CALIFORNIA STUDENT AID COMMISSION

Annual Report *to the* California State Legislature on EdFund

Federal Fiscal Year
October 1, 2004 – September 30, 2005

April 1, 2006

A Report Submitted by the California Student Aid Commission Pursuant to Section 69529.5 of the California Education Code

April 1, 2006

Dear Members of the Legislature:

For half a century, the California Student Aid Commission (Commission) has been serving California students and families with financial aid services and helping Californians obtain a college education. The Commission is the principal state agency responsible for administering state grants and, since 1977, is the designated guaranty agency for the Federal Family Education Loan (FFEL) Program in California.

EdFund was established pursuant to AB 3133 of 1996; this legislation authorized the Commission to create a nonprofit auxiliary corporation to provide operational and administrative services for the Commission's participation in the FFEL Program. The legislation also requires the submission of this annual report to the Legislature. Since January 1, 1997, the Commission has administered student loan services through EdFund, a California nonprofit public benefit corporation.

As a guaranty agency, the Commission through EdFund is responsible for ensuring that federally-insured loans are issued to eligible students attending eligible postsecondary educational institutions and that loans are borrowed through an approved FFEL Program lender. A guarantor also has specific responsibilities relating to the maintenance of borrower account information, for securing borrower repayment of delinquent and defaulted loans, and for payment of claims submitted by lenders when a borrower defaults. A guarantor may be either a state agency or a nonprofit corporation and is authorized to contract with third-party services for program administration. The U.S. Department of Education (USED) designates a guarantor for each state. The designation as a guarantor for a state is non-exclusive; that is, an educational institution may choose to work with any participating guarantor. The Commission through EdFund is the designated state guarantor for California and also provides guarantee services nationwide.

Perhaps the most remarkable aspect of the Commission/EdFund enterprise is that we have become the second largest guaranty agency nationally. In a student loan market that includes guaranty agencies that are affiliated with for-profit companies, the key to the Commission's and EdFund's success is our commitment to premier services to students and higher education institutions. The creation of EdFund was intended to ensure that a California-based, public service-focused provider of student loan services would survive in the face of increasing competition from national agencies and corporations. The State's loan program is administered at no cost to the State's General Fund.

Since EdFund's establishment, annual new loan volume guaranteed by the Commission has risen dramatically to $6.5 billion in the Federal Fiscal Year (FFY) completed September 30, 2005—more than four times the $1.43 billion of 1995-96. The majority of this volume growth has occurred as EdFund has expanded its market outside of California and begun serving students and schools across the nation.

Collection from defaulted borrowers is a significant revenue source for any guaranty agency. Improved EdFund collection tools, techniques and management, along with increased size of loan guarantee portfolio and the associated rise in defaulted loans, have resulted in higher collection revenue for the Commission and EdFund.

Revenue earned through the loan program since EdFund's inception contributed over $600 million back to student borrowers and the state in the form of outreach and training programs for students and institutions; grants to postsecondary education institutions to increase financial aid awareness; funding of the Commission's administrative budget; Cal Grant awards; and the waiver of the one percent loan guarantee fee for borrowers.

In looking toward future revenue streams, the state must also consider that in February 2006, President Bush signed into public law Senate Bill 1932, the Deficit Reduction Act (Act), authorizing approximately $13 billion over five years in cuts to student loans. Savings achieved by the federal government through this Act will increase costs and reduce FFEL Program revenues for guarantee agencies such as the Commission and EdFund, and for lenders.

This report provides further highlights of and information about EdFund's activities during FFY 2004-05. It reviews EdFund's achievements regarding the needs of students, parents, schools and lenders, while also addressing the issues facing this unique organization and the Commission as they look to the future.

Please feel free to contact either of us with any questions or comments you may have regarding this report.

Sincerely,

Diana Fuentes-Michel
Executive Director
California Student Aid Commission

Sam Kipp
President
EdFund

CALIFORNIA STUDENT AID COMMISSION

MISSION

Making education beyond high school financially accessible to all Californians.

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EDFUND® STUDENTS FIRST

MISSION

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

www.edfund.org

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 market 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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PREFACE

Just as the state of California is a dynamic leader and forerunner of progressive change in the nation, the California Student Aid Commission and its nonprofit auxiliary, EdFund, have become a model of efficiency and exceptional student services well-known in the nation's financial aid community. As the principal state agency responsible for administering financial aid programs for students attending public and private universities, colleges, and vocational schools in California, the Commission provides cost-effective operations coupled with outstanding service to students. Due to revenue from the loan program, these services have recently been provided at no cost to the State's General Fund.

Accomplishments

Since its creation in 1955 and with the addition of EdFund in 1997, the Commission has continued to evolve in response to the changing needs of California students and postsecondary institutions. The Commission has never wavered in its central purpose and mission to make education beyond high school financially accessible to all Californians. As the Commission's student loan auxiliary organization, EdFund, is dedicated to maximizing benefits to borrowers by being the premier service provider in the student loan industry.

In considering the future of EdFund, it is important to recognize some of the public benefits that have come to fruition due to the existence and success of the auxiliary organization. EdFund's success has generated a healthy income, which in turn has been used to help middle- and low-income students finance their unmet financial need. In this era of rising college fees, increased costs of books and supplies, and the potential for additional budget cuts, we need to invest in the human capital that is embodied in our students—for the economic future of the State.

- We have kept our promise to identify opportunities to combine the Commission's staff and resources with EdFund's staff and resources to improve customer service for students by providing, among other improvements: 1) the online information system called WebGrants for Students, 2) an Interactive Voice Response System to respond more efficiently to student inquiries, 3) an online GPA Verification form, and 4) increased training and training materials designed specifically for high school counselors and college financial aid administrators.
- Commission Information Technology and School Services staff continue to work together to streamline business practices and systems to provide improved service to students and others. Also known as synergy projects, the Commission will continue to search for opportunities to enhance service and promote efficiency.

EdFund continues to educate student borrowers about their financial aid options and loan responsibilities and to reduce student loan defaults. Over the past eight years, the cohort default rate for loans guaranteed by the Commission and administered by EdFund has been reduced from 12.7 percent to 6.4 percent. While this rate exceeds the national guarantor average, the Commission and EdFund serve a much more diverse range of students and institutions, and cutting its default rate in half represents a very positive accomplishment.

Challenges

As the student loan industry encounters change, many states face challenges. The diversity and sheer size of California's population and the number and variety of postsecondary institutions makes us unique. In the coming year, the Legislature and the Governor face an added challenge as we collectively consider options for the future of the state's administration of the Federal Family Education Loan Program.

This past year has been full of activity and challenges that will continue into the next year, including;

- During 2004-05, the Commission conducted a performance review of EdFund to assess EdFund in terms of efficiency of operations, guaranty and future business, and public accountability. The Commission finalized its Performance Review of EdFund in June 2005.
- In April 2005, the Commission voted to reconstitute the EdFund Board of Directors in order to take steps to clearly define the roles and responsibilities of the Board and to solidify the Commission's role as the parent and policy setting organization.
- In August 2005, the Joint Legislative Audit Committee directed the Bureau of State Audits to conduct an audit of the Commission's governance and oversight of EdFund, including EdFund's financial management and business practices as the Legislature was interested in ensuring the proper use of state assets in maximizing support for financial aid purposes. The audit report is expected to be released late March/early April 2006.
- The Legislative Analyst's Office (LAO) released its report titled California's Options for Administering the Federal Family Education Loan (FFEL) Program on January 24, 2006 as directed by the Legislature in Supplemental Report Language accompanying the Budget Act of 2005.

Commissioners and Commission staff will continue to work with EdFund staff, the Legislature, and the Administration as we explore the future of EdFund.

Moving Forward

When combined with changes and growth in the student loan industry, the federal Deficit Reduction Act will affect the student loan industry in 2005-06 and beyond; more importantly, it will affect California students. Several issues included in the legislation will have an effect:

- Guarantee Fee/Default Fee—The Commission and EdFund pioneered fee waivers in the student loan program. We were the first in the United States to waive the guarantee fee and we continue to save borrowers millions every year by maintaining the waiver. The Deficit Reduction Act includes a provision that would require the guarantors to deposit an amount equal to the fee into the federal reserve account. Although federally mandated changes in student loan fees take effect on July 1, 2006, the Commission and EdFund are continuing their commitment to waive the fee through September 30, 2006. A 1 percent federal default fee will be charged on federal Stafford and PLUS student loans guaranteed on or after October 1, 2006.
- VFA—California has benefited greatly from the Voluntary Flexible Agreement (VFA) that was approved by Congress. Negotiations continue on a new VFA, but the agreement is not yet finalized; and
- The Commission's retention rate from the William D. Ford Federal Direct Loan Program and FFEL consolidations of defaulted loans will decrease beginning October 1, 2006. In anticipation of the related impact on revenue, EdFund's collection strategy will need to shift aggressively towards non-consolidation collection types.

The Commission and EdFund comprise a self-supporting entity that uses loan program revenue to fund outreach and consumer education programs for students, training, materials and professional development for college financial aid staff, and a variety of other benefits. The Cal Grant program has enjoyed the bipartisan support of the Legislature due to its universally agreed-upon mission. We hope to maintain the level of support for the Commission and EdFund, and we are dedicated to working with the Legislature, the Administration, the segments of higher education, our business partners, and students and families to continue to serve the state diligently and efficiently. With this support and past success driving us forward, the Commission and EdFund plan to meet future challenges while maintaining the integrity, efficiency and exemplary service for which we have come to be known in the student financial aid community.

EXECUTIVE SUMMARY

State legislation approved in 1996 granted the 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 and under the terms of an annual operating agreement. The Commission retains responsibility for financial aid policy leadership and FFEL Program oversight. EdFund's functions are limited to activities consistent with the Commission's mission, policy goals, and the provisions of the operating agreement.

As part of the California Student Aid Commission's oversight responsibilities and as authorized in the operating agreement, the Commission conducts regular performance reviews of its auxiliary, EdFund. In addition, EdFund is subject to regular federal and state audits of the loan program due to the services they provide for the Commission. EdFund is also required to have annual third-party financial audits.

Over the past eight years, loan volume has grown from $1.96 billion in FFY 1997-98 to over $6.5 billion in the just-completed FFY 2004-05, including a 15 percent increase during the past year. While there has been a modest increase in student borrowing in recent years, most of the growth has come as a result of attracting new guarantee business from both current clients and new school customers in California and throughout the nation.

Key Strategic Issues

Key current issues facing the Commission and EdFund for the future include: strong competition in the student loan marketplace, competing priorities for use of loan program funds, the restructuring of the FFEL Program, structural/governance issues, and efforts to meet technology challenges. These issues are covered in more detail in the next section of the report.

Services Provided

EdFund administers an insurance program on federal student loans for California students, schools and lenders. Each loan made under the FFEL Program carries a federal guarantee administered by a guaranty agency. In California, the guarantee may be provided by the Commission and administered and serviced by EdFund, or it may be provided by any one of several other independent guaranty agencies. It is up to individual college campuses to decide whether to use the Commission/EdFund, another guaranty agency, or the William D. Ford Federal Direct Loan Program to provide loan services or any combination of these services to its students.

The Commission guarantee is only the starting point for a range of services provided by EdFund. These include assisting schools and lenders with loan processing, information management, and entrance and exit counseling for borrowers, as well as working directly with delinquent and defaulted borrowers to try to bring their loans back into repayment.

Budget, Revenues, Personnel

No California state General Fund monies are used by EdFund. The Commission and EdFund receive revenue from FFEL Program sources authorized and regulated by the Higher Education Act (HEA) and the U.S. Department of Education (USED). In fact, in 2004-05 $11.4 million generated by the loan program was budgeted by the State to cover Commission administrative expenses previously paid for by the General Fund. The rate of federal reimbursement for services provided by EdFund began to shrink in FFY 2000-01 as FFEL Program modifications enacted by Congress in 1998 became effective. Several of these revenue reductions became fully effective on October 1, 2003.

In FFY 2004-05, revenues collected by EdFund totaled $123 million. Expenses for 2004-05 totaled $211 million which included the following: $85 million for standard loan program expenses; $46 million for other loan program expenses; and $80 million in non loan program expenses. The resulting operating deficit of $87.8 million, supported by monies generated through past operating surpluses, was the result of:

- The state's appropriation of $80 million from the Student Loan Operating Fund (SLOF) for support activity formerly funded by the state's General Fund, and
- The minimum reserve subsidy of $42 million to maintain the minimum reserve requirement in the Federal Fund.[1]

The Student Loan Operating Fund (SLOF) operating revenues must be used for loan program operating expenses and/or to promote the Commission's policies and mission, consistent with the Higher Education Act. This can include direct or indirect benefits to borrowers through means such as cost reductions or service and technology enhancements.

The legislation authorizing EdFund's creation, approved by the state Legislature, provided a mechanism whereby civil service employees whose functions were transferred from the Commission to EdFund could opt to remain civil service employees of the Commission while

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[1] The guaranty agency is required to maintain a Federal Fund reserve level of at least .25 percent of the outstanding guaranteed loans. When charged, the guarantee fee is the major source of revenue for the Federal Fund. The Commission's waiver of the 1 percent guarantee fee resulted in the need to subsidize the Federal Fund in recent years. The Commission's decision to waive the fee was financially beneficial to borrowers and made the Commission's guarantee program competitive throughout the country.

being assigned to work for EdFund. Of the 642 people employed at EdFund as of January 1, 2006, 582 (91 percent) are EdFund direct hires and 60 (9 percent) are civil service employees of the Commission assigned to work for EdFund.

Program Changes and Enhancements

During the past year the Commission and EdFund: continued the guarantee fee discount program that saved student and parent borrowers more than $54 million; maintained a 6.4 percent student loan cohort default rate; published and distributed over 700,000 copies of financial aid consumer publications; launched or enhanced additional Web-based services designed to assist schools and students; received high overall ratings in customer surveys; held or participated in hundreds of training and professional development events for school financial aid staff; and continued implementation of a $12 million competitive grant program supporting campus-based debt management, default prevention and borrower education programs.

BACKGROUND

For more than 50 years, the Commission, through its administration of state and federal student financial aid programs in the State of California, has sought to make education beyond high school financially accessible to all Californians.

Since its creation on January 1, 1997 as a nonprofit public benefit corporation, EdFund has supported this mission by:

- providing operational and administrative services associated with the Commission's role as a guaranty agency in the Federal Family Education Loan (FFEL) Program;
- widening the array of financial aid services available to students and their families;
- providing college financial aid staff and lenders with premier customer service;
- supporting the efforts of college counselors and other financial aid professionals to serve students;
- expanding student outreach aimed at promoting access to higher education and improving student financial literacy; and
- implementing the private sector standards and business practices required to compete effectively with other guarantee service providers.

Since 1955, the Commission has evolved from a small state scholarship agency with a handful of employees into a major financial aid organization that awards nearly $900 million a year in Cal Grants, administers a variety of other state financial assistance programs, and guarantees over $6.5 billion in federal student loans annually. Today, the Commission is the principal state agency responsible for administering intersegmental financial aid programs for California students attending public and private universities, colleges and private career colleges.

The creation of EdFund, a nonprofit 501(c)(3) public benefit corporation, was authorized by Assembly Bill 3133 (Chapter 961, Statutes of 1996). The legislation authorized the Commission to establish a nonprofit auxiliary to provide operational and administrative services essential for the Commission to meet its responsibilities as California's designated guarantor in the federal student loan program. AB 3133 was supported by a wide range of groups involved with the delivery of student financial aid in California, including public and private university and college systems, proprietary and vocational schools, financial aid professional organizations, major California lenders, the California Postsecondary Education Commission, and the U.S. Department of Education (USED).

EdFund currently provides services related to the Commission's participation in the FFEL Program pursuant to the terms of an annual operating agreement between the two organizations. The legislation and operating agreement grant EdFund the authority to function as an auxiliary to the Commission. The Commission retains responsibility for financial aid policy leadership and FFEL Program oversight. EdFund's functions are limited to activities consistent with the Commission's mission, policy goals, and the provisions of the operating agreement.

EdFund is governed by a 13-member Board of Directors, all of whom are appointed by the Commission. Commission members, the Commission's Executive Director, financial aid directors, students, financial industry executives and EdFund employees are among those commonly represented on the EdFund Board.

The mission statement adopted by EdFund and approved by the Commission reflects the sense of purpose that governs EdFund's activities:

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

EdFund has identified the following major long-term goals:

FINANCIAL GOAL:

- EdFund will remain financially robust by optimizing revenues and controlling costs.
- To the extent permitted, EdFund will use the resulting net income to drive the greatest possible benefits for customers and borrowers, consistent with its continued growth and fiscal health.

MARKET LEADERSHIP GOAL:

- EdFund will maintain its #2 FFEL Program guarantee volume (#3 position in the total national market including the William D. Ford Federal Direct Loan Program).
- EdFund will continue to achieve a level of school customer service satisfaction better than that of any other similar service provider in the markets it serves.

ORGANIZATIONAL EFFECTIVENESS GOAL:

- Cultivate an organization that delivers results, celebrates success, embraces change, pursues excellence, capitalizes on opportunities and achieves information agility.

EdFund Today

The establishment of EdFund triggered major advances in the breadth and quality of student loan-related services available to California students and schools. The company's ability to respond rapidly to customer needs and to implement innovative solutions to program issues has resulted in significant improvements in customer service and competitive performance in the loan guarantee services marketplace.

FIGURE 1
EdFund/Commission New Loan Volume
FFY 1995-96 through FFY 2004-05

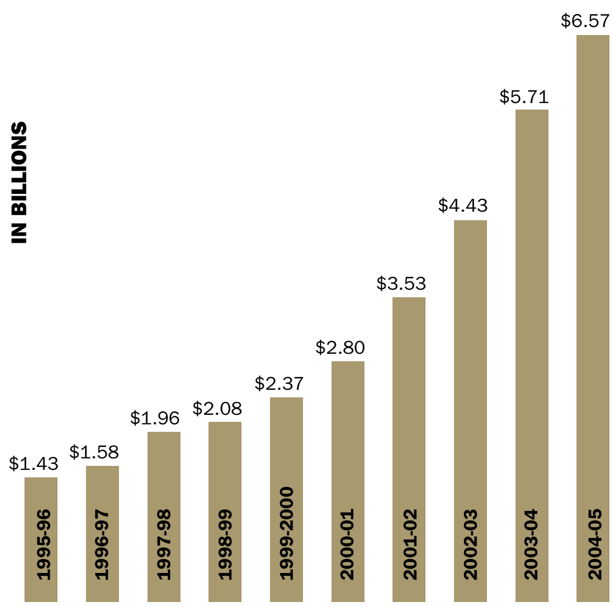

Figure 1 left illustrates the change that has taken place during the past eight years. After the establishment of the William D. Ford Federal Direct Loan Program and declines in 1994-95 and 1995-96, loan guarantee volume took a sharp upward turn beginning in fall 1996 and continued thereafter with the Commission's establishment of EdFund in January 1997. Loan volume reached what was then a new record of $1.96 billion in loans guaranteed during EdFund's first full fiscal year, October 1, 1997 through September 30, 1998. In subsequent years, EdFund consolidated and built upon these gains, expanding the reach of its services throughout the West and then throughout the nation. Meanwhile, EdFund's California market share stabilized during 1997-99 after experiencing a two-year exodus of loan volume to out-of-state guaranty agencies and the William D. Ford Federal Direct Loan Program earlier in the decade.

Beginning in 1999, EdFund achieved five consecutive years of very strong growth, including doubling new loan volume between 2001 and 2004, with new loan volume growth of 25 percent or more each year (see Figure 1 above). In FFY 2004-05, EdFund achieved a 15 percent growth rate. While student borrowing has increased in recent years, most of the growth has come as a result of attracting new guarantee business from both current clients and new school customers in California and throughout the nation.

KEY STRATEGIC ISSUES

The Commission and EdFund continue to face a number of major challenges as a result of stiff competition in the national student loan marketplace and repeated reductions in the revenues available to guaranty agencies under the federal student loan program. Both market conditions and a steady stream of program changes require constant attention and adjustment of strategic priorities. Adding another layer of complexity to these considerations is the state's action in recent years to fund major state financial aid expenses from the SLOF rather than the General Fund.

Key strategic issues for the Commission and EdFund currently include:

- *Strong Competition and Changes in the Student Loan Marketplace*
  Since the 1992 reauthorization of the HEA officially endorsed and even fostered active competition among guaranty agencies, the Commission/EdFund have been in a struggle not just to compete, but, at times, to survive as a California-based provider of student loan guarantee services. In the mid-1990s, the Commission's role as a guaranty agency was in question due to strong competition from other agencies and the William D. Ford Federal Direct Loan Program. After the creation of EdFund, market share stabilized and began to grow. However, the Commission and EdFund continue to face stiff competition, both in California and nationally, from companies such as USA Funds (whose former parent corporation USA Group merged with Sallie Mae in 2000 to create the largest student financial services corporation in the nation), the National Student Loan Program (formerly Nebraska Student Loan Program), Texas Guaranteed Student Loan Corporation and the Great Lakes Higher Education Corporation, among others.

  Loan volume growth slowed significantly in the second half of 2005. EdFund management reported that this was a result of various factors including negative publicity, the removal of non-Commission members from the EdFund Board of Directors, changes in EdFund's executive leadership, and the announcement of a new state audit of the Commission and EdFund.

- *Competing Priorities for Use of Loan Program Funds*
  Per the HEA, the SLOF operating surpluses must be used for loan program operating expenses and/or the support of financial aid-related activities. Until FFY 2002-03, the SLOF was used strictly for paying expenses associated with the administration of the FFEL Program. Since then, the SLOF has been utilized by the State of California to cover the cost of the California Student Opportunity and Access Program (Cal-SOAP), the Commission's operating budget, and, in state FYs 2004-05 and 2005-06, a total of $197.5 million in direct support for

Cal Grant awards. Alternative uses of the SLOF revenue have occurred at the same time that FFEL Program rates of reimbursement have been shrinking and competition in the marketplace has been steadily increasing. The continued use of SLOF funds for non loan program expenses at this time would affect EdFund's ability to compete effectively in the student loan marketplace.

- *Restructuring of the FFEL Program*

  The 1998 reauthorization of the HEA significantly reduced revenues available to guaranty agencies: for example, Congress reduced the Loan Processing Issuance Fee by more than 40 percent; the Account Maintenance Fee by 17 percent; and the Net Collection Retention Fee by 15 percent. A new reauthorization of the HEA is currently pending in Congress, with policy-makers in Washington seeking additional budget savings and reducing revenues further for all FFEL Program participants. These changes require guaranty agencies to work aggressively to streamline processes, enhance business efficiencies, and expand their base of revenue. Those that do not or cannot will likely become financially unstable.

- *Structural/Governance Issues*

  The Commission and EdFund continue to engage in discussions over a variety of governance and organizational issues, ranging from structural management issues to joint long-term financial planning.

- *Technology Challenges*

  Guarantee service providers such as EdFund will continue to rely heavily on technology, particularly Web-based loan management solutions. EdFund must continue to invest in technology solutions that meet customer expectations in order to remain competitive. While EdFund operates with a stable, high-performing operating system, it must continue to invest in the technology required to provide high-quality student loan services.

- *Business Diversification*

  It is important to note that many of our competitors have diversified their business opportunities in the student loan industry. By offering alternative or private loans, secondary market services, providing software support to campus financial aid operations, and/or operating for-fee loan origination and loan servicing for lenders through corporate affiliates, some competitors are able to generate additional sources of revenues. In contrast, the guarantee services function is currently the sole line of business for the Commission/EdFund.

The awareness of the advantages of diversification and the search for financial investment or partnering opportunities increased following the 1998 reauthorization of the HEA, which reduced reimbursement rates and margins for guaranty agency services over a five-year period. Some of the most promising diversification initiatives EdFund proposed in 2000 and 2001 were turned down over questions about the legal authority to proceed without new legislation. While there has been an ongoing exploration of various opportunities for investment or partnering and the Administration and Legislature approved enabling legislation in 2004-05 that both permitted and limited business diversification options, no specific business diversification plan has been adopted by the Commission. The state's use of SLOF revenues (including those previously set aside for business diversification) to support Cal Grants and other formerly General Funded activities during the state budget crisis, and the use of the SLOF to maintain the minimum reserve in the Federal Fund, substantially reduced the SLOF fund balance and has narrowed the scope of diversification opportunities that can now be pursued.

SERVICES PROVIDED

As the Commission's auxiliary organization, EdFund administers an insurance program on federal student loans. Each loan made under the FFEL Program carries a federal guarantee administered by a guaranty agency. In California, the guarantee may be provided by the Commission and administered and serviced by EdFund, or by any one of several other independent guaranty agencies. It is up to individual college campuses to decide whether to use the Commission/EdFund, another guaranty agency, the William D. Ford Federal Direct Student Loan Program, or a combination of any of these to provide loan services to its students.

The Commission guarantee is only the starting point for a range of services provided by EdFund. These include assisting schools and lenders with loan processing, information management, and entrance and exit counseling for borrowers, as well as working directly with delinquent and defaulted borrowers to try to bring their loans back into repayment.

What follows is a brief summary of each of the principal services EdFund provides, structured as a chronological narrative of the stages of an individual student loan.

Guarantee Services

The loan process begins when a student submits an application (the FAFSA, or Free Application for Federal Student Aid) to USED. Once USED's contractor has reviewed the student's application and the student's eligibility for federal aid has been determined, the student works with his or her school's financial aid staff and a lender to assemble the necessary loan documents. If that student attends a school that has selected the Commission as its guarantor (and, therefore, EdFund as its guarantee services provider), the school and lender forward the documents to EdFund, usually electronically. EdFund then conveys the federal government's guarantee of the loan on behalf of the Commission.[2]

Issuance of the guarantee completes EdFund's direct relationship with borrowers if they comply with the terms of the loan and make timely payments throughout its duration. This is the result for the vast majority of loans guaranteed by the agency. For the loans that subsequently become delinquent, however, a series of activities is initiated to attempt to resolve delinquencies and prevent defaults on guaranteed student loans.

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[2] The guarantee is an agreement that the federal government, through the Commission and EdFund, will pay the lender the amount of the loan 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

A lender generally declares a loan delinquent if no payments or attempts to restructure payments have been made for 60 days past the due date. At this stage, federal regulations require lenders to request default aversion assistance from the guaranty agency or guarantee services provider. 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.

Most borrowers resolve the delinquency at this stage and bring their loans back into good standing. Some are resolved as a result of changing economic circumstances; some as a result of increased awareness of the consequences of default; and some as a result of utilizing payment restructuring options, including loan consolidation and deferments.

Payment of Insurance Claims

However, despite a variety of innovative and effective efforts to convince borrowers to stay current on their loans, a number of loans inevitably go into default after at least 270 days of delinquency. EdFund has worked diligently over the past few years to reduce its cohort default rate with significant success. During the last year for which USED figures are available (FFY 2003), the Commission and EdFund had a cohort default rate of 6.4 percent.[3]

When 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 98 percent of face value, and is in turn reimbursed by the federal government for either 95 or 98 percent of the payment made by the guaranty agency to the lender. A change made in the 1998 reauthorization of the HEA lowered the reimbursement rate to guaranty agencies. For all loans guaranteed after October 1, 1998 which later default, the Commission and EdFund receive 95 percent reimbursement from the USED.

Collections

EdFund currently manages a defaulted loan portfolio of approximately $1.6 billion (this represents the amount on which EdFund is actively seeking payment). When EdFund pays an insurance claim to the lender, it then attempts to collect reimbursement from the borrower. EdFund's Internal Collections Unit seeks repayment for 180 days; after that, many loans are sent to outside collection agencies. EdFund implemented a new approach to collections

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[3] Default rates are calculated by the USED using a cohort default rate formula. The current figure, for example, represents the number of students who entered repayment between 10/1/02 and 9/30/03 and defaulted between 10/1/02 and 9/30/04, divided by the number of students who entered repayment between 10/1/02 and 9/30/03.

practices, staffing and processes in 2004-05—including a rigorous performance standard review for outside collection agencies—producing a 17 percent growth in net collection revenue.

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. In FFY 2004-05, EdFund collected $387 million, $10 million more than the prior year, but more than twice the $140.1 million collected in FFY 1995-96, the last full fiscal year before EdFund was incorporated. The collection revenue increase is the result of increased loan guarantee volume, the associated increase in defaulted loans, and improved EdFund collection tools, techniques and management.

Other Services

In addition to the above services, EdFund engages in a number of other important activities related to its role in the student loan process.

- *Premier Customer Service*

  EdFund provides premier customer service to the schools and students it serves via a network of regional associates located throughout California and the nation. EdFund's Client Services team of more than 70 client relations managers and support staff, as well as our headquarters-based School Relations Unit, 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 the company's 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. The Commission created the loan management system software known as FAPS™ (Financial Aid Processing System), currently used by participating schools and lenders. Last year, EdFund enhanced the features of and expanded the number of schools using its new Cohort Management System, a customizable, Web-based tool that assists schools in their efforts to lower default rates. Today, EdFund is actively engaged in developing the next generation of Web-based loan management tools for use by schools and lenders.

- *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 FAPS 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.

- *Portfolio Management*

  EdFund administers an existing loan guarantee portfolio valued at approximately $26 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 & 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.

BUDGET

In accordance with the HEA, surplus funds in the SLOF may only be used for loan program operating expenses and/or the support of financial aid-related activities.

The Commission/EdFund's actual SLOF revenues and expenses for FFY 2004-05 appear in Figure 2. As previously noted, EdFund operates on an October 1 through September 30 fiscal year, reflecting the federal budget cycle.

In FFY 2004-05, revenues collected by EdFund totaled $123 million against total expenses of almost $211 million, with only $85 million of these expenses from standard loan program activity. The remaining expenses are predominantly due to a transfer of $51 million from the SLOF to support Cal Grant awards, minimum reserve subsidy of $42 million to the Federal Fund, and grant administrative and outreach program support of nearly $30 million. These expenses, coupled with the fact that the VFA contract was being renegotiated, resulted in an operating deficit of $87.8 million.

For FFY 2005-06, total revenues of $165 million (including $31.4 million in proposed VFA revenues) are budgeted against total expenses of $186.8 million resulting in a projected operating deficit of $21.8 million. Of total

FIGURE 2:
Commission/EdFund Student Loan Operating Fund
Statement of Revenues and Expenses
FFY 2004-05, 2005-06

In Thousands	2004-05 Actual	2005-06 Budget
REVENUES:		
Net recoveries on loan defaults*	$58,149	$66,900
Account maintenance fee	24,695	27,500
Loan processing and issuance fee	21,833	24,100
Default aversion fee	5,841	9,600
Interest income	2,792	1,900
Voluntary Flexible Agreement /other revenues	9,766	35,036
Total Revenues	**$123,076**	**$165,036**
EXPENSES:		
Loan program personnel costs	$52,180	$56,328
Operating expenses	21,400	25,702
Collection agency expense	9,706	11,151
Minimum reserve subsidy	42,186	56,100
Restricted expenses	3,486	3,636
Borrower benefits—EdShare	865	2,075
CSAC FFELP operating expenses	1,528	1,800
Total Loan Program Expenses	**$131,351**	**$156,792**
LOAN PROGRAM SURPLUS (DEFICIT)	**$(8,275)**	**$8,244**
Outreach programs	$17,087	$17,132
Grant administration costs	11,431	12,907
Cal Grant awards**	51,000	-
Total Non-Loan Program Expenses	**$79,518**	**$30,039**
Total Expenses	**$210,869**	**$186,831**
OVERALL OPERATING (DEFICIT)	**$(87,793)** ***	**$(21,795)** ***

Notes:

* Recoveries on loan defaults, net of the USED's equitable share and the claim purchase complement.

** The state budget for state fiscal year 2005-06 appropriated $51 million from the SLOF for support of the Cal Grant Program. The Governor's Proposed 2006-07 Budget does not include a transfer of funds from the SLOF to directly support the Cal Grant awards.

*** The FFY 2004-05 operating deficit was greater than expected due to the USED's decision to suspend payment while the VFA is being negotiated. Operating deficits are supported by surplus generated in prior years. Surplus SLOFs are used to support the Cal Grant Program, Cal-SOAP program and to subsidize the Federal Fund based on the waiver of the guarantee fee.

budgeted expenses, $95 million support standard loan program activity with the remaining again supporting a minimum reserve subsidy to the Federal Fund, and grant administrative and outreach program costs.

Revenues

The Commission/EdFund receives revenue from six specific sources authorized and regulated by the USED. The rate of 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 USED'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.
- *Investment Earnings*—Interest income from funds held in the SLOF.
- *Voluntary Flexible Agreement* (VFA) *Payments*—Performance-based payments made to the Commission/EdFund by the USED are under the terms of our VFA. In fall 2004, the USED requested renegotiation of the terms of the Commission/EdFund's VFA. Since negotiations are still ongoing, the USED could not finalize payment for FFY 2004-05.

Personnel

The ability to recruit, hire, promote and compensate staff outside of 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 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 civil service employees whose functions were transferred from the Commission to EdFund could opt to remain civil service employees of the Commission while being assigned to work for EdFund.

Of the 642 people employed at EdFund as of January 1, 2006, 582 (91 percent) are EdFund direct hires and 60 (9 percent) are 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.

PROGRAM CHANGES AND ENHANCEMENTS

During FFY 2004-05, EdFund's ongoing efforts to enhance its products and services generated numerous benefits to students, families, schools and lenders.

Benefits to Students and Parents

Over the past year, as part of its efforts to enhance service to consumers and streamline student loan delivery, EdFund:

- Joined with the Commission to renew the guarantee fee discount program (the "Zero G Fee") through September 30, 2006, a program that saved student and parent borrowers more than $54 million during the 2004-05 fiscal year.
- Held the organization's cohort default rate to 6.4 percent by continuing to enhance default prevention and student outreach programs.
- Distributed almost $1 million to support campus-based borrower education, debt management and default prevention programs through its EdShare® grant program.
- In collaboration with the Commission, published an annual student financial aid publication series, including student workbooks, a guide for counselors, brochures (including a new brochure tailored to the needs of career college students), and Spanish editions; last year nearly 1.2 million copies of the California editions of this series were printed for distribution to students and schools in the state.
- Introduced several new publications geared toward increasing financial literacy among students and parents.
- Through marketing, increased school use of the Student Loan Debt Summary, a tool designed to educate students annually of their cumulative student loan obligations as well as provide information that will assist schools in their loan counseling and default prevention efforts.
- Continued implementing enhancements to a variety of Web-based services for students, including EdTe$t, an alternative for in-person entrance and exit counseling for borrowers that assists schools' default prevention efforts while meeting federal loan counseling requirements.
- In collaboration with the Commission, sponsored publication and distribution of *Life 101*, a magazine containing information for high school seniors preparing for college, to 800,000 students in California and five other states.
- In collaboration with the Commission, produced and distributed an updated video guiding students through the process of applying for state and federal financial aid.

- In collaboration with the Commission, produced and distributed an early outreach publication—*The Future 5*—aimed at educating middle school students about career, educational and financial aid options (nearly 800,000 copies of the English and Spanish versions of *The Future 5* products were distributed).

Benefits to Schools and Lenders

Over the past year, as part of its efforts to enhance service to consumers and streamline student loan delivery, EdFund:

- Once again received very high overall ratings for customer service satisfaction in a survey of school and lender customers.
- Expanded customer outreach efforts through a network of locally based regional associates located throughout California and the nation, visiting hundreds of school sites to ensure quality service delivery and strong customer satisfaction.
- Continued to use the Advisory and Enhancement Work Group, a regularly scheduled interactive forum of schools and lenders that is unique to the industry, to receive input and develop enhancements.
- Presented valuable financial aid, ad hoc and conference training workshops.
- Continued offering a series of professional development training programs at campuses and events across the nation.
- Increased outreach to lenders and loan servicers.
- Continued the development and implementation of enhancements to FAPS, already one of the most highly regarded student loan information processing platforms in the industry.
- Created new and expanded other default prevention programs.
- Increased availability of and training for the Cohort Management System, a Web-based product that offers schools the flexibility to define their "contact strategy" and generate communications with the borrower during the grace period and into repayment.
- Continued implementation of the EdShare program, a $12 million institutional grant program targeted to support campus-based debt management, default prevention and borrower education programs.
- Expanded participation in the Early Withdrawal Counseling program. This program offers counseling to students who have withdrawn from school, a group that is known to have a higher propensity to default.
- Published *Missing the Boat: Why Some Make it to College and Others Don't*, an analysis demonstrating the importance of parental encouragement in college enrollment.

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 Board, meets, and are reimbursed for actual and necessary travel expenses.

EdFund management salaries are based on national salary surveys of comparable nonprofit corporations both within and outside of the student loan industry, and are based on a combination of industry norms and individual qualifications. Executive management salaries are set by the Board of Directors; all other salaries are set by the Human Resources Division in consultation with hiring managers.

Position Title	Compensation for FFY 2004-05
President	$ 200,000 *
VP Administration and Finance & CFO	$ 172,000 *
VP Audit Services	$ 141,676
VP Client Services	$ 178,300
VP Default Management	$ 159,733
VP Human Resources	$ 168,022
VP Legal Services & General Counsel	$ 165,000 *
VP Loan Operations	$ 181,000
VP Public Affairs	$ 162,500
VP Technology Solutions & Services	$ 195,500

* No incentive compensation was awarded for these positions because employees resigned prior to the awarding of 2004-05 incentive compensation.

The figures at left include both regular salary and incentive compensation, which is awarded based on the achievement of measurable performance results. Performance targets for the company are established by the Board and approved by the Commission on an annual basis.

The position of President was vacant and filled on an interim basis from August 5 through fiscal year-end on September 30. The figure at left reflects the annual base salary for the former President, who resigned on August 5.

The position of Vice President of Legal Services & General Counsel has been vacant since August 5. The position of Vice President of Administration and Finance has been vacant since July 8.

CONCLUSION

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 altogether. Those same competitive pressures continue to require the Commission and EdFund to re-examine assumptions and to engage in creative and aggressive strategic planning.

The Commission has evolved over the past 50 years from a tiny agency with a handful of employees to a complex financial aid organization. Although we continue to face many challenges, the Commission and EdFund have built a record of innovation, accomplishments and premier customer service.

As we look to the future, the EdFund Board of Directors appointed Dr. Sam Kipp as President of EdFund on January 17, 2006, and the Commission appointed several new members to the EdFund Board of Directors—including Patricia Hurley, Wayne Sparks, and Frederick Weis—who are listed on the following pages. The Commission will again be considering the recommendation of the EdFund Board to clarify the roles and responsibilities of both organizations.

As of March 16, 2006

CALIFORNIA STUDENT AID COMMISSION

James Sandoval, Chair
University of California Representative

Josefina Baltodano
General Public Representative

Rory Diamond
Student Representative

Michele Dyke
General Public Representative

James Fousekis
General Public Representative

Sally Furay
Independent School Representative

Dean Johnston
Public, Proprietary, Nonprofit Representative

Adele Levine
General Public Representative

Louise McClain
Secondary Schools Representative

J. Michael Ortiz
California State University Representative

David Roth
General Public Representative

Four Vacancies
California Community Colleges Representative
General Public Representative
General Public Representative
Student Representative

EXECUTIVE MANAGEMENT

Diana Fuentes-Michel
Executive Director

Keith Yamanaka
Chief Deputy Director

John Bays
Chief, Information Technology Services

Steven Caldwell
Chief, Governmental and Public Affairs
Acting Chief, Outreach and Public Relations

Max Espinoza
Chief, Program Administration and Services

Diane Manning
Chief, Internal Audits

Janet McDuffie
Chief, Management Services
Acting Chief, Federal Policy and Programs

Vacant
Legal Counsel

EDFUND BOARD OF DIRECTORS

Sally Furay, Chair
Attorney at Law and
Consultant for Higher Education

Ryan Alcántara
Student
University of Southern California

Diana Fuentes-Michel
Executive Director
California Student Aid Commission

Patricia Hurley
Associate Dean, Director of Financial Aid
Glendale Community College

Adele Levine
Professor Emeritus
San Jose State University

James Sandoval
Vice Chancellor, Student Affairs
University of California, Riverside

Wayne Sparks
Director of Student Financial Aid
Washington State University

Frederick M. Weis
Executive Practitioner in Residence
Claremont McKenna College

Jennie Woo
Senior Economist
EdFund

Three Vacancies

Ex-Officio Representative:
Sam Kipp
President
EdFund

EXECUTIVE MANAGEMENT

Sam Kipp
President

Therese Bickler
Vice President, Loan Operations

Dorene Rodriguez Hoops
Vice President, Human Resources

Len Hyde
Vice President, Default Management
Acting Chief Financial Officer

Diane Manning
Vice President, Audit Services

Jacque Silver
Vice President, Technology Solutions & Services

Linda Weir
Vice President, Client Services

Vacant
Vice President, Finance & Administration

Vacant
Vice President, Legal Services & General Counsel

Vacant
Vice President, Public Affairs

CALIFORNIA STUDENT AID COMMISSION
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50 YEARS SERVING STUDENTS

10811 International Drive
P.O. Box 419026
Rancho Cordova, CA
95741-9026
916.526.7900

EDFUND®
STUDENTS FIRST

3300 Zinfandel Drive
P.O. Box 419045
Rancho Cordova, CA
95741-9045
916.526.7900