularly out of California, had a high proportion of for-profit schools and these schools have a higher than average defaulted loans rate. Beginning at 15.0 percent of the Commission's total loan guarantees in 1996-97, proprietary school guarantee volume reached 51.9 percent of the Commission's total guarantees during 2005-06. This higher proportion of

proprietary school guarantee volume is reflected by the Commission having a 2004 cohort default rate of 8.2 percent versus the FFEL Program cohort default rate of 5.1 percent for the same period.

While both the Commission's cohort default rate and the FFEL Program cohort default rate have declined over the years of EDFUND's existence, the Commission's particular school mix for loans makes it likely that the Commission's default rate will continue in the future to be above the national average.

Collections on Defaulted Loans

During 2005-06, EDFUND had net defaulted loan collection recoveries of \$59.4 million, a 2.1 percent increase over 2004-05. The 2005-06 fiscal year was a transitional one for EDFUND collection efforts, which had previously relied heavily on Direct Loan Program Consolidation loans as a primary collection tool. The dramatic result of these changes can be seen in the 42.6 percent decline in Direct Loan Program consolidations while wage garnishments were up 72.4 percent, voluntary borrower payments increased 55.6 percent, and loan rehabilitations rose 206.4 percent for the 2005-06 fiscal year compared to 2004-05. The Commission's expectation is that, while this strategic shift will, in the near term, likely result in slightly reduced gross collections, it will also yield higher net collection revenue for the Commission.

Revenue to the Commission and the State

The Commission's guarantee services activities generated positive net revenues during 2005-06 of approximately \$3.3 million. However, other Commission activities funded by its loan program administration had expenses of \$24.6 million (Outreach programs - \$12.5 million; Grants administration - \$12.1 million). These other expenses resulted in a net deficit of \$21.4 million for 2005-06. This deficit was covered by funds previously accrued in the Commission's Student Loan Operating Fund. The Commission and EDFUND anticipate that the 2006-07 loan program operating budget will have a net operating surplus but revenue and loan expenses will balance for 2006-07 after funding non-loan program activities.

CHANGES IN DELIVERY OF LOANS ~ PROGRAM ENHANCEMENTS

In 2005-06, EDFUND implemented several federally required changes to the delivery and services of loans. EDFUND also provided enhanced customer service while improving the efficiency of the loan process.

Federal Legislation

The following two major pieces of legislation impacted the program:

Higher Education Reconciliation Act of 2005: Congress approved the Deficit Reduction Act, more commonly known as the budget reconciliation bill. The Act's goal was to generate tens of billions of dollars in savings, with a substantial portion of the savings extracted from the federal student loan program.

Provided below are the major changes to the FFEL Program that affect guaranty agencies, lenders and borrowers:

Guaranty Agency:

- Federal Default Fee: As of July 1, 2006, guarantors must deposit into the Federal Fund a Federal Default Fee of 1 percent of the principal on Stafford and PLUS loans. By rebuilding the Federal Fund through the Federal Default Fee, guarantors will be able to pay their share of defaults and the costs of default prevention efforts without having to draw from their Operating Funds.

Honoring a long-standing commitment, the Commission and EDFUND paid the fee on behalf of borrowers from July 1, 2006, when the new requirement took effect, through September 30, 2006 -- a period which accounts for the bulk of the fee incurred during the entire academic year. Many large lenders have agreed to pay the fee for the remainder of the academic year (October 1, 2006 through June 30, 2007) on behalf of the borrowers whose loans the Commission guarantees. The Commission and EDFUND are also actively pursuing a multi-year zero default fee strategy for new loans guaranteed after July 1, 2007.

- Collections: As of October 2006, guarantors may only retain 10 percent (instead of 18.5 percent) of the revenues earned from defaulted loan collections where the collection effort relies upon replacing defaulted loans with new Consolidation loans and, effective October 2009, they cannot earn collection revenues on replacement Consolidation loans when these loans represent more than 45 percent of their total annual collection recoveries. As a result, guarantors have had to shift their collection strategy away from consolidations to alternative collection methods such as loan rehabilitation, which now requires fewer timely consecutive monthly payments (nine instead of twelve) from the borrower. EDFUND has successfully shifted its collection strategies toward alternative collection methods.

Lenders:

- Origination Fees: The new rules reduce, and will eventually eliminate by 2010, the origination fee of up to 3 percent that FFEL Program lenders are currently allowed to charge Stafford loan borrowers. The fee will continue to be charged on PLUS loans.

Students/Borrowers:

- Loan Limits: Effective July 1, 2007, first and second-year Stafford limits increase from \$2,625 to \$3,500 and \$3,500 to \$4,500. Unsubsidized Stafford limits increase from \$10,000 to \$12,000 for graduate/professional students and from \$5,000 to \$7,000 for additional borrowing to enroll in a graduate/professional program. The new regulations, however, did not change the aggregate loan limits, which will likely lead to the continued growth of private loans among undergraduates.
- Interest Rates: The interest rate for Stafford loans disbursed on or after July 1, 2006 increased to 6.8 percent fixed and the variable interest rates on existing loans increased to 6.8 percent or higher. Additionally, the new PLUS rate for FFELP loans increased from 7.9 percent to 8.5 percent, but through an oversight, the Direct Loan PLUS rate was not changed.

- Grad PLUS: A new loan for graduate and professional students is now being offered. After process and system conversions were completed prior to July 1, this new type of federal loan was introduced. Grad PLUS is an important new financial mechanism for higher education that can reduce reliance on private loans, which typically offer less favorable terms for borrowers than federal loans.

Reauthorization of the Higher Education Act: On September 27, 2006, the Higher Education Act was extended, once again, by Congress; this time through June 30, 2007. The Third Higher Education Extension Act (HEA) of 2006 (H.R.6138) is the sixth overall extension of programs under the HEA in the current reauthorization cycle. For the first time, the extension was used as a vehicle to make both technical and substantive reforms to the HEA, despite the fact that the full reauthorization remains unfinished. In addition to the standard extension of programs, H.R. 6138 includes new provisions in the following sections:

- Eligible Lender Trustee Relationships with Eligible Institutions;
- Hispanic-Serving Institutions;
- Guaranty Agency Account Maintenance Fees (the cap on AMFs has been removed); and
- Cancellation of Student Loan Indebtedness for Survivors of Victims of September 11, 2001 Attacks.

Proposed Federal Legislation

The FFEL Program may change again. Federal legislation has been introduced which may in time, impact the program.

The College Student Relief Act of 2007 (HR 5): The U.S. House of Representatives passed The College Student Relief Act of 2007 (H.R.5) by a vote of 356-71 on January 17, 2007 and it is slated to be debated next in the Senate. The bill is intended to make changes to the Federal Family Education Loan (FFEL) Program for both subsidized Stafford borrowers and FFEL Program loan holders. To pay for these interest rate cuts, the bill reduces payments to FFEL Program lenders and increases certain lender fees. The following are highlights of proposed changes and the affect on guaranty agencies, lenders and students/borrowers:

Guaranty Agency:

- Collection Retention: Reduce to 20 percent from 23 percent, effective July 1, 2007, the amount that a guaranty agency retains from the money they recover from borrowers who default on loans. The rate would drop to 16 percent by 2011.

Lenders:

- Reduce the amount that the government reimburses lenders for loans made on or after July 1, 2007 that go into default, from 97 cents to 95 cents for every dollar that is not paid back.
- Increase to 1 percent, from 0.5 percent, the one-time fee that lenders must pay the government to consolidate a borrower's loans.
- Cut by 10 "basis points" or 0.1 percentage point the return that lenders receive on federal loans.

- Ending the “exceptional performers” program, this increases the insurance payments to loan services that consistently comply with U.S. Education Department regulations.

Student/Borrowers:

- Reduce the borrower’s interest rates over the next five years from the current fixed rate of 6.8 percent to 3.4 percent. The first reduction is proposed to take effect July 1, 2007 with the last reduction rate to be effective July 1, 2011 through July 1, 2012. After January 1, 2012, the subsidized Stafford rate will revert back to 6.8 percent.

Voluntary Flexible Agreement

Voluntary Flexible Agreement: FFEL Program guaranty agencies may submit applications to USED to provide services under a Voluntary Flexible Agreement (VFA). A VFA incorporates and modifies the guaranty agreements under sections 428 (b) and (c) of the HEA, and is intended to enhance program integrity, increase cost efficiencies, and improve the availability and delivery of student financial aid. Borrowers have benefited greatly from the Commission’s VFA. The Commission received \$36 million during 2006 for successful implementation of various innovative programs within the VFA, covering services through federal fiscal year 2004-2005. The Commission has submitted a proposed VFA for USED consideration.

EDFUND Improvement Initiatives

Strategic Partnerships and the Federal Default Fee: EDFUND’s efforts to strengthen linkages with lender partners are reaping enormous dividends. Over two dozen of EDFUND’s largest lenders have agreed to pay down the federal default fee on behalf of borrowers for loans guaranteed from October 1, 2006 through June 30, 2007.

Information Security at the Highest Level: The state of California faces continued concerns with information security and client privacy issues. EDFUND has taken a proactive role in supporting information security by securing tape exchanges between guaranty agencies and the Federal Student Aid’s Virtual Data Center. This new protocol ensures customer data security and continued customer service and support.

Collections Strategies Transitioning: EDFUND’s movement away from relying on new Consolidation loans and toward borrower payments and loan rehabilitation as collections tools has been aggressive and successful. The federal government had previously voiced concerns about a perceived over dependence on Direct loan consolidations as a collection strategy. Reflecting this federal government concern, the 2006 Deficit Reduction Act caps guarantor income from consolidating defaulted loans at 45 percent of annual defaulted loan collections, beginning in 2009. Therefore, over the last year, EDFUND and the Commission have moved away from this reliance upon consolidation loans as collection techniques. During the past year, revenues from loan rehabilitations, wage garnishments and voluntary borrower payments were all up significantly while revenue from consolidation of defaulted loans was down. This change in collection strategy is well underway and is expected to fully comply with the 2009 target date.

Delivery of Student Loan Debt Summary Enhanced: EDFUND is now offering schools a choice of expanded and enhanced delivery options for the Student Loan Debt summary.

Electronic delivery allows borrowers to access their aggregate loan statement, enter additional loans, and update calculations. Schools can opt to have letters printed only for students nearing the time of loan exit counseling. Upon borrower request, schools can also reprint multiple letters.

New and Improved Publications

New Graduate/Professional Publications Released: Outlook™, magazine-style entrance and exits guides, offers a comprehensive education on student loan basics in an informative and engaging format for graduate and professional students. *Outlook* goes above and beyond the federal loan counseling requirements by offering a broad range of money management tips.

HERA-Driven Publication Updates: EDFUND's entire portfolio of printed materials – brochures, booklets, loan wraps, workbooks, posters, cards, bookmarks, etc. – had to be carefully reviewed and updated to reflect the requirements of the Higher Education Reconciliation Act. The majority of EDFUND's most popular materials were revised and back in inventory by early July.

New Online Publication: Entitled "Peer Assistance Guide and Workbook," contains universal concepts that can be tailored to any type of institution, containing subjects such as determining a target borrower population, selecting and training peer counselors, non-monetary ways to reward counselors, and forming partnerships on campus.

Helping Schools Save Time and Money: EDFUND contacted 300 schools receiving printed quarterly reports which show projected cohort default rate information for their borrowers and showed them how to easily access this same report online through the Cohort Management System. This method is not only more secure, helping to protect borrower information, but also more efficient and cost effective.

Educating Health Professionals: EDFUND worked with Nelnet to develop a financial literacy curriculum for health profession schools seeking to meet new American Association of Medical Colleges requirements. Three presentations were created in fiscal year 2005-06. Joint roll-out and marketing efforts include: training for Client Relations Managers and Nelnet staff, producing a financial literacy guide supported by an explanatory tri-fold brochure, producing a special event at the Health Professions Conference in January 2007, and providing five training events for health professions financial aid staff. These activities will be executed beginning in November 2006.

Forum on Successful Student Borrowing: EDFUND coordinated and hosted a two-day event, focused on identifying tools and resources to help prepare students for a successful financial future. The event drew 78 representatives from 48 schools.

Summary of Achievements

In a year filled with considerable pressure and changes, EDFUND provided positive results as follows:

- Reaching a record new Stafford and PLUS loan volume of \$6.9 billion -- a 4.5 percent increase. Client relations managers had more than 13,000 meaningful

contacts with customers and potential customers, and more than 80 new schools chose to use EDFUND for part or all of their volume for the first time in 2005-06.

- Processing a record number of claims, assisting a record number of defaulted borrowers, collecting a record number of borrower payments and rehabilitations and executing major strategic planning objectives, all while increasing efficiencies.
- Achieving a near perfect on-time delivery of almost one million manual transactions completed on behalf of EDFUND's lender partners and a 30 percent plus increase in combined call volume.
- Assisting a record by volume of more than 340,000 delinquent borrowers, an increase of 27 percent, while defaulted dollars were held to a 10 percent increase. Claim aversions and consolidations reached an all-time high, totaling \$56 million - an increase of 47 percent over the prior year.

ANNUAL BUDGET

With the passage of the 1998 Reauthorization of the Higher Education Act, two funds were created to take the place of the former Federal Guaranteed Loan Reserve Fund. Based on FFEL Program requirements, state law created the Federal Student Loan Reserve Fund (Federal Fund), and the Student Loan Operating Fund (SLOF) in the state treasury in 1999. Federal law establishes FFEL Program revenue sources and allowable expenses for each fund. The assets of the Federal Fund are the property of the Federal Government and their main purpose is to pay lenders for defaulted student loans. Money in the SLOF is the property of the State and must be used for loan program operating expenses and/or the support of financial aid-related activities.

The Commission and EDFUND's actual SLOF revenues and expenses for FFY 2005-06 appear in Figure 1. EDFUND operates on an October 1 through September 30, fiscal year, reflecting the federal budget cycle.

**Figure 1: Commission and EDFUND Student Loan Operating Fund
Statement of Revenues and Expenses
FFY 2005-2006 actual and 2006-2007 budgeted**

In thousands	2005-06 Actual	2006-07 Budgeted
REVENUES:		
Net recoveries on loan defaults*	\$59,380	\$66,725
Account maintenance fee	\$26,875	\$30,358
Loan processing and issuance fee	\$22,712	\$25,714
Default aversion fee	\$10,467	\$11,751
Lender premium fee	\$178	\$800
Interest income	\$1,989	\$770
Voluntary Flexible Agreement/other revenues	\$40,197	\$1,745
Total Revenues	\$161,798	\$137,863
EXPENSES:		
Loan program personnel costs	\$54,341	\$56,840
Operating expenses	\$22,182	\$21,071
Collection agency expense	\$8,386	\$11,868
Minimum reserve subsidy	\$57,727	\$0
Federal default fee subsidy	\$10,797	\$18,863
Restricted expenses	\$3,655	\$1,745
Borrower benefits-EDSHARE	\$307	\$923
CSAC FFELP operating expenses	\$1,127	\$1,800
Total Loan Program Expenses	\$158,522	\$113,110
LOAN PROGRAM SURPLUS	\$3,276	\$24,753
Outreach programs	\$12,539	\$11,128
Grant administration costs	\$12,090	\$13,625
Total Non-Loan Expenses	\$24,629	\$24,753
Total Expenses	\$183,151	\$137,863
OVERALL OPERATING (DEFICIT)	\$(21,353) **	\$0

* Recoveries on loan defaults, net of the USED's equitable share and the claim purchase complement. This amount includes fees earned from consolidating defaulted loans through the Direct Loan Program.

** Operating deficits were supported by surplus generated in prior years.

In FFY 2005-06, revenues collected by EDFUND totaled \$162 million against total expenses of almost \$183 million, with only \$86 million of these expenses from standard loan program activity. The remaining expenses were predominantly due to a minimum reserve subsidy of \$58 million to the Federal Fund and grant administrative and outreach program support of nearly \$25 million. These expenses resulted in an operating deficit of \$21.4 million.

For FFY 2006-07, total revenues of \$138 million are budgeted against total expenses of \$138 million resulting in a balanced budget. Of the total budgeted expenses, \$92 million supports standard loan program activity, with the remaining supporting grant administrative and outreach program costs.

Revenue

The FFEL Program revenue is derived from six specific primary sources authorized and regulated by the USED.

In addition to the six primary revenue sources, the Commission and EDFUND have also generated revenue under a Voluntary Flexible Agreement between the Commission and USED. No California General Fund monies are used by EDFUND; in fact, funds generated by the loan program are currently being used to fund Commission administrative expenses previously paid for by the General Fund. The rate of federal reimbursement for services provided by EDFUND was reduced starting in FFY 2000-01 due to FFEL Program modifications enacted by Congress in 1998. Several of these revenue reductions became fully effective on October 1, 2003.

Current revenue sources are:

- **Loan Processing and Issuance Fee** -- 0.40 percent of the principal of new loans guaranteed is paid to the guaranty agency at time of disbursement. This was reduced on October 1, 2003, from the previous rate of 0.65 percent.
- **Account Maintenance Fee** -- 0.10 percent of the original principal in the outstanding loan portfolio is paid to the guaranty agency on an annual basis. This amount was reduced in 2001 from the prior 0.12 percent, and is projected to continue at the current level.
- **Net Collection Retention** -- Collection dollars after the Department's fair share is deducted. This collection retention percentage from borrower payments has been gradually reduced in recent years from 27 percent to 23 percent as of October 1, 2003, while retention from collection payments obtained through borrowers' loan consolidations will decrease from 18.5 percent to 10 percent in October 2006.
- **Default Aversion Fee** - Default Aversion Fee is equal to 1 percent of the principal and interest on accounts more than 60 days delinquent that are brought current by working with borrowers before their accounts become 270 days delinquent. This fee is currently paid from the Federal Fund.

- **Lender Premium Fee** – This fee represents a premium paid by lenders to the Commission for purchasing previously defaulted loans where EDFUND collection efforts have made the loans and borrowers eligible for reinstatement under the federal guarantee. This is a new initiative for 2005-06.
- **Investment Earnings** – Interest income from funds held in the Student Loan Operating Fund (SLOF).
- **Voluntary Flexible Agreement (VFA) Payments** – Performance-based payments made to the Commission and EDFUND by the U.S. Department of Education are under the terms of our Voluntary Flexible Agreement. In fall 2004, the U.S. Department of Education requested renegotiation of the terms of the Commission and EDFUND's VFA. Since negotiations are still ongoing, the U.S. Department of Education could not finalize payment for FFY 2005-06. The payment received during 2005-06 was for VFA performance during 2004-05.

Personnel

The ability to recruit, hire, promote and compensate staff outside of state civil service was one of the key competitive advantages presented by the opportunity to transfer the Commission's student loan administrative and servicing functions to the auxiliary. Ensuring fair and equitable treatment of all employees regardless of their status as EDFUND direct hires or state civil service employees continues to be a major priority for EDFUND and the Commission.

In an effort to address these aims, AB 3133 provided a mechanism whereby state civil service employees whose functions were transferred from the Commission into EDFUND could opt to remain state civil service employees of the Commission while being assigned to work for EDFUND.

Of the 615 people employed at EDFUND as of September 30, 2006, 565 (92 percent) were EDFUND direct hires and 50 (8 percent) were state civil service employees of the Commission assigned to work for EDFUND.

EDFUND is an equal opportunity employer providing opportunity to all regardless of race, color, creed, national origin, ancestry, sex, marital status, disability, religious or political affiliation, age or sexual orientation.

LEVEL OF COMPENSATION OF MANAGERS AND EXECUTIVES

Members of the EDFUND Board of Directors do not receive a salary. They are compensated for their time with a \$100 stipend for each day when the Board, or a Committee of the EDFUND Board, meets and are reimbursed for actual and necessary travel expenses.

EDFUND management salaries are based on national salary surveys of comparable non-profit corporations both within and outside of the student loan industry, and are based on a combination of EDFUND norms and individual qualifications. Executive management salaries are set by the EDFUND Board of Directors; all other salaries are set by the

Human Resources Division based on local market surveys and salary data, and in consultation with hiring managers. Salaries are set based upon national competitive averages. EDFUND's executive management may receive incentive compensation at the discretion of the Commission upon recommendation from the EDFUND Board. Figure 2 below includes both regular salary and incentive compensation. It should be noted that the Commission is reviewing the policy of compensation for EDFUND executives and management.

**Figure 2: EDFUND Executive and Management Compensation
FFY 2005-2006**

Position Title	Compensation for FFY 2005-06
President	\$ 254,000
VP, Legal Services and General Counsel	\$ 184,413
VP, Technology Solutions and Services	\$ 183,397
VP, Finance and Administration	\$ 189,862
VP, Default Management	\$ 160,166
VP, Human Resources	\$ 157,621
VP, Loan Operations	\$ 195,122
VP, Client Services	\$ 180,486
VP, Audit Services	\$154,653
VP, Public Affairs	\$ 139,725
Total	\$ 1,799,445

Notes: VP, Legal Services and General Counsel vacated on August 5, 2005; filled on June 1, 2006.
 VP, Finance and Administration vacated July 8, 2005; filled on June 1, 2006.
 VP, Human Resources vacated December 15, 2006, currently recruiting.
 VP, Public Affairs vacated February 24, 2006; position eliminated and division duties reorganized.
 The compensation for the VP, Legal Services and General Counsel and VP, Finance and Administration reflect the 12-month federal fiscal year. Because these positions were filled during the latter half of the federal fiscal year, these were compensated for only those months remaining in the federal fiscal year.

CONCLUSION

The Commission and EDFUND faced significant competitive challenges from changes to the guarantor environment in the 2005-06 fiscal years. We worked strategically and successfully to surmount new requirements like the federal default fee, but these changes will continue to impact our business model in 2006-07.

The Commission and EDFUND have taken a series of actions to address all of the issues raised by the report from the Bureau of State Audits, including retaining consultants focused on streamlining operations and clarifying roles and responsibilities of the two organizations. Our continued progress in this area will be covered in greater detail in the 2006-07 Annual Report to the Legislature, after the final report from the consultants has been received and an appropriate action plan has been developed in response to their recommendations.

While it is anticipated that competitive pressures in the student loan guarantee services industry are expected to increase, the Commission and EDFUND will continue to work collaboratively for the benefit of the FFEL Program and California students.

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