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HOUSE OF REPRESENTATIVES
APPROPRIATIONS COMMITTEE HEARING
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STATE CAPITOL
MAJORITY CAUCUS ROOM
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VOLUME VI OF VI

PRESENTATION BY
PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY

BEFORE:
HONORABLE DWIGHT EVANS, CHAIRMAN
HONORABLE MARIO J. CIVERA, JR., CHAIRMAN
HONORABLE STEPHEN E. BARRAR
HONORABLE STEVEN W. CAPPELLI
HONORABLE H. SCOTT CONKLIN
HONORABLE CRAIG A. DALLY
HONORABLE GORDON R. DENLINGER
HONORABLE BRIAN ELLIS
HONORABLE DAN B. FRANKEL
HONORABLE JOHN T. GALLOWAY
HONORABLE WILLIAM F. KELLER
HONORABLE TIM MAHONEY
HONORABLE KATHY M. MANDERINO
HONORABLE FRED McILHATTAN
HONORABLE DAVID R. MILLARD
HONORABLE RON MILLER
HONORABLE JOHN MYERS
HONORABLE CHERELLE PARKER
HONORABLE JOSEPH A. PETRARCA
HONORABLE SCOTT A. PETRI
HONORABLE SEAN M. RAMALEY

BEFORE (cont'd.):
HONORABLE DAVE REED
HONORABLE DOUGLAS G. REICHLEY
HONORABLE DANTE SANTONI, JR.
HONORABLE MARIO M. SCAVELLO
HONORABLE JOSHUA D. SHAPIRO
HONORABLE JOHN SIPTROTH
HONORABLE MATTHEW SMITH
HONORABLE KATIE TRUE
HONORABLE GREGORY S. VITALI
HONORABLE DON WALKO
HONORABLE JAKE WHEATLEY, JR.

ALSO PRESENT:
MIRIAM FOX
EDWARD NOLAN

JEAN M. DAVIS, REPORTER
NOTARY PUBLIC

I N D E X

TESTIFIERS

CHAIRMAN EVANS: I would like to reconvene the House Appropriations Committee meeting.

Today we have the organization of PHEAA before us, and we have the Chairman of the Board as well as a House member, who is a very good friend, and I thank him. He is going to be on the panel, along with the CEO, Mr. Preston. We have him also here.

So what we are going to do is kind of change the rules a little bit again. We're going to allow the Chairman and the CEO to have the opportunity to present to us what exactly is taking place with the organization and those kinds of concerns, because we wanted, you know, to do this in a very open way in a presentation for the public to know.

So, Mr. Chairman, I'm going to let you start off. Representative Adolph, the Chairman.

REPRESENTATIVE ADOLPH: Thank you.

Good afternoon, everyone. Chairman Evans, Chairman Civera, members of the House Appropriations Committee, I want to thank you for this opportunity to be here today.

For about 12 years, I was on the other side of this table. To be quite honest with you, it's a lot more comfortable on that other side than it is on this side of the table.

PHEAA is an absolute great organization and has done an awful lot of good over the years. Like many organizations, okay, there have been mistakes made, and I will be the first one to say that there were mistakes made in this agency.

I became Chairman just about a year ago, February of 2007, and the Board of PHEAA, I believe there are like 45 percent, yeah, 45 percent new board members. The new board members have brought an awful lot to PHEAA, from the Governor's appointees to the legislative members that have been appointed by the various caucus leaders.

My Vice-Chairman, Senator Sean Logan, has been a tremendous help to management as well as myself over this last difficult year. I know I said to Sean -- and I guess it was June of '07 -- I said, I hope when we go in front of the Appropriations Committee in February of 2008, I can talk to them about the Code of Ethics that we started in May of '07, and we challenged the other student loan agencies to do the same; the new Travel Policy that we adopted at our very first board meeting, and show them literally the millions of dollars that we have saved through the agency.

We also talked about transparency, how board members have gone to the legislative leaders, have gone to the caucuses, have gone to editorial boards, and talked about how PHEAA, under new leadership, is changing.

Ladies and gentlemen, that was all done, and if we did not have the disruption in the capital markets nationally, this agency probably would be in the best shape it has ever been in, because it is focused on its mission, and that mission is the students that attend higher education institutions here in Pennsylvania. That mission is talked about at every board meeting, and PHEAA's management and their employees are focused on the mission right now.

No one -- no one in Harrisburg, no one in Washington, no one in Wall Street -- could have predicted the disruption in the capital markets. The disruption in the capital markets has caused PHEAA the loss of millions of dollars. We have cut out of our budget somewhere between $40 to $50 million.

Now, we thought that we were going to be able to live with the Federal law which was passed in September of '07, with these reductions in operating costs, and be able to bring this agency back a lot sooner. However, I want to emphasize to you this disruption in national markets that has caused student loan agencies throughout America to suspend lending, to lay off employees, and get out of the business altogether.

I'm happy to say that this board realized its problem, okay, and listened to PHEAA management, brought in financial consultants, and last week, just last week, had a student loan summit.

We invited our Pennsylvania delegation from Washington, and we had a good showing from our delegation -- some present, some on the phone. Our lending institutions came out in full force, and most of all, representatives from the higher education community came out, from the largest universities in our State to some of our smallest universities of our State.

This ugly secret, which very rarely gets written about in our daily newspapers, outside of the Harrisburg area, this disruption of the capital markets which has its origin from the subprime mortgages, is something that has scared the PHEAA Board and its management to be the first to bring it public and with a plan on how to fix it.

We can't fix it ourselves, ladies and gentlemen. We cannot fix this problem ourselves. This is a lot larger than PHEAA. This is a national crisis, and when you're talking about it, you're talking about 50 to 60 billion -- that is billion with a "b" -- dollars in the student loan business. Washington has to address this, and the confidence level has to come back at Wall Street.

Now, I had written comments, okay, that were prepared for me, but as you can tell, you know, I am going to let the professionals regarding why this capital market is in such bad shape.

It doesn't pay student loan agencies anymore to lend out money. PHEAA would earn money by lending money out and then put back into our public programs for our men and women that come back from Iraq, to our nursing programs, loan forgiveness programs, and also, also contribute back into our State Grant Program, okay, to the tune of over $60 million a year, which helped increase our State grants to an all-time high last year of $4,700 per child, per student.

So we're here to tell you the story, to have it explained to you. I've sat through two very exhaustive work sessions, all right, as well as

Representative Dally, Representative Frankel, members of the PHEAA Board, okay, trying to understand what has caused this problem, and it is very complex.

We are very, very fortunate at PHEAA to have an expert employed since 2003 that knows the capital markets better than anybody in this area, and that is Jim Preston, our Interim CEO. So without further ado, I would like to turn over the mike to Jim Preston, and I want to thank you for giving me the opportunity to give a layman's version of what PHEAA has been like for the last year. Thank you.

MR. PRESTON: Thank you, Mr. Chairman.

CHAIRMAN EVANS: Is your mike on?

MR. PRESTON: Yes, it is. Thank you very much.

CHAIRMAN EVANS: Please state your name for the record.

MR. PRESTON: Jim Preston. I'm the Interim CEO of PHEAA. I've been at PHEAA since April of '03 but in the role of Interim CEO from October 11 to date.

We passed out to the members of the committee a quick handout that I wanted to just try to go through and quantify some of the things that we are talking about, both as it relates to national issues as well as it relates to PHEAA itself. I'll try to run through here and then open it up to any questions.

On page 2, it basically just shows a snapshot of U.S. financial aid and where it comes from across the country. As you can see, the student loan business, which is the Federal student loans, PLUS, the government guaranteed student loans, that represents about 45 percent of all of the financial aid from all sources, other than grants and others, work study and the like. Private loans make up about 11 percent.

On the next page, we show how it looks in Pennsylvania. The issue that is happening, of course, is that the Federal student loan program is a 35-year private-public partnership that has worked very well to provide seamless, efficient, effective funding for all of the colleges and universities in the United States, including Pennsylvania.

When you think about it, that is about $100 billion a year of funds that are distributed when they need it, as they need it, through the FFELP program. It was supplemented over the years --

CHAIRMAN EVANS: Did you say $100 billion?

MR. PRESTON: Yes, $100 billion total when you include all the Federal moneys. That is the direct lending program and the FFELP program.

CHAIRMAN EVANS: Okay.

MR. PRESTON: The Federal Family Education Loan Program is the Federal guaranteed loan program. It's the public-private partnership.

There is another program. The other program is direct lending. This is directly through the Department of Education and through the Treasury. I'll show you in a minute how much those make every year. In total, those two programs add up to about $100 billion.

The issue is that basically the banks end up originating and either holding or selling eventually the loans to the schools under the Federal Family Education Loan Program. When they want to sell, they turn to entities like PHEAA and other secondary markets in the United States, where they buy the loans from the banks and relieve the portfolio of those loans so they can make new loans.

The problem with the financial markets now is that the secondary markets cannot make any money and cannot finance the loans. So as that business stops, then eventually the banks are going to have a problem. It's just a question of when, not if.

Any bank, if you ask them, they'll say, yeah, I'd like to make some more loans, but I can't make all the loans; at some point, I have to allocate my balance sheet to something else, and that is exactly what the problem is.

So with the guidance of the board and our Chairman, they suggested we have a student loan summit so that we could bring the constituencies together, especially the delegation, fine-tune our message to Congress, and make sure the discussion is heard now, because if we don't do it now, FFELP may not exist in another six months, three months, or a year, and rather than just let stuff happen, we need to go and ask Congress to talk about this, because if they want FFELP, they have to help it now.

We believe that the piece in Pennsylvania -- that's the Federal guaranteed loan program -- even if the banks get filled up with loans, we believe that there's another source that will get us through August of this year, this funding cycle, and that is the lender of last resort. It's an untried provision, but basically if there's any access problem, there is legislation on the books to go to the Secretary of Education in Washington and say, there's an access problem and we want to make the FFELP loans through the lender of last resort. So it's aligned to the Treasury.

So one way or the other, we believe the FFELP piece will be taken care of between the banks and the lender of last resort.

The alternative loans is the piece that we are concerned about, because there's no financing in the United States now for alternative loans. It's a direct result of a subprime credit issue.

So we've already seen some of the proprietary schools and the career schools having some access problems because alternative loans may not be there for them, and what we think is that we have to watch this and monitor this carefully so that there isn't an access problem and the schools continue to have choice.

On page 4, there is just some historic trend data that shows how the loans as a percent of total student aid have increased over the past 10 years.

On page 5, the private loans are the fastest growing segment.

On page 6, basically the blue lines are the FFELP guaranteed student loan program, the public-private partnership with the banks, and the yellow is the direct lending. They are two different programs. One is administered completely by the Federal government, the other is a public-private partnership that has been effective for 35 years.

What I think now that Congress has to do and our messaging to Congress is, you have got to talk about this. There's a crisis, and if you are going to support FFELP, you are going to have to talk about this as it relates to the overall need.

Page 7 shows an interesting statistic, that basically how the defaults through the FFELP community keep coming down. That is because the guarantee agencies, like PHEAA, have a number of tools for collecting loans and helping students keep these default rates down.

These are good loans. They are being affected by the crisis of confidence in the market. This is not a bad asset. This is not a troubled asset. This is a good asset, and we're being affected by the market disruptions.

I was in New York in January to try to help restructure some of our debt. The day I was there was the day that the bond insurers also got either put on credit watch or Ambac was downgraded. That took out a big piece of the municipal market, not only for student loans but for all the other entities out there. Cities and towns and villages use insurance to lower their cost of debt, and insurance is not functional right now. We can't get as much bond insurance to do what we need to do in the United States right now.

There are two things that really affected us, and the Chairman talked about two of them. One was the College Cost Reduction Act signed by the President in September, and you can see a number of things in terms of reducing the spread on the loans and the impact.

We thought in and by itself we were able to cover that. The effects in our '07-08 budget were probably around $40 to $45 million, and we thought we could cover that without a problem. It was the one-two punch of these reductions plus the capital markets that has caused us the problem.

Page 9 basically shows the number of secondary markets in the United States. PHEAA is in a fortunate position that we have other revenues. We have revenues coming in from guarantees; we have revenues coming in from third-party servicing. If we just were a lender like some of these secondary markets are in the yellow, they're in trouble. Every day they're losing money. Their interest rate is higher than their rate that they're getting off their assets.

So each day they lose money, they also reduce the equity that they own, and that is the only money they live on. At some point, and it could be a month or it could be two months, three months, some of them may have to close their doors. They've already started laying off and cutting back.

If the secondary markets aren't here to back stop the FFELP business, the banks are going to fill up and then they won't have anywhere to go, and that is what our concern is.

The last page basically just shows historically, in the last couple of months, our borrowing cost is higher than the basic return that we get off our assets that pay off that 90-day CP, commercial paper.

CHAIRMAN EVANS: When you say the last page, are you talking about page 10?

MR. PRESTON: Page 10. I'm sorry.

CHAIRMAN EVANS: Page 10, you mean.

MR. PRESTON: Page 10. I'm sorry.

As it relates to PHEAA, on page 11, over the last 10 years we've given away almost a billion dollars, and this is the various things that we contributed or funded, and basically this is our mission. This is what we were expected to do and we did. We were helping kids.

Page 12 basically is our current debt outstanding. The basic problem is the taxable auction and the tax-exempt auction rate market is non-functional now. It's a huge market in the United States and it's not working correctly, which means interest rates have gone dramatically up, and there is no viable alternative to just flip it in a month or two into another financing vehicle. There's no bond insurance capacity left to handle it, so it's a problem with this.

Today, in one of the industry newsletters or industry magazines called the "Bond Buyer," the editor -- which is a nationally recognized publication -- the editor called on the Treasury to assist in this. This is far bigger than any one sector of the municipal market, and the requests to the government are coming from various sources now, and this is what's important in this market.

On Page 13, it just basically shows that over the years, the green, on top of the line, basically shows the net interest margin. That means the amount of money we make from the bond issues that fund our public service. And as you can see, the red lines are where the auctions and our debt has spiked up, just like everybody else's has.

The technology bubble collapse in 2001 was very short term in duration, but this is seemingly deeper and longer.

Basically on page 14, we just show a snapshot of our lines of business and the profitability. As you can see, we were doing well, and as the Chairman said, this would have been one of our best years if the legislation didn't change and/or the market didn't fall apart.

But one point about this -- I want to make sure -- our lending and secondary market is the part that is giving us the problem. Our full servicing is still strong and growing; our remote servicing where we leverage our IT services to others that use it for servicing, that is still growing; and our guarantee business is still strong and healthy. It the lending and secondary market business that is the concern right now.

On page 15, we tried to itemize the cost reductions to date. We could probably squeeze out a little more for '07-08, but we have really tried to look for everything, and everything is on the table. We have to keep looking and making sure we identify all expenses we can and try to match revenues against our expenditures.

The last couple of slides basically refer to the State Grant Program, which is really where this is all leading. In '07-08, clearly we're funding the rest of our commitment to the State Grant Program for a total of about $447 million, in total. That is our supplement plus what the Legislature appropriated.

In the budget transmittal, the board approved $35 million for '08-09. Our problem now is with the capital markets the way they are, we just don't know what that means in '08-09. We just don't know if we're going to have the money there or not. If everything clears up and improves tomorrow, then, you know, we'll probably have it.

And the last two pages, basically just a bar graph that shows in '07-08, 160,000 individuals received the grant, and then on page 18, basically some projections as to how many students, if we awarded the maximum award, what kinds of combinations we would have basically if PHEAA put the funds in, if PHEAA didn't put the funds in, and we had a 10-percent increase or a 3-percent increase, which was in the budget of the Governor.

So I know I went very quickly, but I'd be happy to answer any questions.

CHAIRMAN EVANS: I would like for you to talk a little bit about what you hope that this letter that was signed by the congressional delegation would accomplish.

MR. PRESTON: Yes. It occurred to me two weeks ago when our delegation, we asked them to help us support the two amendments that we wanted in the Higher Education Act, which was on the floor of the Congress, in the House.

One was the McKeon amendment that would basically recognize that there was a problem or there could be a problem for funding, and the Secretary would report back to Congress by July 1 as to that particular problem. That was not entertained on the floor. It was not allowed as an amendment.

The second one was the Shea amendment, which basically would say to the Treasury, the Secretary of the Treasury, and the Secretary of Education, there is a problem in funding and that we want the

Federal financing bank and the Treasury to provide as much liquidity as possible to solve the immediate problem for FFELP.

Both of those amendments didn't make it, and then we kind of realized we've got to help our congressional delegation to not only get the message and the facts but help them with their talking points, because this is a complicated issue, and we needed to have a grassroots support from the constituency, which is the schools and our other constituencies in this, so that we could craft a message and get the right message to Washington and help our delegation. And we are going to take this kind of forum and use it as well for the other national groups so they can use it in their own States and other congressional delegations.

CHAIRMAN EVANS: Under the current budget, there is $35 million that was said to be a pilot grant. As a result of this particular situation, what impact will it have on that $35 million? Will that $35 million disappear?

MR. PRESTON: I guess it could, and that is what we are worried about. We put it in---

CHAIRMAN EVANS: When you say it could, at what point?

MR. PRESTON: At the point---

CHAIRMAN EVANS: At what point do you think that decision would be made, if that $35 million disappears?

MR. PRESTON: We have an operating line of credit. When that fills up and we can't get any more credit, then my guess is we're going to have to just run a streamlined operation, and I won't have excess funds for next year.

CHAIRMAN EVANS: So that $35 million at this point -- and I don't want to put words in your mouth -- but that could be eliminated at this point, would you say?

MR. PRESTON: Yes.

CHAIRMAN EVANS: So obviously on the grant side of the program, that would mean a reduction in the grant allotment that is given to the young people, right?

MR. PRESTON: Correct.

CHAIRMAN EVANS: So that $35 million, that disappears as a result of what is taking place here, because you basically made that $35 million on interest earned?

MR. PRESTON: Correct.

CHAIRMAN EVANS: That's how you did that?

MR. PRESTON: Correct.

CHAIRMAN EVANS: You did that $35 million on interest earned, was how you were able to put that there.

MR. PRESTON: Right.

CHAIRMAN EVANS: So as a result of what's going on, if that disappeared, that in return affects the contribution on the grant side of the program.

MR. PRESTON: Yes.

CHAIRMAN EVANS: As you think this through -- and, you know, we are all in this together, so it is not just you; it is us, too -- are there specific things that you think from a State perspective that we can do similar to what you have mentioned here with the congressional delegation? What specific things do you think it is that we can do?

MR. PRESTON: I would ask all the members to help us with this word. We can give you talking points to the congressional delegation and help us get this message out, because this is our opportunity to do it and it's an important message, and FFELP is important to our schools.

To me, Washington has to talk about this. It can't be just, we're going to let everything default into another program. We have to talk about the pluses and minuses of what's good for higher education. Higher education is very important in Pennsylvania, very important nationally, and this is too important just to have something happen by unintended consequences.

CHAIRMAN EVANS: When you spoke to, and I saw some of the list to the people you had invited to your student summit, what about the schools of higher ed? What was their reaction to the summit?

MR. PRESTON: I think it ran the gamut of shock, not knowing what to think, as well as, there could be a problem, but I don't see it yet.

CHAIRMAN EVANS: Okay.

MR. PRESTON: And what I know is the part of the financing chain on the back end that supports all the banks, and many of the schools probably haven't seen it yet, but we felt we had to have a discussion with them so they understood what the implications of this were and whether it would have an immediate or an eventual impact to them.

And we know that the alternative loans will be a narrower commodity, less available this year. So we felt at least that we have to get that out and say there has to be a discussion on the FFELP side, because there are problems funding FFELP right now that will get to the banks and to them eventually.

CHAIRMAN EVANS: Since you have only been around since 2003, has at any time this generally occurred where we have been at this particular position?

MR. PRESTON: No, Mr. Chairman. I have been in banking for 25 years in New York, and I've never seen this. I've never seen this dislocation.

CHAIRMAN EVANS: Okay.

MR. PRESTON: You know, in the bond world, it is something that most people don't read about every day or hear about, but it's just as dramatic as the stock market going down, because the bond market builds America. That's how we build America -- roads, sewers, housing. It funds America.

CHAIRMAN EVANS: Okay.

MR. PRESTON: And that's the problem we are having now. And most of us think it will come back at some point in some way, but we're not sure the auction rate market will come back. Those are corporate buyers that have fled this market for safety in a crisis of confidence.

CHAIRMAN EVANS: My understanding, at least with my staff, who has said to me, well, the aspect that there was going to be potentially, and again, I don't want to put words in your mouth, a potential suspension of the loan program for out-of-State students? Is that decision being made?

MR. PRESTON: Yes. One of the things when you're in this bond market and you're having this type of dislocation, you have to preserve all cash. You have to preserve all cash and pay the bondholders. You can't take action that would drain the cash and not be able to pay interest. That is just something you have to do with those types of bonds.

So about two weeks ago, we stopped lending nationally. We weren't a big lender, but we just said, we're going to have to stop lending. About a week ago, we stopped making consolidation loans, because each time I put a loan into a bond issue, it's not only drawing cash out that I need to pay the interest and expenses but it's also reducing the equity in the bonds. I have to preserve the equity for the bondholders.

CHAIRMAN EVANS: Do you know, I want to ask you, how many people has that affected student-wise as a result of that?

MR. PRESTON: At this point, not a lot.

CHAIRMAN EVANS: Okay.

MR. PRESTON: What we've done is started calling our schools, and we've messaged to them that we are going to suspend lending, starting March 7 I think, and we called our largest schools and told them so they were aware; they weren't blindsided by it.

We then are sending a notice out, tomorrow, and we are going to do a couple of things. I have to assure you, one, we're going to work with our banking partners so that it will be a seamless transition with the schools, so there shouldn't be a missed beat at all here, because they still have capacity and can lend, and we're still going to be an originator, servicer, guarantor, so we can meet our mission. We don't have to be a lender if we want to support FFELP and the banks and support them in the business.

So we're going to try to make this as seamless as possible. We can come back in at a later time if things calm down, but right now it's not profitable at all for us to finance loans taxably or tax exempt right now.

CHAIRMAN EVANS: In terms of, that is somewhat the affect of the students outside of the

State. What is the potential affect of students inside the State?

MR. PRESTON: I don't believe any student--- We made about $600 million of loan origination last year, something like that. If we can allow the banks to come in and pick that up, then it should be very seamless and not cause a problem for any of the schools, and the banks will probably welcome it. So in our particular situation, I don't think that is going to hurt any student or any school.

CHAIRMAN EVANS: Okay. Who is the major student loan provider?

MR. PRESTON: PNC.

CHAIRMAN EVANS: PNC is?

MR. PRESTON: Yeah.

CHAIRMAN EVANS: Okay.

MR. PRESTON: And, you know, our mission is to support the banks. So in many ways, some of the banks are probably going to welcome this, so, you know, we are going to work with them and make sure that it is a seamless transition for them.

CHAIRMAN EVANS: Okay. Thank you.

Chairman Mario Civera.

CHAIRMAN CIVERA: Thank you, Mr. Chairman.

First of all, I'd just like to say this

publicly, that, you know, perception, that people, when they don't understand and the perception and sometimes the way the press reports things on what the activities are going -- I'm not here to attack the press in any way -- but the perception and what the people think and what's happened in the past with PHEAA is unfortunate.

MR. PRESTON: Yes.

CHAIRMAN CIVERA: But I can say here today that the presentation that you have put before us in a most very sincere way I think has the committee like startled and, you know, what do we do, because this is the real situation and this is what we are faced with in Pennsylvania. And just basically what I'm hearing here, and you and I had this conversation in my office about a week ago, is that this is a problem throughout the United States---

MR. PRESTON: Right.

CHAIRMAN CIVERA: ---and that the Federal government at this point is going to have to, you know, they are going to have to do something as far as the way you explained it with the lender of last resort and the Secretary of Education. And I'm sure our congressional delegation is supportive of it, because when you are talking $50 to $60 billion worth of money, that is a lot of money.

But let me just ask you this, and before I go to the question, it was interesting this morning, and I'm sorry now, because we had the State-related universities in and we had the State System in, that I didn't be more specific in the question. The University of Penn came out with an idea, what they have been doing for the last couple of years, that if you are basically a middle-income or a low-income family and you make $100,000 or less of total household income, that, you know, basically the $35,000 that they would charge for tuition at the university is for nothing, a student goes there for nothing.

Then I was teasing them in that I had said to them, my God, the entire 203 members of the General Assembly now could go to the University of Penn. But my point is this, okay? My point is this: Has there been any attraction or any talk to the State-related schools of holding the line on tuition, maybe reducing tuition? Was that brought up when you met with the schools when they came in to talk to you?

MR. PRESTON: Nothing was discussed that I'm aware of.

CHAIRMAN CIVERA: Nothing was discussed to that.

The grant program, okay, it was said that we have like $35 million in the State Grant Program. The amount of grants that we have, what's the like number of grants that go out? Could we reduce those amounts?

MR. PRESTON: There are 160,000 expected in '07-08, by the amount that we've contributed as well as the Legislature.

CHAIRMAN CIVERA: Okay. But if we were to reduce the amounts of it, would that be less students getting them?

MR. PRESTON: Yeah. If you kept the maximum award the same, then yes, you would have less students getting them. Or you could, you know, keep it over the same amount, but you would have to reduce the maximum award.

CHAIRMAN CIVERA: I think the real situation comes in August if when we go back and see what, you know, what Congress is going to do, as far as what the Federal government is going to do, to try and help in this situation, because it is definitely going to have some type of effect on higher education.

Thank you for all your information. You were excellent. Thank you very much.

MR. PRESTON: You're welcome.

CHAIRMAN EVANS: Representative John Galloway.

REPRESENTATIVE GALLOWAY: Thank you, Mr. Chairman.

Representative Adolph, ladies and gentlemen, thank you for being here today. It has indeed been a rough year for PHEAA, and it looks like it's going to continue to be rough for quite some time.

I would like to follow up--- I have two questions. First is a quick follow-up to Chairman Civera's remarks about a nationwide problem. Is it truly a nationwide problem? Is this crisis in Pennsylvania different from other States? Are other States currently experiencing this same problem? Is it as serious? Do we see the same immediacy and urgency as we do here today?

MR. PRESTON: I guess the best way to try to answer that is, I talked to a lot of people in the industry, both in terms of being issuers and other agencies like PHEAA. I've had comments told to me from other issuers, other secondary markets, they call me up in desperation and they say, the bankers just told me there's nothing they can do for me. So, you know, what that means is, they don't have any option to refinance, and their interest rates are high and they're losing money every day, and they don't know what to do, and that is a concern. And some of these secondary markets who have no other revenue flow, it's just a question of time. How long can they do it before they have trouble meeting their payroll?

Now, sometimes in the press you will hear things. A Senator from Rhode Island just had a press release, and he has always been a strong supporter of direct lending. What you hear in the press sometimes is part of the story but not the whole story. He had two comments in that press release. It was either yesterday or the day before. One was, there's no problem, because of two things: one, direct lending can handle more; and two, because Chase announced that they will have a discounted loan program for next year.

The question that wasn't asked is, how much can direct lending handle, and how much can Chase handle? Eighty billion, fifty billion dollars a year is an acquisition or two. It's a big number, and that's usually where the message gets lost out there.

REPRESENTATIVE GALLOWAY: A quick follow-up, if I may indulge the committee, Mr. Chairman.

As you know, the Auditor General, Auditor General Wagner, and the Office of the Auditor General is in the process of what they call a performance audit of PHEAA. It's the first such audit in the 40-some-year history of the agency. That's correct, the first performance audit?

MR. PRESTON: I think it is, yes.

REPRESENTATIVE GALLOWAY: You always have these fiscal audits, which is what comes in and what comes out.

MR. PRESTON: Right.

REPRESENTATIVE GALLOWAY: A performance audit differs where it is more the intent of the money and things like that.

MR. PRESTON: Correct.

REPRESENTATIVE GALLOWAY: Can you speak to the reasons why you think this step that has never been taken before is being taken at this time, and can you talk to the cooperation between the agency and the Auditor General's Office? When you expect the conclusion and findings? And as Auditor General Wagner stated, there will be recommendations at the end. Are you prepared to follow up on these recommendations and things like that? Can you speak to that, please.

MR. PRESTON: Sure. I think the first request for information was back in April of '07, or I think the previous CEO was notified that a performance audit was going to be established. I think part of that was because there was, you know, so much in the press that they thought they ought to do that, which is fine.

We've had a number of requests over the last year. I think the last item, No. 11, was submitted in detail to the Auditor General's staff. We have had good working relations with them. We've tried to accommodate every request that they have, and I think we have. We've provided everything, and there are some miscellaneous, but at this point, I believe the update is that everything they've asked us for has been submitted.

I believe that whatever they come out with will be right along with what the new leadership on the board as well as our management team is trying to do, which is cut costs and send all the money to the State Grant Program.

So I welcome any comments that he has, and anything that will help us be more efficient, I'd be glad to follow up with him.

REPRESENTATIVE GALLOWAY: Well, I mean, with all due respect, there are going to be more than comments. I mean, my question specifically is, and we heard from the Auditor General as to why he initiated the performance audit. What I would like to hear from you is, why do you think this step was taken?

MR. PRESTON: I think he wanted to see how the money was being spent and be able to report on it. I think, you know, there have been a lot of changes at PHEAA. I've met with the Auditor General and I said, you know, we'll comply in any way to any request you have.

You know, I have to just say that a lot of changes have been made and that many items that you have asked for, we've already changed or we don't do anymore, but let's go through the process and identify all the areas of concern to you, and we'll address them.

REPRESENTATIVE ADOLPH: Representative, I know this is out of the ordinary, but if I may address that.

The Auditor General's audit was for the

fiscal years ending '04, '05, and '06. Many of those expenditures were suspended, okay, and no longer allowed as a result of the Travel Policy that this new board adopted in April of '07.

In addition to having a performance audit done by our Auditor General, the board also is conducting our internal performance audit on a semiannual basis, okay? So we are now, for the first time in PHEAA's history, receiving an internal performance audit done and correcting our problems internally, okay, as we go on, something that was never done at that agency before.

So most of the expenses that the Auditor General is reviewing and the explanation that was given to him were for years prior to the policy. Now we are policing ourselves to make sure that that policy that we adopted in April of '07 is being carried forward and conducted properly by our employees.

REPRESENTATIVE GALLOWAY: Thank you very much.

Thank you, Mr. Chairman.

CHAIRMAN EVANS: Representative Dally.

REPRESENTATIVE DALLY: Thank you, Mr. Chairman. Good afternoon.

Jim, you mentioned in your testimony about the upheaval in the capital markets, and there's a rumor circulating in the Capitol that I had heard that they said, oh, the reason PHEAA is having problems in the capital markets is because of the last 12 months of turmoil with the agency. Can you respond to that, please?

MR. PRESTON: Sure.

PHEAA has a national reputation, a national reputation with the bond market, a national reputation with our rating agencies, and a global reputation as it relates to our ability to deliver good servicing, and when I say that, I mean if there was any problem with our reputation whatsoever.

We are one of the few servicers in the United States that can do a securitization for any client that comes to us. We are a major third-party servicer in the United States. They come to us because there are no questions asked in the global markets, none, none in Wall Street and none in the rating agencies, because they know us. I have never had to do a road trip, and I said, you know, I'll meet with anybody in Harrisburg, but I haven't had to go anywhere because our reputation is so good. This has not hurt us in any way.

They ask about, you know, are you cutting costs and that kind of stuff, but I say, no more than what we should be doing and allocating to support our business and our clients.

REPRESENTATIVE DALLY: Thank you for that response.

Yesterday the Treasury was before the committee, and I asked her about the $700 million line of credit that PHEAA has with the Treasury, and I guess there has been a position taken by Treasury that they want to be repaid at least $200 million, and ultimately the entire line, and it appears to me that with this liquidity crisis that you are facing, it just seems like that just compounds the problems if you now have to seek outside financing for that line of credit.

MR. PRESTON: Clearly, there have been active negotiations going back and forth. It came to a point this week that we had to decide, and we had enough liquidity in order to transfer the loans and pay down the line tomorrow, I think it is, or Thursday -- Thursday.

So we met, you know, their immediate needs, and we are trying to work with them, too, to handle a difficult situation that everybody is facing. But

I would like to try to keep that $500 million, if I could, and I will try to preserve that going forward.

REPRESENTATIVE DALLY: And I'm not questioning, you know, the Treasurer's rationale for doing so.

MR. PRESTON: No.

REPRESENTATIVE DALLY: I mean, from an investment banking standpoint, I think she made her case on that, in that respect.

MR. PRESTON: Right.

REPRESENTATIVE DALLY: But I think that they could lend a helping hand here to get us through this crisis.

MR. PRESTON: Yeah, they could. Yes.

REPRESENTATIVE DALLY: Thank you.

CHAIRMAN EVANS: Representative Shapiro.

REPRESENTATIVE SHAPIRO: Thank you, Mr. Chairman.

Chairman Adolph, Mr. Preston, it is good to see you.

I wanted to follow up just quickly on a comment that I believe Mr. Preston made earlier. When you talked about the "seamless transfer" -- I think those were your words -- in moving to private banks for loans, you didn't touch on the rate that students would be paying. Would you anticipate in that seamless transfer that rates would be increasing, or should I assume from the "seamless transfer" comment that the rates would be seamless, they would stay the same as they are now?

MR. PRESTON: Yes. Two students, the FFELP program offers the same loan program to those students. It may be a question of borrower benefits that could be added, and in this year, just because of our budget situation, we couldn't offer necessarily the best loan in terms of a free loan to everybody, so there are others out there offering it. So in some ways, it makes sense for us to support the FFELP community that can offer more of the borrower benefits.

So we are still going to do origination servicing and guarantee, but we're just going to try to bring in our other partners, which are lenders, to be able to handle the process, so it shouldn't affect the schools.

REPRESENTATIVE SHAPIRO: Okay. And again, so we shouldn't be experiencing a rate spike costing Pennsylvania students more money as a result?

MR. PRESTON: No, no, and in some cases it may actually be better, because Chase offers a free loan and we don't.

REPRESENTATIVE SHAPIRO: Okay. Great.

And just a second question: As Chairman Adolph certainly knows, and, Mr. Preston, you do as well, Representative Smith and I had introduced, along with many cosponsors, HB 1891, that among other things would ban or prohibit PHEAA from spending money on bonuses, on getaways, on promotional items, things like that, and that bill is pending in the House currently.

And I really want to applaud and publicly applaud Chairman Adolph and Vice-Chairman Logan for their, I believe there's an April 2007 board policy to end this spending on what I have determined to be wasteful items that I think have cost students millions of dollars in Pennsylvania.

I wanted to ask you, on slide 15 where you talk about cost reductions, I wanted to know if any of those, again my term, "wasteful spending" appears on that list of savings?

MR. PRESTON: You know, I would say some of our items that you are concerned about are probably in here. We had to go through and cut out things that we didn't need in this new environment, both under the Code of Conduct and the new competitive environment, and we cut out a lot here, and my guess is some of it you would go through and you would probably say, yeah, I agree with that.

REPRESENTATIVE SHAPIRO: Okay. Sir, I wasn't looking for a particular number, but some of that is reflected in that?

MR. PRESTON: Yes.

REPRESENTATIVE SHAPIRO: Okay. One of the other components of this legislation would be to return some of that money that I believe had been wasted in the past to students in Pennsylvania in the form of grants for school, and there had been some discussion, I know, back and forth in terms of what PHEAA might be prepared to reinvest in the students of Pennsylvania. I'm just curious if PHEAA is in any position.

I recognize, obviously, that the global environment has certainly changed, and I certainly don't blame PHEAA for that -- I want to make it very clear -- but I think it is clear that money had been wasted in the past. It is also clear that through the Chairman's leadership, it is not being wasted now, and I would like to know what can be reinvested in the students in the form of grants.

MR. PRESTON: Again, '07-08, we are honoring our commitment; '08-09, it is the issue that we have.

I believe, to all the members here, that PHEAA's basic business is a solid business, and it will get re-established in a form that we will generate, pursuant to the Chairman and the Vice-Chairman and the board's leadership, we will send every dollar we can to the State Grant Program over and above the ordinary and necessary expenses to maintain and keep our business growing.

So going forward, this is the stuff we can cut out very easily, but in '08-09, I'm just challenged now by how much revenues we will have to even meet the $35 million, and that is the part that I just don't have an answer for.

REPRESENTATIVE SHAPIRO: Okay. So we know what the baseline number is for the grants that, you know, that students are counting on. The money that in the past had been wasted, whether it is, you know, $2 1/2 million in bonuses from 2007 that is no longer being spent on bonuses as the result of your good work there, there is no guarantee, as you sit here now, that that money would be reinvested in the students in the form of higher grants, or additional grants I should say.

MR. PRESTON: It now---

REPRESENTATIVE SHAPIRO: So that money just sort of goes back into a pot and it is not reinvested in the students. Is that---

MR. PRESTON: Yes; yes. Well---

REPRESENTATIVE ADOLPH: All the money is reinvested in the students.

MR. PRESTON: Yeah; all the money is reinvested in our business that directs it to the surplus that we can generate for the grant program. I mean, that is what we are trying to do, and we are trying to also keep this important asset of the Commonwealth growing and being able to maintain its business going forward.

REPRESENTATIVE SHAPIRO: Understood.

And a final question, Mr. Chairman: Because we are saying that there's a baseline level of grant dollars that are going to be spent, and it is unclear whether we are going to be able to achieve that in the future -- I understand that; that is part of the global environment -- but we are also saying on slide 15 that there are savings that you are attributing to the smart decisions the board has made, and I'm just wondering how you square the two.

I was hoping that that savings would---

MR. PRESTON: Yes, sir, I got it. Just a comment.

This is budgetary; it is not necessarily matched up with revenues that did or did not come in. This is reducing the allowable budget that was authorized at the beginning, and we are cutting into it because we are just doing ordinary and necessary expenditures.

The revenue side is the piece that didn't come in this year. It didn't come in from the bond side. If we had half of what we expected, we would have an easier story to tell, and that's the problem. It's the revenue side we are going to try to stabilize in this environment with the bond market and then get back on track so the expenses we put in the budget every year are ordinary and necessary for growing and preserving PHEAA's asset and then sending all the extra money into the grant program.

REPRESENTATIVE SHAPIRO: So it would be a safe assumption then that if you are able to stabilize, if the global environment were to improve, that this savings could in fact be reinvested into grants. Would that be something you would be comfortable agreeing with?

MR. PRESTON: Oh, sure. Absolutely.

REPRESENTATIVE SHAPIRO: I see Chairman Adolph nodding, so.

MR. PRESTON: Oh, yeah, absolutely. That is what we want to do.

REPRESENTATIVE SHAPIRO: Okay. Thank you very much.

Thank you, Chairman Evans.

CHAIRMAN EVANS: Representative Petri.

REPRESENTATIVE PETRI: Thank you, Mr. Chairman.

Thank you, Mr. Preston and Representative Adolph. I think we have had a real eye-opener to things.

But I want to start high, at a high level, and kind of drill down so that when my questioning ends, we are down at where I think my concern is or where all of our concern is, and that is what the impact is on our students and their families.

In December, I recall being at a presentation by the Federal Reserve, and it was quite lengthy, quite complicated, and a lot of charts, graphs, and the like, but what I walked away from -- and I want to see if this is your understanding -- is that basically what happened was we had a lot of pools of investment, some foreign investors and some corporate investors, and those pools have gone away. They are no longer, and we have known that at least since somewhere around December, at least it started hitting them, and that that credit crunch is impacting not just student loans but every form of lending, potentially, that there is, including the housing market.

MR. PRESTON: Absolutely. The unintended consequences of this spiraling effect is just astounding, and that is what we have seen, investors go away from these markets.

REPRESENTATIVE PETRI: And what I gathered from that is, the market's taste for different types of loans may vary, that first mortgages may be less impacted than second mortgages, and it looks like, in the case of college or student loans, there is not much of an appetite to invest in pools where you would have money available and liquidity to lend.

MR. PRESTON: Generally the right concept.

REPRESENTATIVE PETRI: Generally; okay.

I assumed, of course, when Congress started working on their tax proposal, that that was kind of in the back of their minds as well. How do we bridge this credit crunch, which at least according to the Federal Reserve presentation I heard would hopefully somehow be over by August or September. It that roughly what you are hearing?

MR. PRESTON: Yes, but some of the veterans in the business are very shocked by the extent of this and the unintended consequences and how it has gone into various asset classes.

I have actually had buyers in the global floating rate market -- they are overseas buyers -- basically say, oh, when this all comes back, FFELP guaranteed student loans, which are 97 guaranteed by the government, they are better than Treasury's; I'll be right back in; those will be the first classes that come back, but it hasn't happened yet.

REPRESENTATIVE PETRI: Okay. Now, looking at PHEAA's circumstance, I represented over my previous life as an attorney some banks, and one of the things the regulators were always interested in when they reviewed the banks I represented were basically three areas: assets, interest rate risk, and liquidity. You have already testified that your assets are very, very good, these are good loans, so there's no real problem there.

Interest rate risk, I kind of heard what you were saying. That is more on a revenue point of view than a true spike.

But liquidity right now is your problem, so the question that comes to mind is, do you believe that PHEAA currently has enough liquidity to meet what would be more or less your ongoing obligations, and your obligation, as you have clearly indicated, is the mission for our students.

MR. PRESTON: Yes.

REPRESENTATIVE PETRI: Okay.

MR. PRESTON: We can meet our mission, but it may be for awhile that we are not lending.

REPRESENTATIVE PETRI: Right; I understand.

The last thing I want you to just talk to the committee about briefly is, if you have to make a decision--- And perhaps this question is too early. I know you are governed by a board, and you may not have had this board-level discussion yet, so if that is the case, just cut me off.

Do you have an expectation as to how, if you have to turn down loans, in what order or priority you might do that? Would there be a way that you would say, well, we can meet this number of loans at this volume level, but the students are in-State, out-of-State, you know, anything such as that?

MR. PRESTON: One of the advantages of doing it this time of year, it's a slow time, so basically we can phase in the banks to help us out.

I will give you an example. On the consolidation, when we suspended the consolidation, what we basically did, we went to some of our partners and said, we don't want to turn a client down; we don't want to push somebody away; what we want to do is solve their problem, and so we just got other lenders that were working with us to take those loans and make those loans, because they still wanted to do it.

REPRESENTATIVE PETRI: So they were happy to jump into that, into your shoes?

MR. PRESTON: Correct. Right.

REPRESENTATIVE PETRI: So, so far would it be fair to say that through your contacts, you are able to still fulfill the requests by making offerings to other institutions?

MR. PRESTON: Absolutely.

REPRESENTATIVE PETRI: Okay.

I thank you, and I thank you for alerting us and coming in and talking to us about this very, very important issue, and I will say I'm quite impressed at the level of knowledge that the board has undertaken in understanding the realities of where you are in a market that, I guess you have already indicated as a banker for 25 years, you have never seen before, so that makes it very difficult to predict.

Thank you.

MR. PRESTON: Thank you.

REPRESENTATIVE KELLER: Representative Jake Wheatley.

REPRESENTATIVE WHEATLEY: Thank you, Mr. Chairman, and guests, thank you for being here.

I guess I'm going to be the one that, only because this is really confusing to me, on the one hand you tell me that we really have a situation that the Federal government should be alerted to and that we need to put pressure on to respond to, and that is happening all across the nation, but then on the other hand I get a sense that you are saying to the families of Pennsylvanians that this transition that is happening is really not something that they should worry too much about.

And if you can just help me, because it's kind of confusing to me, and I have all this information and all this staff to keep going over this information over and over again and I'm still confused, I can imagine what a parent and a child who is in one of these institutions is fearing right now. So help me walk through this.

Next year, I'm a new student trying to come into one of the universities here. I apply for a loan, and what happens?

MR. PRESTON: It's an excellent question, because it's a matter of timing.

The particular timing of our situation is that we aggravate a very big problem and make that worse by adding more loans to our portfolio. What we are doing is now, students won't see basically what we are doing other than in terms of what the lender may be or what the school will deal with. They will fill out the financial aid the same way, you know, apply for the Pell grants and the State aid; they will have a lender for the unmet need for the FFELP piece; and then if they need an alternative loan, they will look into those alternative lenders that are out there, and hopefully there is no access problem for any student in the Commonwealth. The first part that I see already developing is on the alternative loan side.

REPRESENTATIVE WHEATLEY: So when you say alternative loans and access problem, if I'm Jake

Wheatley who was, 10 years ago, applying for school, my credit history may not have been the best, and, you know, I certainly didn't have family wealth, so under your loan process, you would still give me a loan regardless of whatever that was. You know, it was based off my need, really. Under this other process, will these banks and other lenders, will they look at all of that whole portfolio that will determine if I can receive a loan?

MR. PRESTON: The FFELP program is basically need based. You apply for it; you are eligible; you will get it according to the maximums that you are allowed. That will happen with any lender, and I think one way or the other, that will be covered by either the banks or a lender of last resort in this coming year.

The next piece is a consumer-based ability-to-pay type of loan. A normal bank will take a look at it and determine that they are an acceptable risk, they meet the scoring that they normally have to make the loan, and they will make the loan as a normal consumer loan, and that is how the alternative loan business works.

What I'm afraid is going to happen this year is that the amount of students that have a choice of looking at those alternative loans and applying for those loans will be limited and/or they may have, you know, if 50 percent of the eligible population was willing to get it last year, maybe 25 will get it this year, and that is what I'm worried about, because it's a credit-quality market now.

REPRESENTATIVE WHEATLEY: And so at that point, there will be Pennsylvanians who will be impacted by what is happening, and so that becomes a critical situation for us as policymakers who believe in open access and believe that people should not be eliminated by their financial resources from coming to our campuses and universities.

So at that point, I mean, then it brings me to the next question: What can we do as policymakers to offset that? If we know that this might be a problem that will affect families and students in Pennsylvania, what can we do, outside of advocating at the Federal level, what can we do to offset that?

MR. PRESTON: In one of the charts I showed here, there is about $4 billion of Federal loans made in the Commonwealth every year. There's another, I think it is about a billion to $2 billion of alternative loans made in Pennsylvania.

The advantage Pennsylvania has, there are two types of markets. They call it a direct to consumer, where you may apply because you see a television ad or you get something in the mail. The other is through the financial aid office, and we have built this year -- we haven't rolled it out yet, but we realize that the alternative loan processing is very important for our lender partners and for our schools -- so we built an origination platform to help that, and what that means is, instead of direct to consumer and these applications just come in to the financial aid from all over and they don't know who they are, we will work it through banks and they will actually be school certified. That is an important part, because then you take a big risk of the fraud on many of these loans away, and many of the lenders like that. So I'm guessing that this platform that we built to assist the schools is also going to be helpful for the banks if we roll it out this year, because they are going to want school-certified alternative loans at Pennsylvania schools.

REPRESENTATIVE WHEATLEY: So just---

MR. PRESTON: It won't answer all the

question and it won't solve all the problem, but, you know, alternative loans are an expensive proposition, and you have to have a certain amount of expertise, and that is why the banks are really the best ones to hold those loans and manage that risk.

REPRESENTATIVE WHEATLEY: Just so I'm clear -- and, Mr. Chairman, I apologize for going longer than I need to -- just so I'm clear, you are saying the fact that this apparatus that we have established, this loan originator process, would be enough to maybe leverage banks in need of this alternative market to make sure that all individuals have access to a loan? Is that what you are saying, or are you saying---

MR. PRESTON: I misstated if that is the impression that you are left with. It won't solve the whole problem, but I think it will help interest other lenders to go through this process and make these loans, so---

REPRESENTATIVE WHEATLEY: And I appreciate that response. I guess where I'm coming is, are you saying that there is nothing that we can do as a body to help make sure that in the short term, this year coming up that we see this problem happening, to try to make sure that every individual who used to be able to come to PHEAA and get a loan to access college, that we can't do anything to make sure that that happens again this year until we can figure out what we can do nationally to try to rectify this problem?

MR. PRESTON: It's a big problem nationally, and I'm not sure what this committee can do right now. I'm going to have to think about that and try to get back to you, because it's a complicated question.

REPRESENTATIVE WHEATLEY: I would appreciate that, because, you know, it is very complicated in districts that I represent---

MR. PRESTON: Yes; you are right.

REPRESENTATIVE WHEATLEY: ---that education be accessible, and many of those individuals that I represent will probably fit into that market that will end up having to search for an alternative way to get into colleges and get money for colleges, and I cannot accept nor will I go back to them and say, well, my hands are tied and this is just too complicated to handle, and you have to wait another year to try to access these universities and campuses.

So it's a very important issue for me, and it is a critical issue that I think we have to solve immediately.

MR. PRESTON: Okay.

REPRESENTATIVE ADOLPH: Representative Wheatley, I sat through the work session about two weeks ago, as did Representative Frankel, and I felt the say way as you feel right now when I went through that process, and I came to the conclusion after that work session that there really was not much that the General Assembly could do, okay, and that was the reason why we called the summit, to bring in the banking institutions, to bring in the lenders, to bring in the higher education folks, bring in our congressional delegation from Washington, D.C. Okay?

Two: First of all, bring the problem to the table to explain to the folks out there that there is a problem out there. Okay?

Short term we can get through this, but if this disruption in the global markets continues, we are not going to be able to handle the difference. All the public service programs that PHEAA has contributed to over the last decade will not be there, which also saved our students a billion dollars over the last decade.

So I'm with you in trying to address this problem. We are going to Washington, D.C. I think Senator Specter and Senator Casey are going to host a meeting in the next couple weeks down there for PHEAA and to bring other banking and student lenders from across the nation there.

So we are trying everything we can do to bring this to a head so this can be handled in a very short period of time and so we can meet the crunch in August and September.

REPRESENTATIVE WHEATLEY: Thank you.

Thank you, Mr. Chairman.

REPRESENTATIVE KELLER: Thank you.

Representative Mario Scavello.

REPRESENTATIVE SCAVELLO: Thank you, Mr. Chairman, and good afternoon, gentlemen.

First, I just want to follow up on Representative Shapiro's line of questioning. The legislation that he was discussing, are you familiar with it, Bill?

REPRESENTATIVE ADOLPH: Yes, I am.

REPRESENTATIVE SCAVELLO: Most of that in that legislation, outside of that last piece, the piece about taking those reductions and handing out more grants, was that all addressed by the board?

REPRESENTATIVE ADOLPH: Yes.

REPRESENTATIVE SCAVELLO: It was addressed. So there is really no reason for the legislation.

REPRESENTATIVE ADOLPH: In my opinion, that is correct.

REPRESENTATIVE SCAVELLO: Okay.

REPRESENTATIVE ADOLPH: And we addressed, not only did we make that policy, okay, we also adopted a performance audit, an internal performance audit, where Senator Vincent Hughes is the Chairman of the Audit Committee and, on a quarterly basis, is speaking to the board regarding their findings.

So we are addressing it. We are following in our policy. The employees of PHEAA realize how necessary they are. So the legislation, really, we have already addressed. What Representative Shapiro wanted to accomplish, we are accomplishing it through our inner policies.

REPRESENTATIVE SCAVELLO: And with the reductions that you have made, you can't hand those out because your revenue isn't in place. Am I correct? Otherwise, that might have been one of the--- Very good.

Can you explain the Nursing Loan -- I know with all these other problems -- the Nursing Loan Forgiveness Program and who decides on the specific qualifications or the guidelines?

REPRESENTATIVE ADOLPH: Kelly, could you---

MS. LOGAN: Yes.

REPRESENTATIVE KELLER: Could you identify yourself for the record, please?

MS. LOGAN: Hi. I'm Kelly Logan. I'm the Executive Vice President for Public Service and Marketing.

That program was one of the programs that the PHEAA Board developed, and the PHEAA Board voted on initiating that program, and those requirements are a part of that program.

REPRESENTATIVE SCAVELLO: Okay. What has the impact been on the nursing loan forgiveness initiative specifically?

MS. LOGAN: At this point, the board made a decision in October that the Nursing Loan Forgiveness Program would continue to take applications through June 30 of this year.

REPRESENTATIVE SCAVELLO: Okay.

MS. LOGAN: That is one of those programs, our PHEAA-funded programs, so the evaluations of those programs continue.

REPRESENTATIVE SCAVELLO: Okay. I just want to make a general comment.

I'm very impressed with what you guys have done here, and thank you for your presentation.

And how is the search going for a Chief Executive? How is it progressing?

REPRESENTATIVE ADOLPH: The board, at its March meeting, Representative, will receive a recommendation from the Executive Committee on who will be the next CEO.

I was not a member of the search committee. Representative Jennifer Mann was the Chairman of the search committee. I sat in on all the interviews.

We retained the services of a consulting firm on an Executive search, went through over, you know, several hundred resumes, went through about 12 interviews once, twice, three times, and I think we had a wealth of talent come to us, and I think it was something that was a real experience for most of the board members.

However, I think PHEAA will be well served with the recommendation that is going to be made to the full board at its March meeting.

REPRESENTATIVE SCAVELLO: Just for my two cents, is Jim a candidate, because I have to tell you, I am very impressed with the comments and everything that he has done here today. Jim, are you a candidate?

MR. PRESTON: Yes.

REPRESENTATIVE SCAVELLO: You are? Great. You got my vote.

Thank you very much.

MR. PRESTON: Thank you.

REPRESENTATIVE KELLER: Thank you.

I think that Chairman Adolph has done a great job here in getting everyone's attention. You sat through more Appropriations hearings than I have, and I think this is the most silence I have ever heard in the room. So I think you brought it to everybody's attention, and that's a good thing.

Mr. Preston, if you could just -- because the expert has left; that's why I'm in this chair -- if you could just explain it to a layman.

In the short term, you are going to try to go to Washington and make them understand that they need help with the FFELP program and to shore that up and to make sure that that is around. Then PHEAA will do what they have always done, this servicing? They will concentrate on servicing those loans, and that will generate the revenue stream?

MR. PRESTON: Correct; four basic lines of business.

We have the servicing that we do for ourselves, for the loan portfolio we have, and also for third-party servicing. Sixty percent of our revenues overall from the last fiscal year came from out of State, because we basically service and guarantee for customers across the country.

We also, a smaller piece of our business is leveraging our IT systems. We provide our IT systems to other servicers in the United States, and most people don't even know that we are behind them, but we generate a monthly revenue off that, so that is still growing.

And the guarantee business, although we took a hit on the revenues for '07-08 with the new law, it is still a big business that is going to generate $70, $80 million a year for us.

REPRESENTATIVE KELLER: By suspending the student loans, the out-of-State student loans, does that affect the revenue that will come in generated from them?

MR. PRESTON: Not at this point, because each loan would be a loss for us, and I'm trying to mitigate and save cash and mitigate any losses we are incurring.

REPRESENTATIVE KELLER: The last couple of months, or I guess it was for a year, there was a big push in the Legislature to turn over what you guys did to Sallie Mae. Now, hindsight is 20/20. Would the students in Pennsylvania be better off or worse off if that had occurred?

MR. PRESTON: Again, I am biased. I think that---

REPRESENTATIVE KELLER: Well, so am I; that is why I asked the question.

MR. PRESTON: Yeah. Students are better off if we can continue to meet our mission and provide access and choice for all students and parents in Pennsylvania.

REPRESENTATIVE KELLER: Thank you very much.

Representative Gordon Denlinger.

REPRESENTATIVE DENLINGER: Thank you, Mr. Chairman.

My questions have been largely answered, but I do want to commend all of you for coming before us here and for highlighting a problem that is of national concern, and please keep us in the loop as things move forward.

We are with you in the mission to help our students out there, and I want to applaud your professionalism in coming before us. I appreciate that you have addressed some of the serious concerns that were raised over time, some by my constituents and many by folks in this building. You hit that hard and you did it well, and we appreciate your forthright manner.

Though neither Representative Scavello nor I have a vote in the ultimate outcome of your future leadership, I would second his motion there as well in support of your efforts.

So thank you again. We appreciate it.

MR. PRESTON: Thank you very much.

REPRESENTATIVE KELLER: Representative Kathy Manderino.

REPRESENTATIVE MANDERINO: I was going to say my question has been answered, but really it hasn't, because I'm still struggling with this notion about the affect on students of this inability to sell on the bond market, et cetera, and I was under the impression that with PHEAA not being in the loan business or, you know, if you have to pull back from giving loans and it has to be obtained through the private market, that there was a whole issue of what the interest rates would be, what the credit worthiness of the students would be, what the credit worthiness of the student's family would be, and how that would affect the rate that they would be able to get for their education. I guess I heard you saying that that won't be an issue, and that surprises me. So either I am misunderstanding your answer or I'm just not getting it. Could you try one more time?

MR. PRESTON: Let me try to break it down, because there is a little more specificity that is required to answer that.

There are two components, that if a student needs a FFELP loan and maxes out the FFELP loan and needs more money, then the only thing left really is trying to get an alternative loan.

REPRESENTATIVE MANDERINO: Okay; now stop right there.

MR. PRESTON: Okay.

REPRESENTATIVE MANDERINO: Do we know what percentage of students in our system right now fall into that category? Even a ballpark.

MR. PRESTON: The best example I have is about--- Oh, here it is. How much is that?

REPRESENTATIVE ADOLPH: Page 3.

MR. PRESTON: Yeah. About 12 percent is the number in terms of dollars, and what will happen---

REPRESENTATIVE MANDERINO: Twelve percent of the loans?

MR. PRESTON: Correct.

REPRESENTATIVE MANDERINO: Okay.

MR. PRESTON: Now, those are alternative loans that are not guaranteed by the Federal government.

REPRESENTATIVE MANDERINO: And who usually qualifies for that, the people who are in the most need, meaning they have the fewest of their own personal or family resources to come to the table of higher education?

MR. PRESTON: The way that the system is set up, it tries to take the real needy students, give them the Pell grants and the other aid, the State grant formula, for example, and then supplement it with a need-based FFELP program that does not have any credit criteria.

So you go to a bank or you go to any bank, and you are going to get the same terms and conditions, unless they have some borrower benefits that they attach to it. But it is not based on whether they can pay or not; it's need based. If they are eligible, they get it.

It is really the middle class that falls out between the Pell grant and the real need-based scholarships and have to borrow in the FFELP loan and then find their unmet need over and above the FFELP is what they have to go into the regular consumer market, and they have to show that they can pay it back.

REPRESENTATIVE MANDERINO: Okay. So if I am that child of the middle-class family who overextended, intentionally, unintentionally, unknowingly---

MR. PRESTON: Correct.

REPRESENTATIVE MANDERINO: ---in my own personal situations with the mortgage markets, with the credit card markets, with the whatever markets, so that as the college-age student now trying to finance my education and my family situation being taken into consideration, if I'm that 12 percent, not, I understand, of the market but 12 percent of the loans, what happens to my cost of getting an education?

MR. PRESTON: It can go up.

I have to tell you one more thing. There is what they call a PLUS Loan. It's a parent loan under the Higher Education Act. If you qualify, it is signed by the parent, and it can take the place of the alternative loan, and it is more user-friendly, it is more set interest rates, so therefore, you may not see the types of alternative loan pricing if you take the PLUS Loan. So you can get a PLUS Loan from the Federal government to take care of the total cost of undergraduate costs at---

REPRESENTATIVE ADOLPH: Eight and a half percent, I think it is.

MR. PRESTON: Eight and a half percent, correct, and that is kind of a happy medium between the need-based Stafford loans and the alternative loans.

So they do have a PLUS Loan, so any student and parent that wants to fund it through the Federal programs, their undergraduate cost of education can. If you don't want to use the PLUS Loan, you have to go to an alternative loan.

REPRESENTATIVE MANDERINO: Is anyone going to be ineligible for a PLUS Loan? Is it just a matter of educating families that these PLUS Loans are available and they ought to be looking here first---

MR. PRESTON: Yes.

REPRESENTATIVE MANDERINO: ---as compared to the alternative loans on the private market?

MR. PRESTON: Yes.

REPRESENTATIVE MANDERINO: So it is a matter of education and not a matter of family financial status or student financial status.

MR. PRESTON: Yes. There is a credit check with the PLUS Loan, but it's very, very minimal. It's not a rigorous credit check like you would get with alternative loans. But what has happened over the years is through direct-to-consumer mailings and the like, some folks would see the variable rate nature of those loans and apply for those not knowing that the PLUS Loan was out there. You are hitting on an exact point of what is going on.

REPRESENTATIVE MANDERINO: So let's go to Representative Wheatley's earlier question: What can we do?

MR. PRESTON: Educate.

REPRESENTATIVE MANDERINO: One thing we can do now is a better job of educating folks about the availability of the PLUS Loan---

MR. PRESTON: Agreed.

REPRESENTATIVE MANDERINO: ---as something that they ought to be looking at first, or at least knowing that it is out there, before they think that the alternative private market is their only other option.

MR. PRESTON: Absolutely.

REPRESENTATIVE MANDERINO: Okay.

MR. PRESTON: You are right on.

REPRESENTATIVE MANDERINO: Thank you.

REPRESENTATIVE KELLER: Representative Brian Ellis.

REPRESENTATIVE ELLIS: Thank you very much, Mr. Chairman.

And I would like to say that I agree with your comment that everybody is a little bit biased, and I believe I may be a little bit biased as well. But what he brought up was the mission of PHEAA, and I think sometimes when we get involved in this, and Mr. Preston certainly over the last few months, the conversations we have had and the dialogue has been very good and moving forward in the right direction, but I think what we lose sight of sometimes is what kind of product are we at PHEAA offering out to the students of Pennsylvania.

Now, obviously we have had circumstances that have changed the financial situation over there, and you have indicated we are going to get, much like I had suggested, maybe focused a little bit more on originating and getting out of the lending business.

That being said, we also have the concerns of how we are going to let the lenders compete in the market to ultimately bring down interest rates and offer more products. Can you just give me an idea? I mean, we said at the time in December, if we had a crystal ball and we could look ahead six months -- well, now we are four months ahead, almost -- we might have a clearer picture. Can you just give me a quick update of what is happening with the Keystone best-lender situation and the operational platforms as far as distributing the loans throughout the colleges?

MR. PRESTON: You know, basically we realize that we really had to in this difficult time for FFELP, we had to support the FFELP lenders, so everything that we have done for '08-09 is really circling back around and trying to support them, not get in their way or compete with them for lending but try to offer things that support our mission, support the schools and the students, but also offer the products that they want.

So on a very generic level, what we have offered is a KeystoneBEST program where this year, in '08-09, we are not saying that we need to buy the loans or own the loans, so the lender can own the loans; what we will do is originate service and guarantee. If you are in the KeystoneBEST program, we will pay that default fee to encourage them to stay with us and support the schools.

The second tier, if they don't want to participate in that regard, then we said, we'll do another thing; you can use any guarantor you want or use us, but you are going to have to pay that default fee, but we will give you our e-sign process -- that's the old discussion about opening up the system -- we will give you our e-sign process, but we need to originate and service in order to support you, and you can own the loan and you can do it any way you want. And then there is one last piece after that. That is called our FTS process, which is origination though our guarantee system, which many schools like, and we will charge a basic fee for that. But again, all of it is based on requests that some of the lenders have had to us to keep them in the business and not chase them away.

REPRESENTATIVE ELLIS: Well, I really appreciate the fact that, and if I understand it correctly, there is no reason, that it doesn't matter what lending institution it is, they can compete in Pennsylvania, and ultimately the parents are going to have more choices, okay?

Now, my question is this: I hear you say it and we have been discussing it for awhile, what was the procedure to get to this point? Did it go through the Executive Board? Was it approved? Is this now policy over there, or is it---

MR. PRESTON: No, it is not usually approved by the board. What it is is basically a moving forward in a direction that supports FFELP and meets our mission, and I think what we have really seen, with all the input that we have had over the last couple of years, this is really the choice that the lenders want, and we are offering it to them so they don't go anywhere else or try to do it alone or try to do it around our schools that want to use us. We are trying to offer all the products that will keep them in the business and offer competitive loans to the students.

REPRESENTATIVE ELLIS: Okay.

Thank you very much, and if I could just ask one more little thought there.

PHEAA is going to allocate about $35 million in grants next year. That's the number, correct?

MR. PRESTON: It was in the budget.

REPRESENTATIVE ELLIS: And, you know, certainly in the conversations we have had, one of my concerns is that whenever you get into increasing the amount of grants, you are actually putting the lenders in a tough position where they are not going to be able to lower interest rates to the parents. So essentially you have parents that can afford college subsidizing the college for those who can't, you know, a redistribution of wealth on some levels. Is there any way that we can, in the future, increase grant money and not affect the products that the lenders are offering?

MR. PRESTON: I guess I am going to have to think about that and try to get back to you. That is a full question, and I have to think about all the parameters before I answer you.

REPRESENTATIVE ELLIS: Fair enough, and I look forward to our continued dialogue, and although I also don't have a vote, Mr. Preston, I am very impressed with the way you have been running the operation since you have taken over.

Thank you very much.

REPRESENTATIVE KELLER: Representative Ellis, the way those guys handled the subprime market, maybe we should be for redistributing the wealth.

Representative Matt Smith, please.

REPRESENTATIVE SMITH: Thank you, Mr. Chairman.

And thank you for the work you have done with PHEAA, and Representative Adolph, for the work you have done in changing a lot of things at PHEAA, but I want to just revisit something we touched on a little bit earlier, Representative Shapiro's legislation, and Representative Scavello touched on it in the sense that, you know, asking whether that legislation was necessary at this point. And I just want to go through a couple points that I don't think right now, in my own mind I want to clarify, are a part of the existing law, that are a part of Representative Shapiro's legislation, and that is, first of all, I think that legislation would require annual performance audits of the kind, which Representative Galloway mentioned, that the Auditor General is undertaking right now. Is that your understanding of that legislation, and if so, is that something that we should look into doing on an annual basis, not just this year?

MR. PRESTON: As I remember, there was in the legislation and my comment, I think, was, you know, we are subject to the Right-to-Know; we are subject to these audits every year. If the Auditor General wants to do that, that is up to him, and we will do it. So, you know, I guess it's a question of how far you want to take it.

REPRESENTATIVE SMITH: Sure, but I think Representative Shapiro's legislation would actually codify that requirement that the Auditor General perform that performance, do that performance audit, on an annual basis.

REPRESENTATIVE ADOLPH: Representative, an area that has not been talked about with all these audits that go on is the cost of the audit, okay?

I can tell you that the amount of time and money that PHEAA auditors and management team have put in as a result of the Auditor General's audit, as well as our own internal audit, has a factor, and obviously the performance audits are important, especially when the revenue is not what it used to be.

However, it does get to a point in management that the cost of auditing does not benefit our ultimate mission, and I think with the board establishing a policy of internal performance audits itself, the board members are probably the toughest critics right now and have been on PHEAA management over the last 12 months, okay, whether it is at our monthly board meetings or our Executive sessions.

I can assure you that the Governor's representatives, along with the new board members, are watching every dollar that is being spent over there. And we serve on that board on a volunteer basis, and we are looking over these audits very, very carefully.

So be careful with adding additional expense at a time when we cannot afford additional expense.

REPRESENTATIVE SMITH: Sure, but when you mention the cost of the audit, you are really talking about sort of the intangible institutional cost to PHEAA. PHEAA is not going to pay a fee for the Auditor General to conduct the audit. That's correct, isn't it?

REPRESENTATIVE ADOLPH: There is no fee involved, but the time away from their other job duties is a major cost factor.

REPRESENTATIVE SMITH: Sure.

And you mentioned the new board members. One other item in Representative Shapiro's legislation that I think is certainly worth examining is the limitation on the number of terms that board members can serve with PHEAA, and I don't think that that is something that is certainly existing in current law. That legislation, I think, would limit it to two terms, and I think, you know, Representative Adolph, you hit on a key point that by bringing in new board members, I think what we have seen over the last year is really institutional changes within PHEAA. So I think that may go to the point of the necessity to bring in new blood, so to speak.

REPRESENTATIVE ADOLPH: Yeah; I have talked to Representative Shapiro for that, and I'm all for those term limits. I'm all for those term limits over there. You won't have a problem with me with that, and that is something that we may address as soon as we come out of this tailspin.

REPRESENTATIVE SMITH: Thank you.

REPRESENTATIVE ADOLPH: You're welcome.

REPRESENTATIVE SMITH: And just one more question, Mr. Chairman.

We had heard a little bit earlier about the cost savings, I think on slide 15, $50.6 million in cost savings -- unfilled personnel, cutback on professional services, et cetera -- and I understand that that entire $50.6 million wasn't pushed back into grants and/or loans for students. There was a portion of that that was used to offset declining revenue. What are you able to tell us today, or will you be able to tell us in the future what portion of that $50.6 million was used to offset a corresponding loss in revenue?

MR. PRESTON: Well, in this fiscal year, I mean, we have a combined balance sheet, so I have to take a look at it in total. If we contribute $75 million to the State Grant Program and we have cut $50 million in this '07-08 budget, I think that, you know, you could say that money goes to this, but actually what happened is our revenues dropped during the year, and we are going to have to borrow from our line of credit in order to meet that $75 million.

So I guess '07-08, we are really pushing to make sure we meet our commitment, and we are using all those expenses, not because of anything other than, I really have to match revenues to expenditures.

REPRESENTATIVE SMITH: But at the end of the day, are we able to say, okay, we cut costs by $50 million; of that $50 million, we used $25, $30 million, whatever, on the revenue side to fill in the gap of lost revenue?

MR. PRESTON: Right. I mean, it's very hard to do that. I believe we had one instance a year or two ago when we ended up liquidating some derivatives, and rather than throw that back in the general pot, we just said we will increase the State Grant Program by that. But in general, it kind of is a combined balance sheet, and we don't allocate that in that way.

REPRESENTATIVE SMITH: Okay. And one final question.

On the out-of-State loans, just to clarify that issue, those are students from out of State who are applying for loans to attend school within Pennsylvania?

MR. PRESTON: No.

REPRESENTATIVE SMITH: Or is that any out-of-State loan?

MR. PRESTON: Out of State.

REPRESENTATIVE SMITH: Okay. Thank you, Mr. Chairman.

REPRESENTATIVE KELLER: Thank you.

Representative Fred McIlhattan.

REPRESENTATIVE McILHATTAN: Mr. Preston, I noticed the science and technology scholarship program, you have a backlog of a little over $11 million laying there. You didn't ask for any more money, but the Governor gave you a little over $4 million in his budget. What is going on in that area? Why aren't we able to get scholarships pushed out there? Are the restrictions too strict, or can you educate me a little bit on that?

MR. PRESTON: Kelly, can you?

MS. LOGAN: Sure.

The restrictions are quite strict with that particular program. Senator Tomlinson has introduced some legislation to assist with some of the challenges in that particular program. Part of the funding issue is going to be addressed, we believe, because there has been an expansion of the programs, the educational programs, that students can qualify for with that particular program.

REPRESENTATIVE McILHATTAN: So the main reason was that the restrictions -- and those are legislative restrictions -- have been too severe; you haven't been able to really flex that like you would like to. Is that correct?

MS. LOGAN: That's correct.

REPRESENTATIVE McILHATTAN: Okay. I noticed that in the nursing shortage initiative program, again, you didn't ask for anything and the Governor put some money in there. What is going on in that area that we need to know about or what isn't quite working? What is going on there?

MS. LOGAN: That program, we are working in conjunction with Labor and Industry who had that program, had a similar program last year, and we are working with them to determine how best to allocate that funding to the program that they need to continue again this year.

REPRESENTATIVE McILHATTAN: Well, I guess my question is, are they funded to do that, too, and are you funded to do that, too, and there are two different pots of money, or what is going on here? I'm sort of confused.

MS. LOGAN: I'm not aware whether they received funding in their particular---

REPRESENTATIVE McILHATTAN: You are just driving your money through them?

MS. LOGAN: Right; right.

REPRESENTATIVE McILHATTAN: Okay. All right. Thank you.

REPRESENTATIVE KELLER: Thank you.

Chairman Adolph, the committee would like to thank you. You have done a great job here. Those of us that serve with you in the House know that, unfortunately, you are the right guy for this job at this time, so term limits will only come after this is straightened out.

Mr. Preston, very impressive. Everybody agrees with you. We hope there is something we can do to help, but I guess it all depends on the markets. We appreciate you being here. Thank you very much.

MR. PRESTON: Thank you very much.

REPRESENTATIVE KELLER: We will adjourn this hearing. We will be back in session at 9 o'clock tomorrow morning.

Thank you.

(The hearing concluded at 5:15 p.m.)

I hereby certify that the proceedings and evidence are contained fully and accurately in the notes taken by me on the within proceedings and that this is a correct transcript of the same.

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Jean M. Davis, Reporter
Notary Public