Testimony of James Preston
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U.S. House of Representatives
Committee on Financial Services Hearing:
Auction Rate Securities Market: A Review of Problems
and Potential Resolutions
2128 Rayburn House Office Building
September 18, 2008

I am Jim Preston, President and CEO of the Pennsylvania Higher Education Assistance Agency (PHEAA).

I would like to thank Chairman Frank and Ranking Member Bachus for holding this hearing and for addressing the issues that surround the markets for auction rate securities. I am especially grateful to Mr. Kanjorski for his leadership on the student loan aspect of this issue, for his support for a comprehensive solution to this matter, and for his efforts to assure students and parents that they will enjoy uninterrupted access to federal student loans.

Today, I am going to speak primarily from the viewpoint of a major not-for-profit provider and purchaser of federal student loans. However, as you are aware, student loans are but one of many financial sectors that have been negatively impacted by the problems in the markets for auction rate securities.

My background includes more than 25 years of investment banking and student loan funding experience. I first joined PHEAA in 2003 as the Executive Vice President of Client Relations and Loan Operations and was asked to serve as the interim President and CEO from October 2007 through March of 2008, at which time the Board of Directors appointed me to the position on a permanent basis.

Prior to joining PHEAA, I held various positions with L.F. Rothschild, Unterberg, Towbin, Bear Stearns and Co. and UBS PaineWebber. I received my MBA in Finance from the State University of New York at Albany.

As someone with decades of experience in this industry, I can attest that the situation we face today is unprecedented and is in urgent need of attention. Nobody knows how long it will be before the problems we face today may become too deep and too entrenched to ever be fully resolved without extensive government intervention. Modest, appropriate steps may still be effective if taken today, but may not be as effective if delayed until six or twelve months down the road.

The collapse of the auction rate securities market and the dysfunctional nature of other capital markets that might have provided alternative sources of funding for not-for-profit student loan secondary markets have left PHEAA and its sister agencies with few, if any, avenues that they can use to raise needed funds to provide students and families with the money they need to pay for college. Many of these entities and their lender partners find themselves unable to originate or purchase federal and non-federal student loans. In May, Congress took a welcome step through its passage of the Ensuring Continued Access to Student Loans Act (ECASLA). That Act has been crucial in assuring that students and families have access to federal student loans for this fall. However, that Act is no more than a temporary solution and applies only to some federally guaranteed student loans. Unless Congress and the Administration address the underlying causes of the current liquidity difficulties, there will continue to be instability in the student loan marketplace and participants will continue to cease supporting student loans.

PHEAA is one of America's largest student loan guarantors with a 2007 annual volume of $11 billion in total guarantees. We are also one of the largest student loan servicers, with a total servicing volume of more than $50 billion in loans.

Prior to the disruptions in the capital markets, PHEAA had also been an originator and purchaser of FFELP loans, providing low-cost loans to Pennsylvania students and liquidity to other lenders on the secondary market.

For 45 years, we have been the student aid funding and public service outreach resource for Pennsylvania's students and families, having pioneered industry-leading borrower benefits programs and online planning tools for generations of our students.

Over the last decade, we have used our business earnings to fund approximately $1 billion in free programs and services in Pennsylvania - - without spending one penny of state taxpayer resources. This includes paying for the administrative costs of the state funded student aid programs, including the $407 million Pennsylvania State Grant Program.

The earnings that we have achieved in a stable and competitive FFELP marketplace have benefited Pennsylvania students, families and taxpayers by preserving scarce government dollars while enabling millions of students to afford a higher education without incurring excessive student loan debt.

But this all depends on a stable student loan marketplace, which ultimately ensures the availability of funding for American students who desire and deserve an affordable college education.

In March of this year, PHEAA reached the conclusion that we must suspend originating and purchasing federal student loans. We really had no choice in the matter. Due to the increases in the costs of raising the capital that PHEAA uses to fund loan originations and purchases, student loans had become uneconomic – there was no way to generate a positive return on our investment in student loans. Every additional federal student loan that we put on our books meant that we were digging a deeper hole of indebtedness. In addition, traditional sources of liquidity were withdrawn and just not available. While PHEAA is a not-for-profit entity, we could not sustain limitless losses and, without access to funding, continue providing access to student loans and providing essential services to the citizens of Pennsylvania.

PHEAA is not a depository institution and receives no direct appropriations or other funding from the Commonwealth of Pennsylvania that it can use to capitalize student loans. Instead, PHEAA must rely on the capital markets to provide it with the liquidity we need to fund student loan originations and purchases. In the 2007-08 academic year, PHEAA originated over $760 million in student loans and purchased an additional $770 million in federal student loans from for-profit and not-for-profit loan providers. To support those efforts and to finance the loans we have made and purchased over the years, PHEAA maintains nearly $12 billion in outstanding debt obligations. These obligations take many forms and involve a mix of both taxable and tax-exempt debt issuances. Approximately $7.4 billion is in the form of auction rate securities. Unlike municipalities and certain other types of issuers, not-for-profit student loan providers, such as PHEAA, do not have tax revenues to rely upon. They are therefore much more limited in their ability to refinance auction rate bonds, particularly in a capital market environment such as that which exists today. Because the yield on federally guaranteed student loans is a variable rate, fixed rate securities are not generally used to finance these assets.

PHEAA uses these funds to play two principle roles in funding student loans. PHEAA is a direct originator of student loans and serves as a secondary market for student loans. This second function may be the most important role we play. By providing a secondary market – purchasing student loans from loan originators for par plus a reasonable premium based on the value of the loans – PHEAA allows hundreds of lenders to participate in the federal student loan program. These lenders, which rely on secondary markets to allow them to recycle their funds to make new student loans, now find themselves with no outlet for the student loans they originate. Their balance sheets are filling up rapidly and cannot do so indefinitely. Reviving the secondary market for student loans is a key component of any solution to the current liquidity crisis.

While auction rate securities are the focus of today's hearing, the auction rate market is not the only source of capital that has become unavailable to PHEAA and others. Markets that have supported the issuance of tax-exempt securities are also dysfunctional, as are markets for student loan-backed securities, in general. Today, we find ourselves unable to issue new debt obligations due to the lack of investors for such securities and because, even if investors are found, the price required is too high to allow student loan issuers to make or purchase loans without losing money on each new loan that is added to their balance sheet. Rating agencies and credit providers are demanding that debt issuers add substantial capital of their own to any new security. For those of us without access to funds, it is a significant obstacle to reentering the capital markets.

PHEAA appreciates that any effort to revive the auction rate securities markets or to develop alternatives to that marketplace must serve three purposes: It must benefit the investors who find their assets trapped in these investments; it must benefit the issuers who are unable to refinance these securities; and it must be fair to the federal government, which should not bear any financial burden as a result of any such effort. PHEAA, in concert with the Access Group of Delaware and Brazos Higher Education Service Corporation of Texas, put forward in June 2008 a proposal to Treasury that we believe would accomplish all three of those objectives (a copy of the proposal is attached).

Since that date, Treasury has adopted the core principles of this proposal, but has done so, not for student loans, but for mortgage-backed securities as part of its rescue of Fannie Mae and Freddie Mac. Treasury's plan is to create a new market for mortgage-backed securities, in essence to stand in place of the global markets which are unable to supply sufficient capital to support the homeowners of this nation. One part of our proposal is for Treasury to do the exact same thing for student loans. I would like to share with you a few direct quotes from Treasury's fact sheet that accompanied their announcement on September 7, 2008:

> *Under most likely scenarios,* ***taxpayers will benefit from this program*** *- both indirectly through the increased availability and lower cost of mortgage financing, and* ***directly through potential returns on Treasury's portfolio of [Mortgage Backed Securities]****.*
>
> *Given that Treasury can hold these securities to maturity, the spreads between Treasury's cost of borrowing and GSE [Mortgage Backed Securities] indicate that* ***there is no reason to expect taxpayer losses from this program****.*
>
> *Treasury financing of purchases of GSE [Mortgage Backed Securities] will be deemed as outlays and are subject to the statutory debt limit.*
>
> ***However, Treasury will be receiving an income producing asset*** *(a portfolio of GSE [Mortgage Backed Securities])* ***in return for its invested funds****. (emphasis added)*

We believe that you could easily substitute the words "student loan" for the word "mortgage" in the above excerpt. In the case of student loans, we would add, though, that the assets that are pledged to these securities are already 97% guaranteed by the federal government. Thus, it could be said that applying this action to federally guaranteed student loans is 97% less risky for the federal government than actions that involve non-guaranteed assets. Overall, guaranteed student loans are reliable, performing assets – they are not sub-prime loans.

I also want to make you aware that everything that has stymied our ability to issue federally guaranteed student loans has also crippled the ability of for-profit and non-profit entities to fund private, non-federal student loans. Parents, students, and schools are scrambling today to try to pay the college costs that they had expected would be financed by the private student loans that have suddenly become a scarce resource.

Earlier this year, in a letter to the Pennsylvania Congressional delegation, the Secretary of the Treasury advised Congress that he does not believe that his agency has the statutory authority to purchase student loan-backed securities. It had been our hope that Treasury would have been able to interpret the provisions of ECASLA as granting it all the authority it needed. But, clearly, Treasury does not believe that this is the case. Thus, we urge you, Mr. Chairman, and the Members of the Financial Services Committee to provide Treasury with such authority. We fully support the efforts of Mr. Kanjorski to take such action via his bill, H.R. 5914. If the Committee and the Congress approve H.R. 5914, PHEAA and our student loan partners would be ready to sit down immediately with Treasury to assist in designing a program that revives the marketplace for student loans and protects the interests of U.S. taxpayers. Please give us the chance to solve this issue before too many players are forced to cease their participation in the student loan programs.

In the short term, we strongly support an extension of ECASLA as a means of providing some short-term stability to the student loan marketplace. We commend the House of Representatives for acting earlier this week to approve such an extension and we urge the Senate to follow suit. We need to ensure that students, parents, and schools can depend on student loans being available for the 2009-2010 academic year. If that can be accomplished by the end of the 110th Congress, we will know for certain that federally guaranteed student loans will be available next fall. ECASLA and the way it has been implemented by the Departments of Education and Treasury are far from perfect. When the time is right, we would be pleased to offer our suggestions for improvement. However, we believe that the consequences of allowing the Act to expire next summer could be quite serious for students, parents, schools, and the federal government programs.

Thank you again for allowing me to appear before you today. I would be pleased to answer any questions.

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