Committee on Education and Labor

U.S. House of Representatives

"Ensuring the Availability of Federal Student Loans"

Testimony of

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March 14, 2008

Good Morning. I am Paul Wozniak, a Managing Director and Group Manager of UBS Securities LLC. The group is one of the largest of its kind on Wall Street, and we are mandated to coordinate all education loan related finance activities in the Fixed Income department, which includes asset-backed finance and municipal securities. I am currently in my 26th year of financing postsecondary education loans.

$54 billion of Stafford and PLUS FFELP loans were originated in the 2007-2008 academic year, primarily by banks, private and public non-bank corporations, state agencies and not-for- profit corporations. If patterns held as in years past, banks probably accounted for approximately 60% of loan originations – as they did in the prior year which is the last year for which data were available. However, when one observes holders of loans, banks' market share of outstanding loans falls to less than 24%. This is important when trying to understand how entities finance themselves.

Banks, as deposit taking institutions have a general cost advantage to entities that are required to access the capital markets through securitizations or other means. They must also allocate costs of capital and reserves, but on the margin, they should maintain a funding advantage over those raising money in the capital markets. Further, for those banks that originate and sell their loans to other holders in the secondary market, which appears to be the majority of banks, their funding needs are both modest in size and short-term in nature.

The remaining participants in the FFELP program, those who are holders of more than three-quarters of all FFELP loans outstanding, rely on the capital markets for their funding source. This generally takes several forms. Most of these entities will use some type of warehousing program or line of credit – a commercial paper conduit or bank loan

– with terms that are generally renegotiated every 364-days and permit the FFELP lender to accumulate a sufficient amount of loans to accomplish an efficient financing program that will meet rating agency and investor acceptance. These credit lines must generally be cleaned out into some other financing program at least once per year.

The most common form of refinancing or 'take-out' is a securitization. Primarily this has taken the form of the issuance of Floating Rate Notes or FRN's. A securitization is merely the creation of a trust which issues securities to investors. The trust uses the proceeds to acquire a pool of loans from the warehouse facility, and the warehouse line of credit is paid down. The securitization trust is structured to allow the investor to solely look to the underlying loan collateral for repayment of the investment. This is important because this insulates the investor from any negative credit event that may befall the sponsor of the trust. As a result, the trust receives a higher rating than it would if corporate issuer risk continued as a possibility, and therefore the FRN's bear a lower interest rate spread than it would if it were not so insulated. Alternatively, the trust is required to perform on its own with no additional support from the lender.

It should also be noted that banks also avail themselves of the Floating Rate Note securitization market. Indeed, while banks are holders of less than one-quarter of all outstanding FFELP loans, banks accounting for about 75% of these holdings use or are prepared to use FRN securitizations to finance their portfolios to some extent. Banks do this because it diversifies the funding sources of their assets. While it may be a more expensive cost of funds than deposits, the diversification of funds and the potential for off-balance sheet funding requires its consideration.

Another option that has been used extensively, and more so among state agencies and not-for-profit corporations, has been the auction rate securities market. The education loan backed auction market is now only about 1/3 of the size of the education loan FRN securitization market. In recent years, issuance of FRNs has greatly exceeded the issuance of taxable auction rate securities, especially to finance pre-10/1/2007 originated consolidation loans during the heavy origination era of those loans. Issuers had to weigh the advantages of a fixed spread FRN against the advantages of the auction structure. Auctions permitted a high degree of financing efficiency, in that they acted as a combination warehouse facility and term financing at a reasonable and variable rate cost of funds. Their ability to be redeemed or converted to other structures without significant cost was also a very positive feature. Given the relatively narrow spread on FFELP student loans, it is important to have a highly efficient, flexible financing vehicle.

For 15 years the auction product performed exceptionally well. It was able to withstand numerous market shocks such as the 1994 bond market which at the time was described as the worst since the great depression, the 1998 Russian debt crises, Y2K and an accounting reclassification event in 2004. These tests of the product seemed to show its resilience. Interest rate spreads would widen, and then return to previous levels. For, what I would estimate as 150,000 auctions of education loan backed collateral; the market had never experienced a failed auction (where auction sales exceeded purchases and holds). That ended recently. As a consequence, the ensuing days resulted in significant auction sales resulting in a complete and total failure of the auction market. This was compounded by the problems facing the monoline insurance companies, encouraging sales and reducing restructuring options.

As a result of the continuing liquidity crisis, the deleveraging of investor balance sheets and the failure of the education loan backed auction market, the cost of funds to holders of loans has risen significantly. Those with auction rate securities are incurring a penalty interest rate. Those with warehouse facilities, to the extent that renewals are available, are incurring a much higher rate as well as the requirement of posting significantly more equity than had previously been required. There are approximately $150 billion of education loans currently financed via these two methods. For those who would refinance these loans into a fixed spread FRN structure, they face (i) interest rate spreads that may be a full 1% (100 basis points) higher, (ii) the inability to currently finance certain loans with long average lives (consolidation loans) due to lack of investor demand, and (iii) the need to add significant and costly equity into a structure based on new rating agency assumptions borne of the current market environment. The burden on this marketplace is significant and real and is unlikely to correct itself to avoid having an impact on access to loans.