

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

**CALIFORNIA STUDENT AID COMMISSION
STATE GUARANTEED LOAN RESERVE FUND
FINANCIAL AUDIT REPORT
YEARS ENDED JUNE 30, 1985 AND 1986**

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL

F-628

CALIFORNIA STUDENT AID COMMISSION
STATE GUARANTEED LOAN RESERVE FUND
FINANCIAL AUDIT REPORT
YEARS ENDED JUNE 30, 1985 AND 1986

NOVEMBER 1986



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STATE OF CALIFORNIA
Office of the Auditor General
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Thomas W. Hayes
Auditor General

November 20, 1986

F-628

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its financial audit report of the Student Aid Commission's (commission) State Guaranteed Loan Reserve Fund (fund) for the years ended June 30, 1985 and 1986.

The report shows that the loan defaults during fiscal year 1985-86 totalled \$168.2 million. The federal government purchased \$156.2 million of that amount under a reinsurance agreement; as a result, the fund had to absorb \$12.0 million of the defaults. In fiscal year 1984-85, the amount of defaulted loans was \$126.3 million, and the fund had to absorb \$9.3 million of the defaults. In fiscal year 1986-87, the amount of loan defaults will be approximately the same as in fiscal year 1985-86 since the student loan programs have reached a mature level.

At June 30, 1986, the cumulative rate of defaulted loans reached approximately 16 percent, as compared to approximately 14 percent the year before. This rate does not reflect the recoveries of loan amounts after the lender has filed a default claim and turned the loan over to the commission. Commission officials expect that the actual default rate will become substantially lower when the commission recovers defaulted loans in the future. Nevertheless, a high default rate is inherent in the program since granting the loans is based on financial need rather than credit risk. The credit risk cannot be determined since most students who apply for loans do not have an established credit history.

Respectfully submitted,

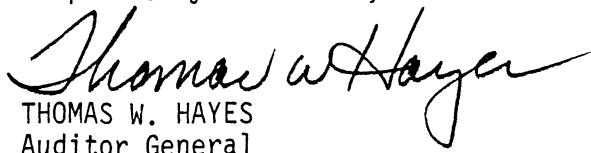

THOMAS W. HAYES
Auditor General

TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION	1
AUDITOR'S OPINION	3
FINANCIAL STATEMENTS	
BALANCE SHEET	5
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE	7
NOTES TO THE FINANCIAL STATEMENTS	9
OTHER COMMENTS	17

INTRODUCTION

We have conducted a financial audit of the California Student Aid Commission's State Guaranteed Loan Reserve Fund. The California Student Aid Commission (commission) requested this audit to meet its obligation to provide audited financial statements to lenders participating in the California Educational Loan Programs.

The State Guaranteed Loan Reserve Fund reflects the financial activities of three programs: the Guaranteed Loan Program, the State Guaranteed Loan Program, and the California Loans to Assist Students Program. Because the Guaranteed Loan Program has been replaced by the State Guaranteed Loan Program, the Guaranteed Loan Program no longer provides loans and contains only residual activity. The State Guaranteed Loan Program and the California Loans To Assist Students Program are collectively known as the California Educational Loan Programs.

In 1975, Section 69760 of the California Education Code established the State Guaranteed Loan Program; in 1977, the Legislature amended Section 69761.5 of the California Education Code to authorize the commission to serve as a guarantee agency for student loans. This program carries out the provisions of the federal Guaranteed Student Loan Program instituted within the federal Higher Education Act of 1965 and subsequent amendments. Also by authority of Section 69760 of the California Education Code, the commission in 1982 established the

California Loans to Assist Students Program. The commission is responsible for guaranteeing federally reinsured loans issued to students and parents for postsecondary education expenses.

The commission has contracted with the Electronic Data Systems Corporation to provide administrative support services. These services include processing and approving all student loan applications, collecting insurance premiums, maintaining and managing the loan portfolio, processing claims from lenders, pursuing collections, and preparing reports required by the United States Department of Education.

The State Guaranteed Loan Reserve Fund is supported by federal funds, investment earnings, and insurance premiums paid by student borrowers.

We conducted this audit under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code.



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Auditor General

Members of the Joint Legislative Audit Committee
State of California

We have examined the balance sheets of the California Student Aid Commission's State Guaranteed Loan Reserve Fund as of June 30, 1985 and 1986, and the related statements of revenues, expenditures, and changes in fund balance for the years then ended. We made our examinations in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of the California Student Aid Commission's State Guaranteed Loan Reserve Fund at June 30, 1985 and 1986, and the results of its operations and the changes in fund balance for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

OFFICE OF THE AUDITOR GENERAL

A handwritten signature in cursive script, appearing to read "Curt Davis".

CURT DAVIS, CPA
Deputy Auditor General

Date: October 8, 1986

Staff: Ulrich Pelz, CPA, Audit Manager
Deborah Tang
Kathleen Perry
Clifford Skinner

**CALIFORNIA STUDENT AID COMMISSION
STATE GUARANTEED LOAN RESERVE FUND
BALANCE SHEET
AS OF JUNE 30, 1985 AND 1986**

	1985	1986
ASSETS		
Cash	\$ 704,493	\$ 686,456
Accounts receivable	0	919,014
Insurance premiums receivable	1,083,807	1,043,735
Due from other funds	87,020,319	119,315,338
Due from federal government	47,099,140	26,777,045
Equipment	138,743	260,178
Total Assets	\$136,046,502	\$149,001,766
 LIABILITIES AND FUND EQUITY		
Liabilities		
Accounts payable	\$ 0	\$ 1,418,214
Payable to lenders and students	47,594,565	4,356,421
Due to other funds	2,358,742	383,437
Due to federal government	464,255	477,839
Liability for compensated absences	87,537	91,548
Total Liabilities	50,505,099	6,727,459
 Fund Equity		
Investments in fixed assets	138,743	260,178
Fund balance		
Reserved for encumbrances	0	554,443
Reserved for loan defaults	46,735,420	52,735,507
Designated for federal advances	14,383,748	55,671,471
Undesignated	24,283,492	33,052,708
Total Fund Balance	85,402,660	142,014,129
Total Fund Equity	85,541,403	142,274,307
Total Liabilities and Fund Equity	\$136,046,502	\$149,001,766

See the notes accompanying the financial statements.

**CALIFORNIA STUDENT AID COMMISSION
STATE GUARANTEED LOAN RESERVE FUND
STATEMENT OF REVENUES, EXPENDITURES,
AND CHANGES IN FUND BALANCE
FOR THE FISCAL YEARS ENDED JUNE 30, 1985 AND 1986**

	<u>1985</u>	<u>1986</u>
Revenues		
Insurance premiums	\$15,847,726	\$ 17,321,673
Intergovernmental	2,361,997	11,787,143
Interest	7,347,567	8,238,575
Collection fees	4,279,228	7,338,499
Miscellaneous	<u>26,252</u>	<u>23,494</u>
Total Revenues	<u>29,862,770</u>	<u>44,709,384</u>
Expenditures		
Personal services	1,464,028	1,449,260
Operating expenses and equipment	942,658	1,372,021
Department and state overhead	1,081,561	2,333,200
Contract and collection costs	9,241,553	12,220,964
State share of loan defaults	<u>9,273,238</u>	<u>12,010,193</u>
Total Expenditures	<u>22,003,038</u>	<u>29,385,638</u>
Excess of Revenues Over Expenditures	7,859,732	15,323,746
Other Financing Sources		
Federal advances	<u>5,257,061</u>	<u>41,287,723</u>
Excess of Revenues and Other Financing Sources Over Expenditures	13,116,793	56,611,469
Fund Balance, beginning of fiscal year	<u>72,285,867</u>	<u>85,402,660</u>
Fund Balance, end of fiscal year	<u>\$85,402,660</u>	<u>\$142,014,129</u>

See the notes accompanying the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

1. Definition of Reporting Entity

The State Guaranteed Loan Reserve Fund accounts for the activities of the California Educational Loan Programs, which comprise the State Guaranteed Loan Program and the California Loans to Assist Students Program, plus the residual activities of the Guaranteed Loan Program, which ceased to provide loans in 1967.

2. Summary of Significant Accounting Policies

The accompanying financial statements reflect the financial position and results of operations of the State Guaranteed Loan Reserve Fund of the California Student Aid Commission (commission). The financial statements have been prepared in conformity with generally accepted accounting principles applicable to state and local governments. Below is a summary of the more significant accounting policies.

A. Fund Accounting

The State Guaranteed Loan Reserve Fund is accounted for as an expendable trust fund. Expendable trust funds account for assets held in a trustee capacity, and both principal and income may be expended in the course of the fund's designated operations.

B. Basis of Accounting

The State Guaranteed Loan Reserve Fund is accounted for on the modified accrual basis. Under the modified accrual basis of accounting, revenues are recognized in the accounting period in which they become measurable and available, and expenditures are recognized, if measurable, in the accounting period in which the liability is incurred. The commission charges the costs of sick leave when this benefit is used rather than when it is earned.

3. Accounts Receivable

This account represents amounts receivable from the Electronic Data Systems Corporation for collections and miscellaneous revenue at June 30, 1986. Before fiscal year 1985-86, these receivables were included in the account Due From Other Funds since certain transactions of the State Guaranteed Loan Reserve Fund were initially recorded in the General Fund.

4. Due From Other Funds

Most of the amount in this account reflects the fund's share of the Surplus Money Investment Fund (SMIF). This amount is available upon demand. The account also includes amounts due from the Personal Income Tax Fund for recoveries of defaulted loans collected by this fund but not remitted to the State Guaranteed Loan Reserve Fund as of June 30. The following schedule summarizes the account balances at June 30, 1985 and 1986:

	<u>1985</u>	<u>1986</u>
Investment in SMIF	\$85,981,259	\$119,246,818
General Fund	965,522	0
Personal income tax	<u>73,538</u>	<u>68,520</u>
Total	<u>\$87,020,319</u>	<u>\$119,315,338</u>

There was no amount due from the General Fund at June 30, 1986, as all transactions in fiscal year 1985-86 were accounted for directly in the State Guaranteed Loan Reserve Fund. In previous years, certain transactions were initially recorded in the General Fund.

5. Due From Federal Government

This account represents the June 30 balance due from the United States Secretary of Education for amounts billed that are to be reimbursed in the subsequent fiscal year. Included in this account are amounts due for administrative cost allowances and amounts billed for defaulted loans that the commission purchased under a federal reinsurance agreement. (See also Notes 17 and 21.) The following schedule summarizes the amounts due from the federal government as of June 30, 1985 and 1986:

	<u>1985</u>	<u>1986</u>
Administrative costs	\$ 5,672,676	\$11,787,143
Defaulted loans purchased	<u>41,426,464</u>	<u>14,989,902</u>
Total	<u>\$47,099,140</u>	<u>\$26,777,045</u>

The increase in the amount due from the federal government for administrative costs resulted from federal legislation, which was signed in April 1986. This legislation mandated the retroactive payment of the administrative cost allowance, which had not been paid since October 1, 1984. The amount due from the federal government for defaulted loans at June 30, 1986, decreased because the commission avoided a delay, which occurred in fiscal year 1984-85, in submitting reimbursement claims. (See also Note 7.)

6. Accounts Payable

This account represents the amount owed to private persons or organizations for goods or services received but not yet paid for at the end of the fiscal year. Before fiscal year 1985-86, purchases of goods and services were accounted for through the General Fund, and these payables were reflected in Due to Other Funds.

7. Payable to Lenders and Students

This account represents amounts payable to lenders for defaulted loans and amounts refundable to students. The following schedule summarizes the account balances at June 30, 1985 and 1986:

	<u>1985</u>	<u>1986</u>
Payable to lenders	\$47,509,546	\$4,329,470
Refunds to students	<u>85,019</u>	<u>26,951</u>
Total	<u>\$47,594,565</u>	<u>\$4,356,421</u>

In the fiscal year ended June 30, 1985, there was a large amount payable to lenders because the commission did not have sufficient spending authority to avoid a delay in purchasing defaulted loans. In the fiscal year ended June 30, 1986, the amount payable to lenders decreased because the commission had sufficient spending authority and thus avoided a delay.

8. Due to Other Funds

Before fiscal year 1985-86, the General Fund paid for most expenditures on behalf of the State Guaranteed Loan Reserve Fund, which subsequently reimbursed the General Fund. In fiscal year 1985-86, the State Guaranteed Loan Reserve Fund paid directly for those expenditures.

9. Due to Federal Government

This account represents collections on defaulted loans less the amount of collection fees that the commission may retain (see Note 18) and the State's share of the individual loan defaults (see Note 21).

10. Reserved for Encumbrances

This account represents goods and services ordered but not yet received by June 30. In fiscal year 1984-85, the General Fund accounted for the purchase of goods and services; therefore, the State Guaranteed Loan Reserve Fund did not account for encumbrances at June 30, 1985.

11. Reserved for Loan Defaults

The California Administrative Code, Title V, Chapter 1, Part IV, Section 30108, requires the commission to maintain a reserve for the purchase of defaulted loans. The commission must deposit to this reserve at least 80 percent of the insurance premium revenue and the interest earnings from federal advances received under Section 422(c) of the Higher Education Act of 1965. Funds in this reserve may be used only for the purchase of defaulted loans.

12. Designated for Federal Advances

The United States secretary of education made advances to the commission to establish or strengthen the State Guaranteed Loan Reserve Fund. These advances may be used only to purchase defaulted loans. An agreement between the commission and the secretary also specifies that the secretary at any time may call upon the commission to repay part or all of any advanced monies when the secretary determines that the fund no longer needs the advanced monies.

13. Lenders' Agreements

The commission's agreements with lending institutions require that it maintain a guarantee reserve fund. This fund must be represented by cash and marketable securities, and it must have a total market value of not less than one percent of the total amount of unpaid principal and interest of all approved notes that are covered by federal reinsurance under the agreement between the commission and the United States secretary of education. At June 30, 1986, the State Guaranteed Loan Reserve Fund had a cash balance and investments in the Surplus Money Investment Fund totaling \$119.9 million. These amounts are readily available. Under the agreement with the lenders, the required balance was \$35.5 million at June 30, 1986, based on the amount of original principal of outstanding notes. The amount of original principal does not reflect amounts paid on the notes, nor does it reflect unpaid interest, neither of which is reported to the commission.

In January 1983, the commission also entered into a guarantee reserve agreement with the California Student Loan Authority, which was established to provide a secondary market for loans to students and parents. This agreement requires that the commission maintain a fund balance reserved for loan defaults in the California Educational Loan Programs. This fund balance must be equal to at least one percent of the unpaid principal amount of all loans guaranteed by the commission. At June 30, 1986, the commission maintained a reserve for loan defaults of \$52.7 million. Under the agreement, the required reserve was \$35.8 million.

14. Retirement Commitments

Regular employees of the commission are members of the Public Employees' Retirement System (PERS), which is a defined benefit, contributory retirement plan. The amount that the commission and its employees contribute to the PERS is determined actuarially under a program in which contributions plus retirement system earnings provide the necessary funds to pay retirement costs as they are accrued. The State Guaranteed Loan Reserve Fund's share of retirement contributions for the fiscal years ended June 30, 1985 and 1986, was \$178,630 and \$182,777, respectively.

15. Liability for Compensated Absences

This account represents the State Guaranteed Loan Reserve Fund's liability for accumulated vacation, compensated time off, and personal holidays. The liability does not include amounts for accumulated sick leave because employees cannot receive cash for sick leave balances when they leave state service. Accumulated sick leave may be exchanged upon retirement for service credits in an employee's retirement account.

16. Insurance Premiums

At the time the lending institutions disburse the student loans, they withhold an insurance premium that is equal to one percent of the loan times the number of years until the repayment is expected to begin. The insurance premium is then remitted to the commission, which must use at least 80 percent of the premiums to underwrite defaulted loans. The remainder may be used to cover costs that the commission incurs in administering the loan program. (See also Note 22.)

17. Intergovernmental Revenue

This amount represents federally reimbursed administrative costs. In previous years, the United States secretary of education reimbursed the commission for administrative costs of up to one percent of the loans guaranteed during the year. For the federal fiscal year 1985, which began on October 1, 1984, the secretary suspended payment of administrative cost allowances. In April 1986, the Congress passed a bill that mandated the payment of the administrative cost allowances retroactively to October 1, 1984. Under the new law, the administrative cost allowance is set at one percent of loans guaranteed regardless of actual costs incurred. Because of the suspension of the payments in fiscal year 1984-85 and the subsequently mandated retroactive payment, the amount for fiscal year 1985-86 includes the administrative cost allowance of \$4,805,900 for the period of October 1, 1984, to June 30, 1985. The remainder of \$6,981,243 represents the administrative cost allowance for the year ended June 30, 1986.

18. Collection Fees

The federal government allows guarantee agencies to retain up to 30 percent of loan default recoveries for collection efforts.

19. Reclassification of Personnel Positions

For the fiscal year 1985-86, the commission reclassified 11 personnel positions from direct program costs to department administration costs to reflect their responsibilities for more than one program or fund. The cost of these positions was approximately \$663,000 in fiscal year 1985-86. Without the reclassification, a majority of these personnel costs would have been included in personal services rather than department overhead.

20. Contract and Collection Costs

This amount represents payments to the Electronic Data Systems Corporation for administrative support services and for collection costs on recoveries of defaulted loans. Under the contract with the Electronic Data Systems Corporation, contract fees are calculated at various percentages of the loan amount, depending on whether the loan is classified as guaranteed during the month, as outstanding at the end of the month, or as a defaulted loan purchased during the month. In addition, contract costs include payments for changes in the processing system that the commission requested. The total contract costs were \$3,969,132 and \$4,475,220 for the years ended June 30, 1985 and 1986, respectively. The remainder of each amount represents collection costs of \$5,272,421 and \$7,745,744, which were paid to the Electronic Data Systems Corporation for the years ended June 30, 1985 and 1986, respectively.

21. State Share of Loan Defaults

The agreements between the California Student Aid Commission and the lenders participating in the loan program require that the commission purchase guaranteed loans that have been defaulted if the lender has exercised due diligence in making, servicing, and collecting the loan. Likewise, the agreement between the commission and the United States secretary of education requires the secretary to purchase from the commission a percentage of those defaulted loans that the commission purchases from the lenders. The percentage of defaulted loans that the secretary will purchase may vary. During each federal fiscal year, the federal government will purchase 100 percent of the amount of defaulted loans until the total amount of the defaulted loans purchased reaches 5 percent of the amount of loans in repayment status at the end of the preceding federal fiscal year. After the amount of defaulted loans purchased reaches 5 percent of the amount of loans that were in repayment, the federal government will purchase 90 percent of the amounts of defaulted loans. When

the amount of the defaulted loans purchased reaches 9 percent of the amount of loans that were in repayment, the federal government will purchase 80 percent of the amount of defaulted loans.

For the year ended June 30, 1986, the federal government purchased \$156.2 million of the \$168.2 million of defaulted loans. For the year ended June 30, 1985, the federal government purchased \$117.0 million of the \$126.3 million of defaulted loans.

22. Subsequent Events

Effective July 1, 1986, the commission has reduced the insurance premiums from a base rate of one percent per year to three-quarters of one percent per year for all student loans disbursed on or after that date. The student borrowers will thus enjoy higher loan payouts. Although the commission believes that the reduction in the insurance premiums will not have a significant effect on the State Guaranteed Loan Reserve Fund, it will nevertheless review the rates annually. Had the new rates been in effect in the fiscal year ended June 30, 1986, the premium revenue would have been approximately \$4.3 million lower.

On October 17, 1986, the president of the United States signed a bill that will require guarantee agencies, such as the commission, to pay a reinsurance fee of one-quarter of one percent of total loans guaranteed. However, if the defaulted loans purchased during each federal fiscal year total 5 percent of the loans in repayment status at the end of the preceding federal fiscal year, the reinsurance fee will be one-half of one percent of the total loans guaranteed. Had the new bill been in effect in fiscal year 1985-86, the reinsurance fee would have been approximately \$3.5 million, which represents one-half of one percent of the total loans guaranteed in that fiscal year.

OTHER COMMENTS

As an integral part of our examination, we reviewed the accounting procedures of the California Student Aid Commission and its related system of internal accounting control to the extent we considered necessary to form an opinion on the fairness with which the financial statements of the State Guaranteed Loan Reserve Fund present the fund's financial position and the results of the operations in accordance with generally accepted accounting principles consistently applied. As part of our review, we are issuing a management letter to the commission suggesting action that it should take to improve its administration of the State Guaranteed Loan Reserve Fund.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
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