

STATE OF CONNECTICUT



***AUDITORS' REPORT
CONNECTICUT HIGHER EDUCATION
SUPPLEMENTAL LOAN AUTHORITY
FOR THE FISCAL YEAR ENDED JUNE 30, 2006***

AUDITORS OF PUBLIC ACCOUNTS
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August 22, 2007

**AUDITORS' REPORT
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FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

We have examined the books, records, and accounts of the Connecticut Higher Education Supplemental Loan Authority, as provided in Section 2-90 and Section 1-122 of the General Statutes, for the fiscal year ended June 30, 2006.

SCOPE OF AUDIT:

This audit was primarily limited to performing tests of the Authority's compliance with certain provisions of laws, regulations, contracts, and grants, including but not limited to a determination of whether the Authority has complied with its regulations concerning the following areas:

- Affirmative action
- Personnel practices
- Purchase of goods and services
- Use of surplus funds
- Distribution of loans, grants and other financial resources

We also considered the Authority's internal control over its financial operations and its compliance with requirements that could have a material or significant effect on its financial operations in order to determine our auditing procedures for the purpose of evaluating the Authority's financial operations and compliance with certain provisions of laws, regulations, contracts and grants, and not to provide assurance on the internal control over those control objects. Our consideration of internal control included the five areas identified above.

Our audit included a review of a representative sample of the Authority's activities during the fiscal year in the five areas identified above and a review of other such areas as we considered necessary. The financial statement audit of the Connecticut Higher Education Supplemental

Loan Authority, for the fiscal year ended June 30, 2006, was conducted by the Authority's independent public accountants.

COMMENTS

FOREWORD:

The Connecticut Higher Education Supplemental Loan Authority (hereafter referred to as CHESLA) operates primarily under the provisions of Title 10a, Chapter 187b, Sections 10a-221 through 10a-246 of the Connecticut General Statutes.

Effective October 1, 1985, Section 10a-232 permits CHESLA to create and establish one or more Special Capital Reserve Funds for which the State of Connecticut has a contingent liability.

CHESLA is a quasi-public agency and political subdivision of the State. CHESLA's purpose is to assist borrowers (students, their parents or others responsible for paying the costs of education) and institutions of higher education in the financing and refinancing of the costs of higher education through its Bond Funds. During the audited period, CHESLA reported no loans to institutions.

Under CHESLA's Connecticut Family Education Loan Program, qualifying applicants can receive an Education Loan for each academic year in an amount that does not exceed the student's cost of education for the year. The cost of education is determined by the college or university in which the student is enrolled and is reduced by all other financial assistance received by the student.

CHESLA is defined by the General Statutes as a Quasi-Public Agency. Provisions for Quasi-Public Agencies are codified primarily in Sections 1-120 through 1-127 of Chapter 12 of the General Statutes. The provisions require that an annual compliance audit be performed addressing CHESLA's compliance with its regulations concerning affirmative action, personnel practices, the purchase of goods and services, the use of surplus funds, and the distribution of loans, grants and other financial assistance. Effective July 1, 2004, Section 1-122 of the General Statutes requires that the Auditors of Public Accounts perform or contract out such audits. This is our report on our audit of CHESLA's compliance with these requirements during the audited period.

Board Members:

As authorized under Section 10a-224 of the General Statutes, responsibility over the operations of the Authority is vested in an eight member board of directors, consisting of the State Treasurer, the Secretary of the Office of Policy and Management, and the Commissioner of Higher Education, all serving as ex-officio directors, and five directors appointed by the Governor.

As of June 30, 2006, CHESLA's board of directors was as follows:

Ex-Officio:

Denise L. Nappier, State Treasurer
Robert L. Genuario, Secretary of the Office of Policy and Management
Valerie F. Lewis, Commissioner of Higher Education

Appointed by the Governor:	<u>Term Expires July 1,</u>
Michael E. McKeeman, Chairman	2008
Kathleen Woods	2011
Julie B. Savino	2011
William J. Pizzuto	2012
Delores P. Graham	2009

Gloria F. Ragosta was appointed the Executive Director of CHESLA on May 19, 1998, and has served in that position throughout the audited period.

Accounting Policies:

CHESLA maintains financial records for its own operation and for the debt issue outstanding in accordance with the requirements of bond issue documents. Assets of the Bond Issue Funds are held by a trustee. A brief description of each fund follows:

Authority Operating Fund – Revenues and expenses applicable to the Authority's operations are accounted for within this fund. Revenues are generated from interest income and administrative fees.

Bond Funds – CHESLA issues revenue bonds whose proceeds are used to provide loans directly to students and others to finance the cost of higher education. Bond Fund revenue is generated from interest earned on investments and loans outstanding.

Bond Issue Funds Outstanding as of June 30, 2006, included:

2005 Series A and B, 2003 Series A and B, 2001 Series A, 2000 Series A and B, 1999 Series A and B, 1998 Series A and B, and 1996 Series A.

In August 2006, subsequent to the period under review, CHESLA closed the 2006 Series A Senior Revenue and Revenue Refunding bond deal. A portion of the \$33,270,000 issuance will be used to refund the 1996 Series A bonds. The refunding of bonds is most frequently done to take advantage of more favorable interest rates and to escape from less favorable bond covenants. By this and other measures, such as restricting its administrative fees and covering

bond issuance costs from its operating fund, CHESLA seeks to achieve a competitive advantage in the market place for its student loans.

As of June 30, 2006, CHESLA had issued \$292,570,000 in Revenue Bonds and Revenue Refunding Bonds with \$115,815,000 outstanding. During the audited period, the aggregate amount of Special Capital Reserve Fund-backed (to be discussed below) bonds outstanding at any given time was limited by statute to \$170,000,000.

With respect to bond issues outstanding as of June 30, 2005, the 1996, 1998, 1999, 2000, 2001, 2003, and 2005 Series loans may be made to finance educational needs, under the Connecticut Family Education Loan Program (CT FELP), in principal amounts from \$2,000 up to the costs of education for eligible students. Cumulative loan amounts are capped at \$125,000 for each eligible student over the life of the CT FELP program.

CHESLA contracts for the following services, among others, to help it achieve its accounting objectives:

- Loan Servicer: Originates and services student loans.
- Accountant: Produces financial statements and supporting ledgers.
- Investors services: Invests and accounts for bond proceeds, payments.
- Financial Advisors: Performs underwriting, cash flow analyses, arbitrage calculations.
- Collection Agency: Pursues non-performing student loans.

Other Audit Examinations:

An independent certified public accountant audited the books and accounts of CHESLA for the fiscal year under review.

The independent public accountant's report to CHESLA for the fiscal year ended June 30, 2006, expressed an unqualified opinion on CHESLA's financial statements and reported no material weaknesses in internal control.

Section 1-122 of the Connecticut General Statutes requires that quasi-public agencies such as CHESLA have a compliance audit performed annually. Such audits should determine whether these agencies comply with their own regulations concerning affirmative action, personnel practices, the purchase of goods and services, the use of surplus funds, and the distribution of loans, grants and other financial assistance. In accordance with this statute, we performed the compliance audit of CHESLA covering the 2005-2006 fiscal year. We noted certain weaknesses in compliance and internal control, which are discussed in the "Condition of Records" and "Recommendations" sections of this report.

RÉSUMÉ OF OPERATIONS:

CHESLA had 21 bond issues as of June 30, 2006. The 1983 Series A Revenue Bonds were issued for the purpose of financing loans to Yale University, Wesleyan University, and Connecticut College in order to fund education loans to students, and parents of students, and to finance the students' attendance at such institutions. The 1985, 1990, 1991, 1993, 1994, 1996, 1998, 1999, 2000, 2001, 2003, and 2005 Series A Revenue Bonds and the 1998, 1999, and 2000 Series B Revenue Bonds were issued for the purpose of providing financial assistance directly to students in or from the State, their parents and others responsible for the costs of students attending eligible institutions for higher education under the Family Education Loan Program (FELP). The 1990, 1991, 2000, 2003, and 2005 Series B and 1992 Series A issues were Revenue Refunding Bonds.

The bonds are special obligations of CHESLA, which has no taxing power. The bonds shall not be deemed to constitute a debt or liability to the State or any of its political subdivisions, but shall be payable solely from the revenues and other receipts, funds or moneys pledged therefore. However, effective October 1, 1985, the State became contingently liable in that it must provide annual debt service requirements if not met by CHESLA's funds. The State's contingent liability in connection with the various Series A and B Bonds is the Special Capital Reserve Fund requirement for such Bonds, funded as of June 30, 2006, in the aggregate amount of \$9,050,000. As of June 30, 2006, the State has not made nor was it required to make any such deposit.

The Vice President of the Connecticut Conference of Independent Colleges (CCIC), Gloria F. Ragosta, served as the Executive Director of CHESLA. The Executive Director was compensated by CCIC. The CCIC charged CHESLA for services provided by the Executive Director, pursuant to a written agreement for services with the CCIC. Such fees totaled \$102,000 for the fiscal year ended June 30, 2006.

CHESLA also entered into a sublease agreement with the CCIC for the use of office space in connection with CHESLA's operation. Under the agreement, CCIC charged CHESLA a monthly fee for the use of such space.

Revenues credited to Bond Funds totaled \$8,260,689 for the fiscal year ended June 30, 2006. This amount consisted primarily of interest income derived from investments and loans to individuals.

Expenditures for the Bond Funds totaled \$7,116,766 for the fiscal year ended June 30, 2006. This amount consisted primarily of debt service (interest). The Bond Funds balance of \$5,727,233 as of June 30, 2005, increased to \$6,871,156 as of June 30, 2006.

Revenues credited to the Authority Operating Fund for the fiscal year ended June 30, 2006, totaled \$852,572 and consisted of administrative fees and investment income. Operating expenses paid from the Operating Fund during the same fiscal year totaled \$674,861 and consisted primarily of professional and administrative expenses, and bond issuance costs. The Authority Operating Fund fund balance increased from \$3,023,931 at June 30, 2005, to \$3,201,642 at June 30, 2006.

The cumulative number of loans made to students by CHESLA for all Bond Funds as of June 30, 2006, totaled 23,294, compared to 22,189 as of June 30, 2005, amounting to 1,105 additional loans over the audited period. The average of the cumulative dollar amount loaned to each student as of June 30, 2006, totaled \$9,602.

CONDITION OF RECORDS

Affidavits Required by Legislation:

- Criteria:* Public Act 05-287, effective July 13, 2005, and codified in Section 4a-81 of the General Statutes, states that no State or quasi-public agency shall execute a contract for the purchase of goods or services with a total value of \$50,000 or more in any calendar or fiscal year unless the agency obtains an affidavit signed by the chief official of the vendor awarded the contract attesting to whether any consulting agreement has been entered into in connection with the contract.
- Condition:* The Authority's Board of Directors entered into a contract for underwriting services related to the issuance of the 2006 Series A Bonds. The agreement, dated April 26, 2006, sets the underwriting fee at \$225,000. We noted that the Authority did not obtain the consulting agreement affidavit required by Section 4a-81 of the General Statutes.
- Effect:* The Authority was not in compliance with Section 4a-81 of the General Statutes.
- Cause:* The Authority believed that the affidavit required by Section 3-13j of the General Statutes relating to third-party fees disclosed the same agreements noted in the consulting agreement affidavit required by Section 4a-81 of the General Statutes.
- Recommendation:* The Authority should obtain consulting agreement affidavits required for all goods or services purchases in the amount of \$50,000 or more. (See Recommendation 1.)
- Agency Response:* "The Authority does not agree with the statement above in connection with the 'Effect'.... Prior to entering into the underwriting agreement, the Authority obtained from Goldman Sachs an affidavit...satisfying all the statutory requirements of C.G.S. Section 4a-81. The affidavit included the attestation of an individual authorized to execute the underwriting agreement on behalf of Goldman Sachs indicating that no fees had been paid to third parties, that there was no fee arrangement with any third party, and that no services were provided by any third party, in connection with the award of the contract, which affidavit otherwise satisfied the requirements of C.G.S. Section 4a-81.
- The Authority acknowledges that the affidavit did not refer to 'consulting services', which are defined for purposes of C.G.S. Section 4a-81 as 'any written or oral agreement to retain the services, for a fee, of a consultant for the purposes of (A) providing counsel to a contractor, vendor, consultant or other entity seeking to conduct, or conducting, business with

the state, (B) contacting, whether in writing or orally, any executive, judicial, or administrative office of the state, including any department, institution, bureau, board, commission, authority, official or employee for the purpose of solicitation, dispute resolution, introduction, requests for information, or (C) any other similar activity related to such contract.’ Instead the affidavit obtained refers to ‘third party fees’, which term, as defined by C.G.S. Section 3-13j, ‘includes, but is not limited to, management fees, placement agent fees, solicitation fees, referral fees, promotion fees, introduction or matchmaker fees, and due diligence fees.’ (Emphasis added.) In addition, the definition of ‘third party fees’ included on the affidavit expands the statutory definition by adding at the end of the statutory definition, the following language: ‘...paid to any person or entity in connection with any transaction or ongoing arrangements related to procuring or doing business with the Authority.’ The Authority believes that the underscored language encompasses any arrangement which might also fall within the definition of a ‘consulting service’ within the meaning of C.G.S. Section 4a-81. The affidavit in question indicates that no services were obtained, and no fees were paid. While the format was not that of the Form A3, it included the required information, and clearly attested that there were no agreements within the meaning of C.G.S. Section 4a-81. The Authority will use Form A3 in the future in connection with all contracts in excess of \$50,000.” [Note that the Authority’s reference to Form A3 refers to an internal modified form that will combine the attestations included in the third-party fee affidavit and the consulting agreement affidavit into one form.]

Auditors’ Concluding

Comment:

We consulted with legal counsel at the Office of Policy and Management and the Treasurer’s Office to determine whether the affidavits required by both Section 3-13j and Section 4a-81 of the General Statutes disclose the same agreements. They informed us that the affidavits do not cover precisely the same situations and that both are required for contracts of \$50,000 or more.

Distribution of Student Loans:

Criteria:

The Authority’s Family Education Loan Program Manual states that, upon receipt of a completed loan application, the loan servicer shall:

- verify the applicant’s and co-applicant’s income.
- verify the employment status of the applicant and co-applicant.
- calculate a debt-to-income ratio; such ratio may not exceed 40 percent of the stable gross monthly income.

- Condition:* The Authority contracted with a loan servicer in October of 2004 to provide servicing of CHESLA's student loans. Instructions provided to the loan servicer included general procedures for income determination. We reviewed the applications and supporting documentation for eight student loans. We found that, for one student loan, the servicer did not consider the current employment status of the co-applicant when determining income used for the debt-to-income ratio calculation; the co-applicant had retired five months before the date of application. The servicer used pre-retirement income in calculating the debt-to-income ratio. We noted that the application instructions do direct the co-applicant to provide income figures from the most recent Federal Income Tax Return. As a result, the loan servicer used the income figure provided by the co-applicant, but did not take into consideration the co-applicant's current employment status provided in both the application and the credit report.
- Effect:* The debt-to-income ratio provides a critical indicator that the co-applicant will be able to repay the loan, if necessary. The student may not have qualified for a student loan if the ratio had been calculated using the co-applicant's retirement income figure, which was not provided. As a result, there is a higher degree of risk that the co-applicant will not be able to repay the loan.
- Cause:* The Authority has been working with the loan servicer to resolve issues related to the definition of income and had not, as yet, had cause to address a co-applicant's retirement.
- Recommendation:* The Authority should provide the loan servicer with detailed written procedures related to income determination and other factors used in the loan approval process. Such procedures will ensure that each loan application is evaluated using the same criteria. (See Recommendation 2.)
- Agency Response:* "There are detailed written procedures in the CHESLA Program Manual, which is part of the Servicing Contract. As the CT FELP program matures and new issues arise, CHESLA continues to improve information provided to the servicer and borrowers. However, this program still involves a human element and errors are made. CHESLA is in the process of reviewing some of the issues around retirement income. In the case mentioned, the servicer should have used the allowable retirement income in the current guidelines and not used the prior year income since it was clearly stated on the application that the co-borrower was retired. The Authority has pulled together all the emails and procedures and is in the process of compiling an in-house document. Upon further research with the Servicer and additional staff members, we have compiled the documents that Firstmark is using for its staff and the documents do reflect all directives from CHESLA staff."

RECOMMENDATIONS

Status of Prior Audit Recommendations:

There were no recommendations included in our prior audit report.

Current Audit Recommendations:

- 1. The Authority should obtain consulting agreement affidavits required for all goods or services purchases in the amount of \$50,000 or more.**

Comment:

The Authority entered into a contract for underwriting services in the amount of \$225,000 without obtaining a consulting agreement affidavit as required by Section 4a-81 of the General Statutes for purchases of goods or services in the amount of \$50,000 or more.

- 2. The Authority should provide the loan servicer with detailed written procedures related to income determination and other factors used in the loan approval process. Such procedures will ensure that each loan application is evaluated using the same criteria.**

Comment:

We found that, for one student loan, the loan servicer did not consider the current employment status of the co-applicant when determining income used for the debt-to-income ratio calculation. The co-applicant had retired five months before the date of application; however, the loan servicer used the pre-retirement income information from the co-applicant's most recent tax return.

INDEPENDENT AUDITORS' CERTIFICATION

As required by Section 2-90 and Section 1-122 of the General Statutes, we have conducted an audit of the Connecticut Higher Education Supplemental Loan Authority's activities for the fiscal year ended June 30, 2006. This audit was primarily limited to performing tests of the Authority's compliance with certain provisions of laws, regulations, contracts and grants, including but not limited to a determination of whether the Authority has complied with its regulations concerning affirmative action, personnel practices, the purchase of goods and services, the use of surplus funds and the distribution of loans, grants and other financial resources, and to understanding and evaluating the effectiveness of the Authority's internal control policies and procedures for ensuring that the provisions of certain laws, regulations, contracts and grants applicable to the Authority are complied with. The financial statement audit of the Connecticut Higher Education Supplemental Loan Authority, for the fiscal year indicated above, was conducted by the Authority's independent public accountants.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Connecticut Higher Education Supplemental Loan Authority complied in all material respects with the provisions of certain laws, regulations, contracts and grants and to obtain a sufficient understanding of the internal control to plan the audit and determine the nature, timing and extent of tests to be performed during the conduct of the audit.

Compliance:

Compliance with the requirements of laws, regulations, contracts and grants applicable to the Connecticut Higher Education Supplemental Loan Authority is the responsibility of the Authority's management.

As part of obtaining reasonable assurance about whether the Connecticut Higher Education Supplemental Loan Authority complied with laws, regulations, contracts and grants, noncompliance with which could result in significant unauthorized, illegal, irregular or unsafe transactions or could have a direct and material effect on the results of the Authority's financial operations for the fiscal year ended June 30, 2006, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, including but not limited to the following areas:

- Affirmative action
- Personnel practices
- Purchase of goods and services
- Use of surplus funds
- Distribution of loans, grants and other financial resources

Our examination included reviewing all or a representative sample of the Authority's activities in those areas and performing such other procedures as we considered necessary in the circumstances. The results of our tests disclosed the following instance of noncompliance, which is further described in the accompanying "Condition of Records" and "Recommendations" sections of this report: noncompliance with Section 4a-81 of the General Statutes concerning consulting agreement affidavits.

Internal Control:

The management of the Connecticut Higher Education Supplemental Loan Authority is responsible for establishing and maintaining effective internal control over its financial operations and compliance with the requirements of laws, regulations, contracts and grants applicable to the Authority. In planning and performing our audit, we considered the Authority's internal control over its financial operations and its compliance with requirements that could have a material or significant effect on the Authority's financial operations in order to determine our auditing procedures for the purpose of evaluating the Authority's financial operations and compliance with certain provisions of laws, regulations, contracts and grants, and not to provide assurance on the internal control over those control objectives. Our consideration of internal control included, but was not limited to, the following areas:

- Affirmative action
- Personnel practices
- Purchase of goods and services
- Use of surplus funds
- Distribution of loans, grants and other financial resources

Our consideration of the internal control over the Authority's financial operations and over compliance would not necessarily disclose all matters in the internal control that might be material or significant weaknesses. A material or significant weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants that would be material in relation to the Authority's financial operations or noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions at the Authority may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control that we consider to be material or significant weaknesses.

However, we noted certain matters involving internal control over the Authority's distribution of loans, which are described in the accompanying "Condition of Records" and "Recommendations" sections of this report.

This report is intended for the information of the Governor, the State Comptroller, the Appropriations Committee of the General Assembly and the Legislative Committee on Program Review and Investigations. However, this report is a matter of public record and its distribution is not limited. Users of this report should be aware that our audit does not provide a legal determination of the Connecticut Higher Education Supplemental Loan Authority's compliance with the provisions of the laws, regulations, contracts and grants included within the scope of this audit.

CONCLUSION

We wish to express our appreciation for the courtesies and cooperation extended to our representatives by the personnel of the Connecticut Higher Education Supplemental Loan Authority during the course of our examination.

Cynthia A. Ostroske
Associate Auditor

Approved:

Kevin P. Johnston
Auditor of Public Accounts

Robert G. Jaekle
Auditor of Public Accounts